

COMPANHIA DE SANEAMENTO BASICO DO ESTADO DE SAO PAULO-SABESP
Form 20-F
April 30, 2012

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 20-F

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

OR

o ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2011

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

OR

o SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report _____

Commission file number 001 31317

Companhia de Saneamento Básico do Estado de São Paulo - SABESP
(Exact name of Registrant as specified in its charter)

Basic Sanitation Company of the State of São Paulo SABESP
(Translation of the Registrant's name into English)

Federative Republic of Brazil
(Jurisdiction of incorporation or organization)

**Rua Costa Carvalho, 300
05429 900 São Paulo, SP, Brazil**
(Address of principal executive offices)

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

Title of each class	Name of each exchange on which registered
Common Shares, without par value	New York Stock Exchange*
American Depositary Shares, evidenced by American Depositary Receipts, each representing 2 Common Shares ⁽¹⁾	New York Stock Exchange

* Not for trading purposes, but only in connection with the registration of American Depositary Shares pursuant to the requirements of the Securities and Exchange Commission.

(1) Until June 8, 2007, each American Depositary Share, evidenced by American Depositary Receipts, represented 250 Common Shares.

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

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

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

227,836,623 Shares of Common Stock

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

Yes No

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

Yes No

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

Yes No

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

Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

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

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

Item 17 Item 18

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

Yes No

Table of Contents

		Page
PART I		<u>8</u>
ITEM 1.	IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS	<u>8</u>
ITEM 2.	OFFER STATISTICS AND EXPECTED TIMETABLE	<u>8</u>
ITEM 3.	KEY INFORMATION	<u>8</u>
ITEM 4.	INFORMATION ON THE COMPANY	21
ITEM 4A.	UNRESOLVED STAFF COMMENTS	62
ITEM 5.	OPERATING AND FINANCIAL REVIEW AND PROSPECTS	62
ITEM 6.	DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES	86
ITEM 7.	MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS	93
ITEM 8.	FINANCIAL INFORMATION	100
ITEM 9.	THE OFFER AND LISTING	112
ITEM 10.	ADDITIONAL INFORMATION	116
ITEM 11.	QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK	127
ITEM 12.	DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES	127
PART II		129
ITEM 13.	DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES	129
ITEM 14.	MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS	129
ITEM 15.	CONTROLS AND PROCEDURES	129
ITEM 16.	[RESERVED]	130
PART III		133
ITEM 17.	FINANCIAL STATEMENTS	133
ITEM 18.	FINANCIAL STATEMENTS	133
ITEM 19.	EXHIBITS	133

PRESENTATION OF FINANCIAL AND OTHER INFORMATION

General

We maintain our books and records in *reais*. We prepared our consolidated financial statements as of and for the years ended December 31, 2009, 2010 and 2011 included in this annual report in compliance with International Financial Reporting Standards, or IFRS, as issued by the International Accounting Standards Board, or IASB.

Convenience Translations

We have translated some of the *real* amounts contained in this annual report into U.S. dollars. The rate used to translate such amounts in respect of the year ended December 31, 2011 was R\$1.876 to US\$1.00, which was the commercial rate for the purchase of U.S. dollars in effect on December 31, 2011, as reported by the Central Bank. The U.S. dollar equivalent information presented in this annual report is provided solely for the convenience of reader and should not be construed as implying that the *real* amounts represent, or could have been or could be converted into, U.S. dollars at the above rate. See “Item 3.A. Selected Financial Data—Exchange Rates” for more detailed information regarding the Brazilian foreign exchange system and historical data on the exchange rate of the *real* against the U.S. dollar.

Rounding

Some percentages and numbers included in this annual report have been subject to rounding adjustments. Accordingly, figures shown as totals in certain tables may not be an arithmetic aggregation of the figures that precede them.

Other Information

In this annual report, unless the context otherwise requires, references to “we,” “us,” “our,” “Company,” or “SABESP” refer to Companhia de Saneamento Básico do Estado de São Paulo - SABESP.

In addition, references to:

- § “*real*,” “*reais*” or “R\$” are to the Brazilian *real*, the official currency of Brazil;
- § “U.S. dollars” or “US\$” are to the United States dollar, the official currency of the United States;
- § “Brazil” are to the Federative Republic of Brazil;
- § “State” are to the State of São Paulo, which is also our controlling shareholder;
- § “federal government” and “Brazilian government” are to the federal government of the Federative Republic of Brazil and “state government” are to the state government of the State of São Paulo;
- § “São Paulo metropolitan region” are to the area where the Metropolitan executive office operates, comprising 38 municipalities, including the city of São Paulo;

§ “Regional systems” are to the area where the Regional systems executive office operates, comprising 325 municipalities in the interior and coastline regions of the State of São Paulo;

§ “water coverage ratio” are to the ratio between the number of residences connected to the water supply network, divided by the number of urban residences in a certain area; and

§ “sewage coverage ratio” are to the ratio between the number of residences connected to the sewage collection network, divided by the number of urban residences in a certain area.

Information in this annual report related to liters, water and sewage volumes, number of employees, kilometers, water and sewage connections, population served, operating productivity, water production rate, sewage lines (in kilometers), savings achieved and investment in improvement programs has not been audited.

Market Information

5

We make statements in this annual report about our market share and other information relating to Brazil and the industry in which we operate. We have made these statements on the basis of information from third-party sources and publicly available information that we believe is reliable, such as information and reports from the Brazilian Institute of Geography and Statistics (*Instituto Brasileiro de Geografia e Estatística*), or IBGE, and the State Data Analysis System Foundation (*Fundação Sistema Estadual de Análise de Dados*) or SEADE, among others. We have no reason to believe any of this information is inaccurate in any material respect.

References to urban and total population in this annual report are estimated based on a research made by the SEADE: “Projections for the State of São Paulo – Population and Residences until 2025” (*Projeções para o Estado de São Paulo – População e Domicílios até 2025*).

CAUTIONARY STATEMENTS ABOUT FORWARD LOOKING STATEMENTS

This annual report includes forward-looking statements, mainly in Items 3 through 5. We have based these forward looking statements largely on our current expectations and projections about future events and financial trends affecting our business. These forward-looking statements are subject to risks, uncertainties and assumptions, including, among other factors:

- § general economic, political, demographical and other conditions in Brazil and in other emerging market countries;
- § changes in applicable laws and regulations, as well as the enactment of new laws and regulations, including those relating to environmental, tax and employment matters in Brazil;
- § fluctuations in inflation, interest rates and exchange rates in Brazil;
- § the interests of our controlling shareholder;
- § our ability to collect amounts owed to us by our controlling shareholder and by municipalities;
- § our ability to continue to use certain reservoirs under current terms and conditions;
- § our capital expenditure program and other liquidity and capital resources requirements;
- § droughts, water shortages, intensive rains and other climate events;
- § power shortages or rationing in energy supply or significant changes in energy tariffs;
- § the effects of the agreement for provision of water and sewage services in the city of São Paulo, that we executed with the State and the city of São Paulo;
- § our lack of formal agreements with certain municipalities to which we render our water and sewage services, including the cities comprising metropolitan regions;
- § the municipalities' ability to terminate our existing concession agreements prior to their expiration date and our ability to renew such agreements;
- § our ability to provide water and sewage services in additional municipalities and to maintain our rights to provide the services currently contracted;
- § the size and growth of our customer base;
- § our ability to comply with certain levels of services and attendance in the provision of water and sewage services established in our agreements with the municipalities;
- § our level of indebtedness and limitations on our ability to incur additional indebtedness;

- § our ability to access financing with favorable terms in the future;
- § our costs relating to compliance with environmental laws and potential penalties for failure to comply with these laws;
- § our exposure to probable increases in the frequency of extreme weather conditions;
- § the outcome of our pending or future legal proceedings;
- § our management's expectations and estimates relating to our future financial performance;
- § the regulation issued by the São Paulo State Sanitation and Energy Regulatory Agency, or the ARSESP, regarding several aspects of our business, including limitations on our ability to set and adjust our tariffs; and
- § other risk factors as set forth under "Item 3.D. Risk Factors."

The words "believe," "may," "estimate," "continue," "anticipate," "plan," "intend," "expect" and similar words are intended to forward-looking statements. In light of these risks and uncertainties, the forward looking events and circumstances discussed in this annual report might not occur. Our actual results could differ substantially from those anticipated in our forward-looking statements. Forward looking statements speak only as of the date they were made and we do not undertake the obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, unless required by law. Any such forward looking statements are not an indication of future performance and involve risks.

PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

A. Selected Financial Data

The tables below contain a summary of our financial data as of and for each of the periods indicated. The summary of our financial data was derived from our consolidated annual financial statements, prepared in compliance with IFRS, as issued by the IASB. You should read this selected financial data in conjunction with our consolidated financial statements and the related notes thereto included in this annual report.

The selected consolidated financial information as of and for the years ended December 31, 2009, 2010 and 2011 prepared in compliance with IFRS, has been derived from our audited consolidated financial statements, which appear elsewhere in this annual report.

The following tables present our selected financial data as of and for each of the periods indicated.

IFRS Summary Financial Data

	Year ended December 31,		
	2009	2010	2011
	<i>(in millions of reais, except per share and per ADS(1) data)</i>		
Statement of operations data:			
Net revenue from sales and services	8,579.5	9,231.0	9,941.6
Cost of sales and services	(5,087.3)	(5,194.5)	(6,031.1)
Gross profit	3,492.2	4,036.5	3,910.5
Selling expenses	(610.4)	(712.9)	(619.5)
Administrative expenses	(717.1)	(653.2)	(846.6)
Operating profit	2,120.3	2,672.2	2,354.3
Financial income (expenses), net	(10.0)	(379.4)	(633.6)
Net income	1,507.7	1,630.5	1,223.4
Earnings per share – basic and diluted	6.62	7.16	5.37
Earnings per ADS – basic and diluted	13.24	14.32	10.74

Dividends and interest on shareholders' equity per share	1.73	2.00	1.27
Weighted average number of common shares outstanding	227,836,623	227,836,623	227,836,623

(1) American Depositary Shares, or ADS.

	2009	As of December 31, 2010	2011
	<i>(in millions of reais)</i>		
Balance sheet data:			
Property, plant and equipment, net (*)	190.4	249.6	356.5
Intangible assets, net (*)	16,917.5	18,546.8	20,141.7
Total assets	20,243.1	23,350.6	25,215.0
Short-term loans and financing	1,009.9	1,242.1	1,630.0
Long-term loans and financing	5,548.0	7,022.5	6,966.3
Interest on shareholders' equity payable	365.4	354.3	247.5
Total liabilities	11,804.5	13,668.8	14,669.1
Shareholders' equity	8,438.6	9,681.8	10,545.9
Capital stock	6,203.7	6,203.7	6,203.7
Other financial information:			
Cash provided by operating activities	2,072.5	2,083.0	2,717.1
Cash used in investing activities	(1,964.0)	(2,091.4)	(2,008.3)
Cash provided by (used in) financing activities	36.9	1,226.5	(548.0)
Capital expenditures	(1,982.4)	(1,901.5)	2,211.1

(*) Reclassification between property, plan and equipment and intangible assets, in the amounts of R\$139.8 million in 2009.

Operating Data

	As of and for the year ended December 31,				
	2007	2008	2009	2010	2011
Number of water connections (in thousands)	6,767	6,945	7,118	7,295	7,481
Number of sewage connections (in thousands)	5,167	5,336	5,520	5,718	5,921
Percentage of population with water connections (in percentages)	99	99	99	99	99
Percentage of population with sewer connections (in percentages)	79	79	80	81	82
Volume of water billed during period (in millions of cubic meters)	1,847	1,878	1,917	1,992	2,045
Water loss percentage during period (average)(in percentages)(1)	29.5	27.9	26.0	26.0	25.6
Water loss per connection (average)(2)	467	436	402	403	395
Number of employees	16,850	16,649	15,103	15,330	14,896

(1) Includes both physical and non physical losses. Water loss percentage represents the quotient of (i) the difference between (a) the total amount of water produced by us less (b) the total amount of water invoiced by us to customers minus (c) the volume of water set out below that we exclude from our calculation of water losses, divided by (ii) the total amount of water produced. We exclude from our calculation of water losses the following: (i) water discharged for periodic maintenance of water mains and water storage tanks; (ii) water supplied for municipal uses such as firefighting; (iii) water we consume in our facilities; and (iv) estimated water losses associated with water we supply to *favelas* (shantytowns).

(2) Measured in liters/connection per day, according to the method of measuring our water losses, based on worldwide market practice for the sector. See “Item 4.B. Business Overview—Description of Our Activities—Water Operations—Water Losses.”

Exchange Rates

In the past, the Brazilian National Monetary Council (*Conselho Monetário Nacional*), or the CMN, has introduced changes to the Brazilian foreign exchange regime, such as unifying the Commercial and Floating Markets and easing the rules governing Brazilian residents’ ability to acquire foreign currency, among others. On March 24, 2010, the CMN and the Central Bank approved Resolution No. 3,844, under which a series of measures were adopted to consolidate and simplify acts and proceedings applicable to foreign exchange market regulations in Brazil.

The Brazilian foreign exchange system allows for the purchase and sale of foreign currency and the international transfer of *reais* by any person or legal entity, regardless of the amount, subject to certain regulatory procedures.

The Brazilian currency has, during the last few decades, experienced frequent and substantial variations in relation to the U.S. dollar and other foreign currencies. Between 2003 and mid-2008, the *real* appreciated significantly against the U.S. dollar with the exchange rate reaching R\$1.634 in August 2008. Primarily, as a result of the global financial crisis, the *real* depreciated 32.0% against the U.S. dollar during 2008 and closed the year at R\$2.337 per US\$1.00, but strengthened during 2009 and 2010. In 2011, the *real* suffered a depreciation of 12.6% against the U.S. dollar. On December 31, 2009, 2010 and 2011, the *real*/U.S. dollar exchange rate was R\$1.741, R\$1.666 and R\$1.876 per US\$1.00, respectively.

The Central Bank has intervened occasionally to combat instability in foreign exchange rates. We cannot predict whether the Central Bank or the Brazilian government will continue to let the *real* float freely or will intervene in the exchange rate through a currency band system or otherwise. The *real* may fluctuate against the U.S. dollar substantially in the future. For further information on these risks, see “Item 3.D. Risk Factors—Risks Relating to Brazil—Exchange rate instability may adversely affect us and the market price of our common shares or ADSs.”

The following tables set forth the selling rate, expressed in *reais* per U.S. dollar (R\$/US\$), for the periods indicated.

Year ended December 31,	Year end	R\$ per US\$1.00		
		Average ⁽¹⁾	High	Low
2007	1.771	1.948	2.156	1.733
2008	2.337	1.837	2.500	1.559
2009	1.741	1.994	2.422	1.702
2010	1.666	1.759	1.881	1.655
2011	1.876	1.675	1.902	1.535

Month ended	Period end	R\$ per US\$1.00		
		Average ⁽¹⁾	High	Low
December 31, 2011	1.876	1.837	1.876	1.783
January 31, 2012	1.739	1.790	1.868	1.739
February 29, 2012	1.709	1.718	1.738	1.702
March 31, 2012	1.822	1.795	1.833	1.715
April 27, 2012 (through April 23, 2012)	1.886	1.845	1.889	1.826

Source: Central Bank

(1) Average of the exchange rates on the last day of each period.

On April 23, 2012, the exchange rate published by the Central Bank was R\$1.886 per US\$1.00. Exchange rate fluctuations will affect the U.S. dollar equivalent of the *real* price of our common shares on the São Paulo Stock Exchange (BM&FBOVESPA S.A. - *Bolsa de Valores, Mercadorias e Futuros*), or the BM&FBOVESPA, as well as the U.S. dollar equivalent of any distributions we make in *reais* with respect to our common shares.

B. Capitalization and Indebtedness

Not applicable.

C. Reasons for the Offer and Use of Proceeds

Not applicable.

D. Risk Factors

Risks Relating to Brazil

The Brazilian government has exercised, and continues to exercise, significant influence over the Brazilian economy. This influence, as well as Brazilian political and economic conditions, could adversely affect us and the market price of our common shares and ADSs.

The Brazilian government frequently intervenes in the Brazilian economy and occasionally makes significant changes in policy and regulations. The Brazilian government's actions to control inflation and other policies and regulations have often involved, among other measures, increases in interest rates, changes in tax policies, price and tariff controls, currency devaluations, capital controls and limits on imports. Our business, financial condition and results of operations, as well as the market price of our common shares or ADSs, may be adversely affected by changes in public policy at federal, state and municipal levels with respect to public tariffs and exchange controls, as well as other factors, such as:

§ the regulatory environment related to our business operations and concession agreements;

- § interest rates;
- § exchange rates and exchange controls and restrictions on remittances abroad;
- § currency fluctuations;
- § inflation;
- § liquidity of the Brazilian capital and lending markets;
- § tax and regulatory policies and laws;
- § economic and social instability; and
- § other political, diplomatic, social and economic developments in or affecting Brazil.

Uncertainty over whether the Brazilian government will implement changes in policies or regulations affecting these or other factors may contribute to economic uncertainty in Brazil and to heightened volatility in the Brazilian securities markets and in the securities issued abroad by Brazilian issuers, which could have a material adverse effect on us and on our common shares and ADSs.

Inflation and the Brazilian government's measures to combat inflation may contribute to economic uncertainty in Brazil, adversely affecting us and the market price of our common shares or ADSs.

Brazil has, in the past, experienced extremely high rates of inflation. Inflation and the Brazilian government's measures to combat inflation have had significant negative effects on the Brazilian economy, contributing to economic uncertainty and heightened volatility in the Brazilian securities markets. The Brazilian government's measures to control inflation have often included maintaining a tight monetary policy with high interest rates, thereby restricting the availability of credit and reducing economic growth. The Special Clearing and Settlement System (*Sistema Especial de Liquidação e Custódia*), or SELIC, the official overnight interest rate in Brazil, at the end of 2009, 2010 and 2011 was 8.65%, 10.66% and 10.91% respectively, in line with the target rate set by the Brazilian Committee on Monetary Policy (*Comitê de Política Monetária*), or COPOM.

The annual rate of inflation, as measured by the General Market Price Index (*Índice Geral de Preços—Mercado*), or IGP-M index, fell from 9.95% in 2000 to 3.83% in 2006, increased to 7.75% in 2007 and further increased to 9.81% in 2008. According to the IGP-M index, in 2009, there was a deflation of 1.71% and the rate of inflation for 2010 and 2011 were 11.32% and 5.1% respectively. Brazilian governmental actions, including interest rate decreases, intervention in the foreign exchange market and actions to adjust or fix the value of the *real*, may trigger increases in inflation. If Brazil again experiences high inflation, our costs and expenses may rise, we may be unable to increase our tariffs to counter the effects of inflation, and our overall financial performance may be adversely affected. In addition, a substantial increase in inflation may weaken investors' confidence in Brazil, causing a decline in the market price of our common shares or ADSs.

Additionally, in the event of an increase in inflation, the Brazilian government may choose to raise official interest rates. Increases in interest rates would not only affect our cost of funding, but could also have a material adverse effect on us and may also adversely affect the market price of our common shares or ADSs.

Exchange rate instability may adversely affect us and the market price of our common shares or ADSs.

The Brazilian currency experienced frequent and substantial devaluations in relation to the U.S. dollar and other foreign currencies during the last decades. Throughout this period, the Brazilian government has implemented various economic plans and utilized a number of exchange rate policies, including sudden devaluations, periodic mini devaluations during which the frequency of adjustments ranged from daily to monthly, floating exchange rate systems, exchange controls and dual exchange rate markets. From time to time, there have been significant fluctuations in the exchange rate between the Brazilian *real* and the U.S. dollar and other currencies. For example, the *real* appreciated 13.8%, 9.5% and 20.7% against the U.S. dollar in 2005, 2006 and 2007, respectively. In 2008, as a result of the worsening of the international economic crisis, the *real* depreciated by 32.0% against the U.S. dollar. In 2009 and 2010, the *real* appreciated 25.5% and 4.3% against the U.S. dollar, closing at R\$1.741 and R\$1.666 per US\$1.00, respectively. In 2011, the *real* suffered a depreciation of 12.6% against the U.S. dollar, closing at R\$1.876 per US\$1.00. There can be no assurance that the *real* will not further depreciate against the U.S. dollar. As of April 23, 2012, the commercial selling rate as reported by the Central Bank was R\$ 1.886 per US\$1.00.

Depreciation of the *real* against the U.S. dollar could create inflationary pressures in Brazil and cause increases in interest rates, which could negatively affect the growth of the Brazilian economy as a whole and harm our financial condition and results of operations, curtail access to financial markets and prompt government intervention, including recessionary governmental policies. Depreciation of the *real* against the U.S. dollar can also, as in the context of the current global economic recovery, lead to decreased consumer spending, deflationary pressures and reduced growth of the economy as whole.

In the event of a significant devaluation of the *real* in relation to the U.S. dollar or other currencies, our ability to meet our foreign currency denominated obligations could be adversely affected, particularly because our tariff revenue and other sources of income are denominated solely in *reais*. In addition, because we have foreign currency denominated indebtedness, any significant devaluation of the *real* will increase our financial expenses as a result of foreign exchange losses that we must record. We had total foreign currency denominated indebtedness of R\$3,053.4 million as of December 31, 2011, and we anticipate that we may incur substantial amounts of foreign currency denominated indebtedness in the future. In 2011, our results of operations were negatively affected by the 12.6% depreciation of the *real* against the U.S. dollar, which amounted to R\$382.3 million. We do not currently have any hedging instruments in place to protect us against a devaluation of the *real* in relation to any foreign currency. A devaluation of the *real* may adversely affect us and the market price of our common shares or ADSs.

Developments and the perception of risk in other countries, especially in the United States and in emerging market countries, may adversely affect the market price of Brazilian securities, including our common shares and ADSs.

The market price of securities of Brazilian companies is affected to varying degrees by economic and market conditions in other countries, including the United States and other Latin American and emerging market countries. Although economic conditions in these countries may differ significantly from economic conditions in Brazil, investors' reactions to developments in these other countries may have an adverse effect on the market price of securities of Brazilian issuers. Crisis in other emerging market countries or economic policies of other countries may diminish investor interest in securities of Brazilian issuers, including ours. This could adversely affect the market price of our common shares or ADSs, and could also make it more difficult for us to access the capital markets and finance our operations in the future, on acceptable terms or at all.

The global financial crisis has had significant consequences, including in Brazil, such as stock and credit market volatility, unavailability of credit, higher interest rates, a general slowdown of the world economy, volatile exchange rates, and inflationary pressure, among others, which have and may continue to, directly or indirectly, materially and adversely affect us and the price of securities issued by Brazilian companies, including our common shares and ADSs.

Risks Relating to Our Control by the State of São Paulo

We are controlled by the State of São Paulo, whose interests may differ from our or from minority shareholders' interests, which could have a material adverse effect on us.

The State of São Paulo, through its ownership of our common shares, has the ability to determine our operating policies and strategy, to control the election of a majority of the members of our board of directors and to appoint our senior management. As of April 23, 2012, the State owned 50.3% of our outstanding common shares.

The State has directed from time to time in the past, and may direct in the future, through its control of our board of directors and through the enactment of State decrees, that we engage in certain business activities and make certain expenditures that promote political, economic or social goals but that do not necessarily also enhance our business and results of operations. See "Item 5.A. Operating and Financial Review and Prospects—Factors Affecting Our Results of Operations."

Following the 2010 elections for State governor, in 2011 the new governor elected Ms. Dilma Seli Pena as our chief executive officer and Mr. Edson de Oliveira Giriboni, the Secretary of State for the State Secretariat for Sanitation and Water Resources (*Secretaria de Saneamento e Recursos Hídricos do Estado de São Paulo*), was elected as chairman of our board of directors.

We have a substantial amount of accounts receivable owed to us by the State and some State entities, and we cannot assure you as to when or whether the State will pay us.

Historically, the State and some State entities have had substantial overdue accounts payable to us relating to (i) the provision of water and sewage services and (ii) State mandated special retirement and pension payments that we make to some of our former employees for which the State is required to reimburse us. As of December 31, 2011, the amounts owed to us by the State for the provision of water and sewage services totaled R\$145.4 million. With respect to payment of pensions on behalf of the State, as of December 31, 2011, we believe that the State owed to us R\$1,290.7 million, but due to the uncertainty regarding the recovery of the amount our management decided not to record the reimbursements that we believe are due to us. In addition, as of December 31, 2011, we had recorded a

provision for actuarial liability in the amount of R\$1,512.1 million in respect of future supplemental pension payments the State does not believe it is responsible for paying. Amounts owed to us by the State for water and sewage services and reimbursements for pensions paid may increase in the future.

We have entered into agreements with the State to settle these overdue amounts payable to us. For a detailed discussion of these agreements, see “Item 7.B. Related Party Transactions,” and Note 8 to our consolidated financial statements. Pursuant to these agreements, the amounts due with respect to water and sewage services through December 2007 could be settled through the application of dividends payable by us to the State. In December 2007, the State agreed to pay us the outstanding balance in the amount of R\$133.7 million (as of November 30, 2007), in 60 consecutive monthly installments, beginning on January 2, 2008, and an amount of R\$236.1 million relating to part of the accounts overdue and unpaid from March 2004 through October 2007 regarding the provision of water supply and sewage collection services. We agreed to pay the State the outstanding balance of dividends, in the form of interest on shareholders’ equity, due from March 2004 through December 2006, in the amount of R\$400.8 million, in the period from January through March 2008.

In March 2008, we entered into a commitment agreement with the State for the settlement of outstanding debts related to the reimbursement of pension benefits. Pursuant to the commitment agreement, the amounts due to us with respect to payments of pensions on behalf of the State may be partially settled through the transfer to us of certain reservoirs in the Alto Tietê System that we use and are owned by the State. In November 2008, we entered into an agreement with the State relating to payments of pension benefits made by us on its behalf. The State acknowledged that it owed us the outstanding balance of R\$915.3 million as of September 30, 2008 relating to payments of pension benefits made by us on its behalf. We provisionally accepted the reservoirs in the Alto Tietê System as partial payment (R\$696.3 million) subject to the transfer of the property rights of these reservoirs to us. In November 2008, the State began paying the remaining balance in the amount of R\$219.0 million in 114 successive monthly installments. We are unable to predict whether and when these reservoirs will be transferred to us because the Public Prosecution Office of the State of São Paulo (*Ministério Público do Estado de São Paulo*) filed a civil public action alleging that a transfer to us of ownership of the Alto Tietê System reservoirs is illegal. The Company and the São Paulo State Government are working together to obtain legislative authorization to transfer the reservoirs to us, overcoming the uncertainties arising from the public lawsuit challenging the absence of a specific legislative authorization for the transfer of the property of the reservoirs.

See “Item 8.A. Financial Information—Consolidated Statements and Other Financial Information—Legal Proceedings—Other Legal Proceedings.” In addition to the R\$915.3 million that the State acknowledges it owes us pursuant to the November 2008 agreement, we are negotiating with the State further amounts that the State does not recognize it owes us. While we continue to negotiate directly with the State, we are not able to assure you that we will be successful in these negotiations. Accordingly, as of December 31, 2011, we have not recorded R\$1,290.7 million related to reimbursements that we believe are due to us for pension benefits paid on behalf of the State, but we have recorded R\$1,512.1 million in pension obligations.

We cannot assure you when or if the State will pay the total overdue amounts owed to us. Due to the State’s history of not making timely payments to us in respect of services and of not reimbursing us in a timely manner for the payments of pensions on behalf of the State, we cannot assure you that the amount of accounts receivable owed to us by the State and some State entities will not significantly increase in the future.

We may be required to acquire reservoirs that we use and that are owned by a State-controlled company, or we may be required to pay substantial charges to the owner with respect to our use of these reservoirs.

In connection with the provision of water services, we use the Billings and Guarapiranga reservoirs which are owned by a State controlled company, the Water and Energy Metropolitan Company (*Empresa Metropolitana de Águas e Energia S.A.*), or the EMAE. We are entitled to use these reservoirs based on a grant issued by the State Department of Water and Energy (*Departamento de Águas e Energia Elétrica do Estado de São Paulo*), or DAEE. The State, through its control of our board of directors, could require us to acquire the Billings and Guarapiranga reservoirs. As a result of these acquisitions, our cash position and overall financial condition could be adversely affected. In addition, since we are not currently charged for the use of these reservoirs, we are uncertain as to whether we will continue to be able to use the reservoirs without paying charges, or what the likely fee scale would be, if imposed. We may also be required to pay additional maintenance and operational costs for our use of the Billings and Guarapiranga reservoirs. If we were required to pay substantial charges to the owner or additional maintenance or operational costs for our use of these reservoirs, we could be materially and adversely affected.

Risks Relating to Our Business

We cannot anticipate the effects that further developments of the Basic Sanitation Law and its interpretation will have on the basic sanitation industry in Brazil and on us.

Law No. 11,445, or the Basic Sanitation Law, was enacted on January 5, 2007. While it has been in effect for more than five years, it is still in its early stages of implementation in Brazil, and we continue to be unable to anticipate all of the effects that it might have on our operations and business. There are still several uncertainties related to the interpretation of the Basic Sanitation Law. On June 21, 2010, the federal government enacted Federal Decree No. 7,217 regulating the Basic Sanitation Law. Among other things, Law No. 11,445 and Federal Decree No. 7,217 provided that (i) public hearings regarding the bid announcements and technical and economic viability studies are requirements for the validity of public-public partnership contracts (program contracts) ; (ii) the rights and obligations, including penalties, of customers and service providers shall be ruled by the owner of the public service, not by the regulatory agency; (iii) financial feasibility may be demonstrated by means of the requirement for new investments, other than the proceeds arising from the rendering of services; and (iv) when a service is divided and rendered by different service providers, the services will be considered as interdependent and will be subject to an agreement that will regulate the activities of the different services providers. We cannot currently anticipate all the effects that the law and the decree will have on our business and operations, if any.

Pursuant to the Basic Sanitation Law, tariff regulation is to be performed by an independent regulatory entity. To exercise this assignment, the State of São Paulo created the São Paulo State Sanitation and Energy Regulatory Agency, or the ARSESP. The ARSESP is the State agency responsible for regulating the basic sanitation industry, including tariff regulation in certain municipalities. The ARSESP acts as tariff regulator both in municipalities where the State provides basic sanitation services (municipalities in metropolitan areas), and in those municipalities that have delegated their regulatory powers to the State through cooperation agreements. The ARSESP presently regulates our tariff structure and adjustments pursuant to the same tariff structure and adjustment formula that we otherwise apply. Pursuant to a cooperation agreement among the State and some municipalities, the ARSESP also regulates our tariffs in municipalities that have selected the ARSESP to regulate our tariffs.

Since 2008, the ARSESP has been developing new concepts in the tariff structure and adjustment formula. In July 30, 2010, the ARSESP published Resolution No. 156 establishing the methodology and general criteria for the definition of our regulatory asset base, in order to move forward with the tariff review process and to define the initial parameters of the auditing process that the ARSESP will have to conduct pursuant to the terms of the Basic Sanitation Law. Throughout 2011 and 2012, the ARSESP commenced public consultations regarding the methodology for tariff revisions. The ARSESP estimates that a final public hearing at which our preliminary average tariff, efficiency gains factor and tariff structure will be subjected to public scrutiny will be scheduled by November 2012. However, although the ARSESP has indicated that it will implement the new tariff methodology in 2012, we cannot assure you when the new rules will be enacted, and the aforementioned schedule may suffer alterations or be subject to delays. We cannot anticipate the additional changes that the ARSESP will implement on our tariff structure and adjustment formula or the effects that these changes will have on us. If the changes are unfavorable to us, they could materially and adversely affect us.

Furthermore, since Law No. 11,445 permits municipalities to create their own regulatory agencies rather than being subjected to overview by the ARSESP, a number of municipalities created their own regulatory agencies. The municipality of Lins, which had decided in 2007 to create its own regulatory authority, revised this decision in 2010 and transferred the regulation of the water activities performed in Lins, including the setting of tariffs to the ARSESP. Lins has retained, however, the power to ultimately approve the tariff set by the ARSESP. The municipalities in which the hydrographic basins of the rivers Piracicaba, Capivari and Jundiaí are located have created a consortium for regulation and supervision of our activities in that area. As this regulatory entity has recently been created, we cannot predict how it may implement regulation changes that may affect our activities. If other municipalities create new agencies or retain regulatory powers, we will be subject to their regulation, supervision and limitations to our services. We cannot foresee any changes that any such new agency may implement regarding our business, and if the changes are unfavorable, they could materially and adversely affect us.

Pursuant to the Basic Sanitation Law, the ARSESP has enacted, in 2009, certain rules establishing (i) the general conditions for the services we render, (ii) the communication process for any failure in our services; (iii) penalties for deficiencies in the provision of basic sanitation services; and (iv) procedures for confidential treatment of our clients' private information. We are currently evaluating the enforceability and legality of some of these rules. Implementation of these rules started during 2011 and is expected to continue for the next few years. The implementation of these rules will impact our commercial and operations processes and may adversely affect us as described below and in other ways we cannot currently predict.

In particular, regarding changes to the general conditions for our services, in 2011 the ARSESP altered the standard contract that we are required to use in our relationships with retail costumers. The ARSESP changed the rule regarding the collection of water and sewage tariff, requiring that collection be directed to the consumer of our services, rather than to the owner of the served property, as used to be the case. We estimate that this change will affect ongoing legal disputes, particularly those regarding collection procedures, as well as business discussions in

general. However, we are not currently able to predict the impact of this change on our business, as the change is still being implemented.

14

For more information, see “Information on the Company—Business Overview—Tariffs,” “Information on the Company—Business Overview—Government Regulation—Tariff Regulation in the State of São Paulo” and “Information on the Company—Business Overview—Government Regulation—Consumer Relations in the State of São Paulo.”

The terms of our new agreement to provide water and sewage services in the city of São Paulo could have a material adverse effect on us.

Our provision of water and sewage services in the city of São Paulo accounted for 55.1% of our gross revenues from sales and services (excluding revenues relating to the construction of concession infrastructure) in the year ended December 31, 2011.

On June 23, 2010 the State and the city of São Paulo entered into a convention (*convênio*) with the intermediation and our consent and the consent of the ARSESP pursuant to which they agreed to jointly manage the planning of and investment in the basic sanitation system of the city of São Paulo, among other things. This agreement established that the State and the city of São Paulo would enter into an agreement with us, granting us exclusive rights with respect to the provision of water and sewage services in the city of São Paulo. In addition, the agreement established the role of the ARSESP in regulating and overseeing our activities (including the tariffs we collect) and established a management committee (*Comitê Gestor*) that will be responsible for planning the water and sewage services and for reviewing our investment plans. The management committee will be composed of six members appointed for two year terms. The State and the city of São Paulo will have the right to appoint three members each. We are permitted to participate in the meetings of the management committee; however, we are not afforded any voting rights

Also, on June 23, 2010, we entered into a formal agreement with the State and the city of São Paulo to regulate the provision of these services. This agreement requires, among other things, (i) that the estimated investments mentioned in the agreement comply with 13% of the gross revenue from the municipality of São Paulo, net of the taxes on revenues. The investment plan, upon its execution by us, must be compatible with the activities and programs included in the sanitation plan of the State, Municipality, and if necessary, of the Metropolitan region. The invest plan is not irrevocable and will be reviewed by our management committee every four years, especially the investments to be executed in the subsequent period; and (ii) that we contribute 7.5% of the gross revenues from sales and services we obtain from this agreement, net of COFINS and PASEP taxes, to the Municipal Fund for Environmental Sanitation and Infrastructure (*Fundo Municipal de Saneamento Ambiental e Infraestrutura*), or the São Paulo Municipal Sanitation Fund, established by Municipal Law No. 14,934/2009. In addition, the agreement provides that the ARSESP will ensure that the tariffs charged (a) will adequately compensate us for the services we provide and (b) can be adjusted to restore the original balance between each party’s obligation and economic gain (*equilíbrio econômico-financeiro*). We currently have an investment plan in place that reflects these obligations and addresses their compatibility with the activities and programs included in the sanitation plan of the State and of the municipality of São Paulo and, if necessary, the plan of the metropolitan region of São Paulo. This investment plan will be reviewed by a management committee every four years so as to ensure compliance with government policies and contractual terms.

Because we were not previously required to make the mandatory allocations described in items (i) and (ii) above, they were not taken into account in calculating our existing tariff and its adjustment formula. Despite the contractual provisions and the ARSESP’s role in setting and adjusting adequate tariffs, which are necessary for our economic and financial balance, we cannot guarantee that the tariffs we will be allowed to charge for the provision of water and sewage services in the city of São Paulo will continue to adequately compensate us.

A decision of the Brazilian Supreme Court regarding whether State or municipal governments have the right to execute concession and program agreements in metropolitan regions could have a material adverse effect on us.

Our provision of water and sewage services in the metropolitan regions in which we operate is governed by agreements with the relevant State authorities (other than in the city of São Paulo, where we now have an agreement with the municipal authorities as well as the State). In a lawsuit initiated by third parties that is currently before the Brazilian Supreme Court, the Court is considering whether the State or the municipal governments have the proper authority to plan and regulate basic sanitation services rendered in metropolitan regions, as well as the right to execute concession and program agreements. If the Brazilian Supreme Court grants this authority to municipal governments, under certain circumstances, we may be required to cease our operations in certain metropolitan regions where we have agreements with the State only, to the extent that those municipalities opt to use another water and sewage service provider. To mitigate this risk, we have commenced a process of executing agreements with both the State and the municipal governments of certain metropolitan regions, and we already have such agreements regarding the city of São Paulo. We cannot anticipate the effects of the Brazilian Supreme Court decision on the provision of our services in other metropolitan regions, which could have a material adverse effect on us.

We have not entered into formal agreements for the provision of water and sewage services with certain of the municipalities we serve, including municipalities in metropolitan regions, as required by the Basic Sanitation Law, and therefore we may not be able to enforce our rights to continue to provide services in these municipalities.

Under the Basic Sanitation Law, we were required to have entered into formal agreements before December 31, 2010 with every municipality with which we did not have a formal agreement in place or with which our agreements had already expired, as is the case of certain municipalities located in the metropolitan regions where we are authorized to operate in accordance with local legislation. If such contractual arrangements were not entered into by December 31, 2010, the informal or expired services concessions would no longer be valid.

As of the date of this annual report, of the 363 municipalities we provide water and sewage services to, we have informal or expired arrangements with 99 municipalities. These 99 concessions include municipalities located in and outside metropolitan regions, including the municipality of Santos, located in the coastal region. Together, these 99 municipalities accounted for 23.8% of our total revenues for the year ended December 31, 2011, and 29.7% of our intangible assets as of that same date.

We are currently negotiating with these municipalities the renewal or the formalization of the concessions through the execution of program agreements. In order to renegotiate or formalize the agreements, we face the following problems: (i) we are still awaiting the final decision of the Brazilian Supreme Court regarding whether the State or the municipalities have the right to enter into contractual arrangements for the provision of the basic sanitation services in the metropolitan regions (until the execution of the agreement with the city and State of São Paulo in June 2010 there was no precedent for a joint management contractual arrangement between the State, the municipalities and us); (ii) the execution of new agreements will depend on certain acts that are beyond our control, such as the compliance by the municipalities located outside the metropolitan regions with certain legal procedures.

The Basic Sanitation Law did not define any penalty for the non-compliance with the December 31, 2010 deadline by the municipalities or for the water and sewage service companies in case the deadline is not observed. Consequently, we cannot anticipate if we are going to be subject to any penalty due to the lack of a formal agreement with some municipalities or if any eventual penalty will have a material adverse effect on us.

We cannot assure you when or whether there will be changes to the conditions under which we currently provide water and sewage services to the municipalities with which we do not have formal concession agreements or are renegotiating expired agreements, or whether we will be able to continue to provide water and sewage services in any municipalities where we are unable to renew or enter into a formal concession agreement. Because we do not hold concessions or contractual rights to provide services in 99 municipalities, we may not be able to effectively enforce our right to continue to provide services therein or may face difficulties in being timely paid for the services that we provide.

In addition, in the future, our rights in respect of these municipalities could be modified or adversely affected by Brazilian federal, state or municipal governmental actions, judicial decisions or other factors. For further information, see “Item 4.B. Business Overview—Government Regulation—The Basic Sanitation Law” and “Item 4.B. Business Overview—Government Regulation—Concessions—Public Consortia and Cooperation Agreement Law for Joint Management.”

We are exposed to risks associated with the provision of water and sewage services.

Our industry is specifically affected by the following risks associated with the provision of water and sewage services:

- § we are subject to substantial charges imposed by state and federal government agencies that manage water resources related to the abstraction of water from, or dumping of sewage into, water bodies, which we may not be able to pass on to our customers. See “Item 4.B. Business Overview—Government Regulation—Water Usage;”
- § in some cases, we are required to continue providing services to certain municipalities to which we provide water on a wholesale basis that have overdue amounts owed to us and are not paying us on a regular basis and we cannot assure you of when or whether these municipalities will pay us in a timely manner. See “Item 4.B. Business Overview-Billing Procedures;”

- § the degradation of watershed areas may affect the quantity and quality of water available to meet our customers' demand. See "Item 4.A History and Development of the Company—Capital Expenditure Program;"
- § our tariffs may not increase in line with increases in inflation and operating expenses, including taxes, or increase in a timely manner, which may hinder us from passing on to our customers increases in our cost structure. See "—The terms of our new agreement to provide water and sewage services in the city of São Paulo could have a material adverse effect on us". These constraints may also have an adverse effect on our ability to fund our capital expenditure program and financing activities, and to meet our debt service requirements. See "Item 5.A. Operating and Financial Review and Prospects—Factors Affecting Our Results of Operations—Effects of Tariff Increases;"
- § we are exposed to probable increases in the frequency of extreme weather conditions in the future, which may adversely affect both the quality and quantity of waters available for abstraction, treatment, and supply. Given that our financial performance is closely linked to climate patterns, droughts could adversely affect the water supply systems, resulting in a decrease in the volume of water distributed and billed as well as in the revenue derived from water supply distribution services. An increase in heavy rainfalls could impact water quality and regular operations of water sources, including abstraction of waters from our dams, due to increased soil erosion, silting, pollution and eutrophication of aquatic ecosystems. See "Item 5.A. Operating and Financial Review and Prospects—Factors Affecting Our Results of Operations—Effects of Climate Change (Drought and Intense Rainfalls);" and
- § we are dependent upon energy to conduct our operations and eventual shortages or rationing of energy may prevent us from providing water and sewage services and may also cause material damage to our water and sewage systems when we resume operations. Also, we may not be able to pass on to our customers significant increases in energy tariffs. See "Item 4.A. History and Development of the Company-Energy Consumption."

The occurrence of any of the above may have a material adverse effect on us.

We may face difficulties in continuing to provide water and sewage services in the municipalities we serve and we cannot assure you that these municipalities will continue to require our provision of services under the same terms.

As of December 31, 2011, we were a provider of water and sewage services to 363 municipalities. Between January 1, 2007 and December 31, 2011, we had entered into 30-year agreements with 225 of these municipalities (including our services agreement with the city of São Paulo), of which 25 were entered into in 2011. These 225 municipalities accounted for 65.2% of our total revenues for the year ended December 31, 2011 and 62.6% of our intangible assets as of December 31, 2011. As of December 31, 2011, we have been renegotiating 99 concession agreements that expired, including the municipality of Santos. Together, these 99 municipalities accounted for 23.8% of our total revenues for the year ended December 31, 2011 and 29.7% of our intangible assets as of that same date.

From January 1, 2012 to 2033, 39 concession agreements will expire. These 39 concession agreements accounted for 8.6% of our total revenues for the year ended December 31, 2011 and 6.7% of our intangible assets as of that same date.

We cannot assure you that these municipalities will continue to require our services and enter into new concession agreements or program agreements with us. In the event that we are successful in renegotiating our concession agreements or entering into program agreements with the municipalities whose concession agreements expired or will

expire, we cannot assure you that the new concession or program agreements will have the same terms under which we currently provide services to these municipalities. We cannot make any such assumption because the Basic Sanitation Law prevents us from planning, regulating and monitoring our services and it requires more stringent control by the municipalities or by the ARSESP.

In addition, these municipalities may choose to assume the direct provision of water and sewage services or promote a public bidding process to select another water and sewage service provider. Depending on the eligibility requirements to participate in the public bidding processes, we may not qualify to participate in some or all of these public bidding processes. If we participate in these public bidding processes, we cannot assure you that we will win the bid. In the event that these municipalities assume the direct provision of water and sewage services or promote a public bidding process to select another water and sewage service provider, or the new terms or conditions of the concession or program agreements are less favorable to us, we may be materially and adversely affected. See “Item 4.B. Business Overview—Our Operations” and “Item 4.B. Business Overview—Government Regulation—Concessions—Public Consortia and Cooperation Agreement Law for Joint Management.”

Municipalities may, under certain circumstances, terminate our concessions before their expiration and the indemnification may be inadequate to recover the full value of our investments.

The concessions we hold are subject to early termination provisions, which entitle municipalities to terminate our concessions prior to their expiration date under certain circumstances. Municipalities may terminate our concessions if we fail to comply with our obligations under the relevant concession agreement or applicable law, or if the municipality determines, through an expropriation proceeding, that terminating our concession prior to its expiration date is in the public interest. If any municipality terminates our concession before the expiration date, we are entitled to be indemnified for the unamortized portion of our investments, but the indemnification may not be sufficient for us to recover the full value of our investments. Further, under the terms of the Constitution of the State of São Paulo, municipalities may pay the indemnification over a term of 25 years. However, the Brazilian Supreme Court stayed the application of this provision of the Constitution of the State of São Paulo in 1997, and the decision remains valid until final judgment.

In 1997, the municipality of Santos enacted a law expropriating our water and sewage systems in Santos. There are pending legal proceedings concerning the expropriation carried out by this municipality. We continue to provide water and sewage services to the city of Santos.

In 1995, the municipality of Diadema terminated the concession agreement that had been entered into with us prior to the expiration of the concession agreement. As a result, we filed a lawsuit against the municipality of Diadema which we eventually settled in 1996. The municipality of Diadema did not comply with this settlement. In December 2008, we entered into a memorandum of understanding with the State of São Paulo, the municipality of Diadema and the State Secretariat for Sanitation and Water Resources, formerly known as the State Secretariat for Sanitation and Energy (*Secretaria de Saneamento e Energia do Estado de São Paulo*). This memorandum establishes our agreement to conclude negotiations and settle all outstanding amounts and stay the collection proceedings we filed against the municipality of Diadema. In 2011, the municipality of Diadema agreed with us to develop a shared infrastructure for the provision of water and sewage services through a mixed-capital company called Companhia de Água e Esgoto de Diadema, or CAED, and we cannot predict when this company will begin operations. The amount owed to us by the Diadema municipality would be returned to us through our capital participation in CAED. We can give no assurance that we will recover our investments in such company.

For further information on these lawsuits, see “Item 8.A. Financial Information—Consolidated Statements and Other Financial Information—Legal Proceedings.”

We cannot assure you that other municipalities will not seek to terminate their concession agreements before the contractual expiration date. The early termination of concession agreements by municipalities, our inability to receive adequate indemnification for the investments we made, or the payment of indemnification due to us over a long period, may have a material adverse effect on us.

The Basic Sanitation Law has established provisions governing the indemnification of water and sewage service providers in case of early termination of concession agreements by a municipality and reduced the term over which indemnification must be paid to four years. These provisions are also applicable to concession agreements entered into prior to the enactment of the Basic Sanitation Law, as long as these concession agreements do not have a contractual indemnification provision in case of early termination or we have not otherwise entered into an agreement with the municipality with regard to such early termination. Nevertheless, we cannot anticipate the effects of the Basic Sanitation Law on the amount of, and enforceability of the right to, indemnification and how Brazilian courts will enforce the provisions of the Basic Sanitation Law.

Any failure to obtain new financing may adversely affect our ability to continue our capital expenditure program.

Our capital expenditure program will require substantial liquidity and capital resources of approximately R\$7.9 billion in the period from 2012 through 2015. We recorded R\$2.4 billion of capital expenditure in 2011 in connection with our capital expenditure program.

We have funded in the past, and we plan to continue to fund these expenditures with funds generated by operations and domestic and foreign currency borrowings on acceptable terms. A significant portion of our financing needs have been funded by lenders controlled by the federal government. We also benefit from long term financing from domestic and international multilateral agencies and development banks at attractive interest rates. Changes in the policies of the federal government regarding the financing of water and sewage services, or our failure to continue to benefit from long-term financing from domestic and international multilateral agencies and development banks at attractive interest rates may impair our ability to meet our obligations or finance our capital expenditure program, which could have a material adverse effect on us.

As a general rule, financial institutions and other institutions authorized to provide credit by the Central Bank may only provide loans to public sector entities, such as us, up to a certain percentage of the entity's shareholders' equity. Because of these limitations on our ability to obtain credit from domestic financial institutions, our options for raising funds, other than the cash generated by our operations, consist mainly of borrowing from governmental agencies, national and international financial institutions or multilateral agencies and issuing debt securities in both the domestic and international capital markets. These legal limitations could adversely affect our ability to continue our capital expenditure program.

We are also subject to financial covenants limiting our ability to incur additional indebtedness, which could have a material adverse effect on us. For further information on these covenants, see "Item 5.B. Liquidity and Capital Resources—Capital Sources—Indebtedness Financing—Financial Covenants." Our failure to comply with these covenants could impair our ability to finance our capital expenditure program, which could have a material adverse effect on us.

We are subject to cost increases to comply with environmental law requirements and potential environmental liability that could have a material adverse effect on us.

Our facilities are subject to extensive Brazilian federal, state and municipal laws and regulations relating to the protection of human health and the environment. These laws and regulations establish potability standards for consumption and limit or prohibit emissions or spills of effluents, such as raw sewage, produced in connection with our operations. We could be subject to civil public actions and criminal, administrative and other civil proceedings for non-compliance with environmental laws and regulations, which could expose us to administrative and civil penalties and criminal sanctions, such as fines, closure orders and significant indemnification obligations. Since environmental laws and their enforcement by Brazilian authorities are becoming more stringent, our capital expenditures and expenses for environmental compliance may increase substantially. Expenditures required for compliance with environmental laws and regulations may result in reductions in other strategic investments that we have planned, which could negatively affect us. In addition, due to more stringent enforcement of environmental laws by Brazilian courts, we may be required to pay substantial fines and indemnifications in amounts that may vary widely from those currently anticipated. We are presently a party to a number of civil public actions and administrative proceedings related to environmental matters, with regard to which we are unable to calculate our estimated amount of potential liability. Any unfavorable judgment in relation to these lawsuits and proceedings or any material unforeseen environmental liabilities may have a material adverse effect on us. For further information on these lawsuits, see "Item 8.A. Financial Information—Consolidated Statements and Other Financial Information—Legal Proceedings."

The enactment of new laws and regulations relating to climate change and changes in existing regulation, as well as the physical effects of climate change, may result in increased liabilities and increased capital expenditures, which could have a material adverse effect on us.

As new laws and regulations relating to climate change, including carbon controls, become applicable to us, and as existing environmental regulations relating to climate change become more stringent, it is possible that our capital expenditure for compliance with these laws and regulations will increase substantially in the future. If we increase capital expenditure to comply with these laws and regulations, we may be required to reduce expenditure on other strategic investments.

In addition, if climate change leads to significant physical effects, such as variations in the intensity of droughts and rain, our services may be affected and we may be required, among other things, to: (i) make significant investments in seeking new water sources located further from major consumer centers and (ii) make significant investments in new technologies.

We have not adopted any method for calculating the investments that would be necessary in the event of a significant physical effect from climate change. Any substantial increase in expenditure related to climate change, whether for compliance with environmental regulations or for preventing or remedying the physical effects of climate change, may have a material adverse effect on us. See “Item 4.B. Business Overview—Environmental Matters—Climate Change Regulations: Reduction of Greenhouse Gases (GHG).”

Any substantial monetary judgment against us in legal proceedings may have a material adverse effect on us.

We are a party to a number of legal proceedings involving significant monetary claims. These legal proceedings include, among others, civil, environmental, tax, labor, condemnation and other proceedings. As of December 31, 2011, the total value of all outstanding claims was R\$24,152.0 million (net of R\$133.1 million in court deposits). A substantial monetary judgment against us in one or more of these legal proceedings may have a material adverse effect on us. Based on advice from our legal counsel, we have provisioned a total aggregate amount of R\$1,571.8 million (net of court deposits) as of December 31, 2011 to cover probable losses related to legal proceedings. This provision does not cover all legal proceedings involving monetary claims filed against us and it may be insufficient to cover our liabilities related to these claims.

Any unfavorable judgment in relation to these proceedings may have a material adverse effect on us. For more information, see “Item 8.A. Financial Information—Consolidated Statements and Other Financial Information—Legal Proceedings.”

Risks Relating to Our Common Shares and ADSs

The relative volatility and illiquidity of the Brazilian securities markets may substantially limit your ability to sell our common shares underlying the ADSs at the price and time you desire.

Investing in securities that trade in emerging markets, such as Brazil, often involves greater risk than investing in securities of issuers in major securities markets, and these investments are often considered to be more speculative in nature. The Brazilian securities market is substantially smaller, less liquid, more concentrated and can be more volatile than major securities markets. Accordingly, although you are entitled to withdraw the common shares underlying the ADSs from the depositary at any time, your ability to sell the common shares underlying the ADSs at a price and time at which you wish to do so may be substantially limited. There is also significantly greater concentration in the Brazilian securities market than in major securities markets. The ten largest companies in terms of market capitalization represented approximately 53.1% of the aggregate market capitalization of the BM&FBOVESPA as of December 31, 2011. The top ten stocks in terms of trading volume accounted for approximately 50.4%, 48.8% and 47.0% of all shares traded on the BM&FBOVESPA in 2009, 2010 and 2011, respectively.

Investors who exchange ADSs for common shares may lose their ability to remit foreign currency abroad and to obtain Brazilian tax advantages.

The Brazilian custodian for the common shares underlying our ADSs must obtain a certificate of registration from the Central Bank to be entitled to remit U.S. dollars abroad for payments of dividends and other distributions relating to our common shares or upon the disposition of our common shares. If an ADR holder decides to exchange ADSs for the underlying common shares, this holder will be entitled to continue to rely on the custodian’s certificate of registration for five business days from the date of exchange. After that period, the holder may not be able to obtain and remit U.S. dollars abroad upon the disposition of our common shares, or distributions relating to our common shares, unless he or she obtains his or her own certificate of registration or register under Resolution No. 2,689, dated January 26, 2000, of the CMN, which entitles registered foreign investors to buy and sell on the Brazilian stock exchanges. If the holder does not obtain a certificate of registration or register under Resolution No. 2,689, this holder will generally be subject to less favorable tax treatment on gains with respect to our common shares.

If a holder attempts to obtain his or her own certificate of registration, the holder may incur expenses or suffer delays in the application process, which could delay his or her ability to receive dividends or distributions relating to our common shares or the return of his or her capital in a timely manner. We cannot assure you that the custodian’s certificate of registration or any foreign capital registration obtained by a holder may not be affected by future

legislative changes, or that additional restrictions applicable to the holder, the disposition of the underlying common shares or the repatriation of the proceeds from disposition will not be imposed in the future.

A holder of common shares or ADSs may face difficulties in protecting his or her interests as a shareholder because we are a Brazilian mixed capital company.

We are a mixed capital company (*sociedade de economia mista*) organized under the laws of Brazil, and all of our directors and officers and our controlling shareholder reside in Brazil. All of our assets and those of these other persons are located in Brazil. As a result, it may not be possible for a holder to effect service of process upon us or these other persons within the United States or other jurisdictions outside Brazil or to enforce against us or these other persons judgments obtained in the United States or other jurisdictions outside Brazil. Because judgments of U.S. courts for civil liabilities based upon the U.S. federal securities laws may only be enforced in Brazil if certain requirements are met, a holder may face difficulties in protecting his or her interests in the case of actions by our directors, officers or our controlling shareholder than would shareholders of a corporation incorporated in a state or other jurisdiction of the United States. In addition, under Brazilian law, none of our assets which are essential to our ability to render public services are subject to seizure or attachment. Furthermore, the execution of a judgment against our controlling shareholder may be delayed as payment of the judgment must be made pursuant to the State's budget in a subsequent fiscal year. None of the public property of our controlling shareholder is subject to seizure or attachment, either prior to or after judgment.

Mandatory arbitration provisions in our bylaws may limit the ability of a holder of our ADSs to enforce liability under U.S. securities laws.

Under our bylaws, any disputes among us, our shareholders and our management with respect to the application of *Novo Mercado* rules, Brazilian Corporate Law and the application of the rules and regulations regarding Brazilian capital markets will be resolved by arbitration conducted pursuant to the BM&FBOVESPA Arbitration Rules in the Market Arbitration Chamber. Any disputes among shareholders, including ADR holders, and disputes between us and our shareholders, including ADR holders, will also be submitted to arbitration. As a result, a court in the United States might require that a claim brought by an ADR holder predicated upon the U.S. securities laws be submitted to arbitration in accordance with our bylaws. In that event, a purchaser of ADSs would be effectively precluded from pursuing remedies under the U.S. securities laws in the U.S. courts.

A holder of our common shares and ADSs might be unable to exercise preemptive rights and tag-along rights with respect to the common shares.

U.S. holders of common shares and ADSs may not be able to exercise the preemptive rights and tag-along rights relating to common shares unless a registration statement under the U.S. Securities Act of 1933, as amended, or the Securities Act, is effective with respect to those rights or an exemption from the registration requirements of the Securities Act is available. We are not obligated to file a registration statement with respect to our common shares relating to these rights, and we cannot assure you that we will file any such registration statement. Unless we file a registration statement or an exemption from registration is available, an ADR holder may receive only the net proceeds from the sale of his or her preemptive rights and tag along rights or, if these rights cannot be sold, they will lapse and the ADR holder will receive no value for them.

A holder of our ADSs may find it more difficult than a holder of our common shares to exercise his or her voting rights at our shareholders' meetings.

Holders may exercise voting rights with respect to the common shares represented by our ADSs only in accordance with the deposit agreement relating to our ADSs. There are no provisions under Brazilian law or under our bylaws that limit the exercise by ADR holders of their voting rights through the depository with respect to the underlying common shares. However, there are practical limitations upon the ability of ADR holders to exercise their voting rights due to the additional procedural steps involved in communicating with these holders. For example, our common shareholders will receive notice of shareholders' meetings through publication of a notice in an official government publication in Brazil and will be able to exercise their voting rights by either attending the meeting in person or voting by proxy. ADR holders, by comparison, will not receive notice directly from us. Instead, in accordance with the deposit agreement, we will provide the notice to the depository, which will, in turn, as soon as practicable thereafter mail to ADR holders the notice of the meeting and a statement as to the manner in which instructions may be given by holders, but only if we request the depository to do so. To exercise their voting rights, ADR holders must then instruct the depository as to voting the common shares represented by their ADSs. Due to these procedural steps involving the depository, the process for exercising voting rights may take longer for ADR holders than for holders of common shares. ADSs for which the depository fails to receive timely voting instructions will not be voted at any meeting.

ITEM 4. INFORMATION ON THE COMPANY

A. History and Development of the Company

Overview

Companhia de Saneamento Básico do Estado de São Paulo – SABESP is a mixed capital company (*sociedade de economia mista*) with limited liability. We were incorporated on September 6, 1973 under the laws of the Federative Republic of Brazil. We are registered at the Commercial Registry of the State of São Paulo (*Junta Comercial do Estado de São Paulo*) under registration number NIRE 35300016831. Our principal executive offices are located at Rua Costa Carvalho, 300, 05429-900 São Paulo, SP, Brazil. Our telephone number is +(55) 11 3388 8000. Our agent for service of process in the United States is CT Corporation System, with offices at 818 West Seventh Street – Team 1, Los Angeles, CA 90017. We are allowed to operate, in a subsidiary form, in other Brazilian locations and abroad. See “Item 4.B. Business Overview—Government Regulation—Concessions—Public Consortia and Cooperation Agreement Law for Joint Management.”

We believe we are one of the largest water and sewage service providers in the world (based on the number of customers in 2011), according to the 13th edition of the *Pinsent Masons Water Yearbook (2011-2012)*. We operate water and sewage systems in the State of São Paulo in which the city of São Paulo, Brazil's largest city, is located. According to the IBGE, the State of São Paulo is Brazil's most populous state and the state with the highest gross domestic product, or GDP, in Brazil. For the year ended December 31, 2011, from our total revenues we had a consolidated net revenue of R\$9,941.6 million and a consolidated net income of R\$1,223.4 million. Our total consolidated assets was R\$25,215.0 million and our total shareholders' equity was R\$10,545.9 million as of December 31, 2011.

As of December 31, 2011, we provided water and sewage services to a broad range of residential, commercial, industrial and governmental customers in 363 of the 645 municipalities in the State of São Paulo, including the city of São Paulo. Substantially all of our concessions or program agreements have 30-year terms. 99 of these concessions have expired and are currently being renegotiated. From January 1, 2012 through 2033, 39 concessions will expire, which we will seek to replace with program agreements.

We also supply water on a wholesale basis to six municipalities located in the São Paulo metropolitan region and to the municipality of Sumaré (with a total estimated urban population of approximately 3.7 million), in which we do not operate water distribution systems. Within these municipalities, five of them utilize our sewage treatment services. For the year ended December 31, 2011, the São Paulo metropolitan region (including the municipalities to which we provide water on a wholesale basis) and the Regional Systems accounted for 73.9% and 26.1% of our gross revenue from sales and services (excluding revenues relating to the construction of concession infrastructure), respectively.

As of December 31, 2011, we provided water services through 7.5 million water connections to approximately 23.9 million people, representing approximately 59.0% of the urban population of the State of São Paulo, and effectively had a water coverage ratio of approximately 100% in respect of all regions. As of that date, we provided sewage services through 5.9 million sewage connections to approximately 20.5 million people and effectively had a sewage coverage ratio of 82.0%. As of December 31, 2011, we operated through 66,389 kilometers of water pipes and mains and through 45,073 kilometers of sewer lines.

We also provide water and/or sewage services to four other municipalities through special purpose companies. In addition, we render consulting services related to the rational use of water and commercial and operational management in Panama and Honduras through a partnership with Latin Consult.

The State, our controlling shareholder, is required by law to own at least 50% plus one of our common shares. As of April 23, 2011, the State owned 50.3% of our outstanding common shares. As a mixed capital company, we are an integral part of the State governmental structure. Our strategy and major policy decisions are formulated in conjunction with the State Secretariat for Sanitation and Water Resources as part of the overall strategic planning for the State. The majority of the members of our board of directors and our board of executive officers are nominated by the State government.

In addition, our capital expenditure budget is subject to approval by the State legislature and is approved in conjunction with the budget of the State Secretariat for Sanitation and Water Resources as a whole. Our consolidated financial statements and accounting records are subject to review by the State Accounts Tribunal (*Tribunal de Contas*), as are all accounts of the State.

Our Strengths

We believe that our strong business position and future prospects relate to the following strengths:

Well-established business with significant size, scale and know-how to operate in complex urban settings. We believe we are one of the largest water and sewage service providers in the world. We provide water services directly to approximately 23.9 million people and supply water on a wholesale basis to an additional urban population of 3.7 million people. As of December 31, 2011, we effectively had a water coverage ratio of approximately 100% in respect of all regions in which we operate. We also provide sewage services directly to approximately 20.5 million people, achieving a sewage coverage ratio of 82.0% in respect of all regions in which we operate as of December 31, 2011. During the year ended December 31, 2011, our net revenue from sales and services increased by 7.7% as compared to the year ended December 31, 2010 (including revenues relating to the construction of concession infrastructure). Our significant size and scale have required us to operate in complex urban settings such as *favelas* (shantytowns) and environments without urban planning, which has enabled us to develop skills to operate in adverse conditions and have well-trained personnel and a specialized structure that we believe our competitors lack.

Operations in Brazil's most populous and wealthy state. The State of São Paulo, part of the most developed and economically active region of Brazil, is the most populous state in Brazil, with an estimated population of 43.0 million as of December 31, 2011. The city of São Paulo had an estimated population of 11.0 million as of that date, with 20.4 million inhabitants in the São Paulo metropolitan region. Based on its GDP, the State of São Paulo is the wealthiest state and largest economy in Brazil. The GDP of the State of São Paulo was approximately R\$1.1 trillion in 2009, representing approximately 33% of Brazil's total GDP. The State of São Paulo generates more revenue from water and sewage services than any other Brazilian state.

Strong Contract Log. From the 363 municipalities we serve, in the last five years, we have executed 30-year agreements with 225 of them, including an agreement with the municipality of São Paulo entered into in June 2010. As of December 31, 2011, the income from those 225 municipalities in which we have long-term contracts accounted for 65.2% of our revenues.

Access to low-cost and diverse sources of financing. Our strong cash flow generation from operations and our role as an essential public service provider places us in a privileged position in our industry to obtain low cost, long-term financing from Brazilian public banks, and domestic and international multilateral agencies and development banks. In addition, we are not dependent upon a limited number of sources of financing. We benefit from various funding alternatives available in the Brazilian and international markets for our working capital needs and our capital expenditure programs.

Strong corporate governance practices. In 2002, we joined the *Novo Mercado* segment of the BM&FBOVESPA, which is the listing segment in Brazil with the highest corporate governance requirements. As a result, we are committed to maintaining certain additional corporate governance practices that are not required by Brazilian law, ensuring additional protection to our shareholders rights and enhancing the quality of information we disclose to the market. On December 1, 2007, we became part of the BM&FBOVESPA Corporate Sustainability Index, or ISE, which reflects our high degree of commitment to sustainable environmental and social practices.

High quality operations. We believe that we adhere to high standards of service and utilize the best available technology in the sanitation business to control the quality of the water captured, produced and distributed. All of our water quality control laboratories operate in accordance with the ABNT NBR ISO 9001, which follows the highest international water quality standards. In addition to our central laboratory, 11 of our regional laboratories are accredited by the National Institute of Metrology, Standardization and Industrial Quality, or INMETRO, thereby assuring the quality and accuracy of our test results, according to ABNT NBR ISO IEC 17025. Moreover, our laboratories and field teams use the latest equipment to detect substances controlled by regulations and have highly trained teams to handle contingencies and customer complaints. We believe our technology enhances the efficiency and quality of our operations. As of December 31, 2011, 50 of our sewage treatment facilities had obtained the ISO 14001 certification.

Our Strategy

Our mission is to provide water and sewage services, contributing to the improvement of the quality of life and of the environment. To this end, our strategic objectives are based upon the guiding principles of growth, quality, universalization of sanitation services and social, economic and environmental sustainability, while focusing on reaching excellence on customer service. We also base our strategic objectives on our political and institutional relationships as well as on our commitment to the market to increase shareholder value. We seek to implement these guiding principles through the following strategies:

Continue to seek growth while improving our financial results by reducing operating costs, increasing productivity and profitability and prudently managing our levels of indebtedness. We aim to apply our principles of financial growth and sustainability to each business unit, assigning goals and setting clear responsibilities to each unit so as to reach better financial results. To achieve this goal, we intend to use our best efforts to reduce operating costs and increase productivity and profitability. We plan to improve the management of our assets, as well as to continue to reduce our total operating expenses by automating some of our facilities, streamlining operational processes, implementing integrated planning and further investing in internal technological research and development. We also plan to continue our efforts to improve our collection of overdue accounts receivable from municipalities to which we provide services, from the State and from other governmental entities, including by exploring opportunities to offset these outstanding debts against certain possessory or property rights over utilities relating to water and sewage systems. We intend to continue to fund our working capital needs and estimated capital expenditure programs with diversified sources of financing, such as domestic and international development banks and multilateral agencies. We will continue to seek market opportunities for low-cost financing and restructuring of our indebtedness if and when advantageous and appropriate.

Improve operating efficiency and reduce water losses. We seek to reduce both physical water losses, which result mainly from leakage, and non-physical water losses, which result primarily from the inaccuracy of our water meters installed at our customers' premises and at our water treatment facilities, and from clandestine and illegal use. In order to achieve more consistent long-term results, we have developed a comprehensive 11-year program to reduce our water loss rate. The first three years of the program from 2009 to 2011 was funded by the BNDES. During 2012 to 2016 the program is being also funded by a loan granted by the government of Japan through the Japan International Cooperation Agency, or JICA. The program's focus is on the renewal of our water distribution infrastructure and the improvement of maintenance and control services as a means of reducing physical water losses. We are also seeking to reduce physical water losses by creating smaller water supply districts through the construction of district metering areas, or DMAs, that reduce the system's pressure and pipe bursts, allowing leaks to be detected and repaired more efficiently. The program also seeks to reduce non-physical water losses by upgrading and replacing inaccurate water meters and through inspections of non-authorized water consumption in water service connections.

Ensure the quality and availability of our services in our existing service area. Our goal is to maintain an effective water coverage ratio of around 100%, coupled with a high standard of quality and availability and meet the expected population growth by adding 1.3 million water connections from 2012 to 2019. We also intend to increase our sewage coverage ratio to 95% by 2019 by adding 1.8 million sewage connections. In addition, we are also developing short, medium and long term marketing strategies, such as client segmentation and tailor made solutions for each type of client, which we believe will help us increase our customer base. We also seek to improve our customer support strategies by modernizing our telephone and internet-based customer support and continuously measure the level of satisfaction of our clients.

Maintain and continue to expand our existing service areas. We intend to maintain our operating base through the execution of new agreements. To this end, we are actively seeking to develop closer relationships with the municipal governments that we currently serve in order to increase customer loyalty and thereby renew all or substantially all our expiring concession agreements. In June 2010, we entered into an agreement with the State and city of São Paulo with a 30-year term for the provision of water and sewage services in the city of São Paulo, which in the year ended December 31, 2011 accounted for 55.1% of our gross revenues from sales and services (excluding revenues relating to the construction of concession infrastructure). Between January 1, 2007 and December 31, 2011, we entered into 225 agreements with 30-year terms with municipalities (including our services agreement with the city of São Paulo), of which 25 were entered into in 2011. These 25 municipalities accounted for 2.9% of our total revenues for the year ended December 31, 2011 and 3.3% of our intangible assets as of that same date. As of December 31, 2011, 99 of our concessions had expired and are currently being renegotiated. These 99 municipalities accounted for 23.8% of our total revenues for the year ended December 31, 2011 and 29.7% of our intangible assets as of that same date. From January 1, 2012 through 2033, 39 concession agreements accounting for 8.6% of our revenues for the year ended December 31, 2011 and 6.7% of our intangible assets as of December 31, 2011 will expire.

We have also developed a platform to offer unique services relating to sustainability, environmental preservation and water resource management to our large industrial, commercial and residential customers in order to encourage these customers to continue to use our water services. We also intend to continue to expand our sewage services. A significant portion of our capital expenditure program, of approximately R\$7.9 billion between 2012 and 2015, is designed to achieve this goal. We also regularly explore the possibility of executing agreements for the provision of water and sewage services in municipalities of the State of São Paulo in which we currently have no operations or to which we currently supply water and provide sewage treatment solely on a wholesale basis, representing a total population of approximately 17 million. We evaluate possible expansion opportunities in terms of proximity to our existing service areas to maximize return on investment and improve our financial performance. We also intend to study, and take advantage of, opportunities in other Brazilian states and in other countries to expand our services and increase our market share.

Expand our water and sewage services. We had a sewage coverage ratio of 82.0% as of December 31, 2011, and we plan to increase our sewage coverage ratio to 95% by 2019, by adding over 1.8 million sewage connections. In addition, there are municipalities in the State of São Paulo representing an aggregate population of approximately 17 million to which we currently do not provide water or sewage services, or to which we currently supply water solely on a wholesale basis. Our strong presence in the State and experience in providing water and sewage services places us in a privileged position to expand our sewage services to municipalities in which we provide only water services and our water and sewage services to municipalities in which we do not yet operate, in both the State of São Paulo and also in other states in Brazil and abroad. Further, we seek to deepen our relationships with strategic clients that consume high volumes of water (more than 500 cubic meters per month) by applying special tariffs for these clients.

Seek selective opportunities to expand our business. In 2007, a change in our bylaws expanded the scope of our corporate purpose to include activities complementary to our water and sewage services, such as urban rainwater management and drainage services, urban cleaning services and solid waste management services. Since then we have:

- § executed cooperation agreements to exchange technology with six regional basic sanitation companies in Brazil, as well as with international businesses such as Mekorot National Water Company, an Israeli company, Sociedade General Aguas de Barcelona S/A – Agbar, a Spanish company, Instituto Costarricense de Acueductos y Alcantarillados, a Costa Rican company, Empresa Pública de Medellín, a Colombian municipal multi-utilities company and Agua y Saneamientos Argentinos - AYSA, an Argentine company, which will allow us to exchange know-how and learn about future opportunities;
- § executed memoranda of understanding with three municipalities to study the possibility of operating landfills;
- § created four special purpose companies (SESAMM – Serviços de Saneamento de Mogi Mirim S/A; Águas de Castilho S.A.; Águas de Andradina S.A.; and Saneaqua Mairinque S.A.) to operate water and/or sewage concessions granted by four municipalities in the State of São Paulo;
- § executed an agreement with the Servitec/Tecniplan consortium for the use of small hydroelectric power plants in our water treatment stations in Guaraú and Vertedouro Cascata;
- § executed an agreement with the basic sanitation company of the state of Alagoas to transfer technology for the reduction of water losses in the city of Maceió;
- § executed a service agreement with the basic sanitation company of the state of Espírito Santo to license the use of our proprietary software “Aqualog” designed to remotely monitor water treatment;
- § won two international public biddings for the provision of: (i) consulting services relating to a program for the rational use of water and for the implementation of a new model for commercial and operational management of the Instituto de Acueductos y Alcantarillados Nacionales, the company responsible for the provision of the water and sewage services in the central provinces of Panama, and (ii) consulting services for the implementation of a new model for commercial and operational management in nine municipalities of Honduras;
- § created a special purpose company (Aquapolo Ambiental S.A.), in partnership with a private sanitation services operator, to build and operate the largest water recycling facility in the southern hemisphere, which will supply up to 1,000 liters per second to industries in the São Paulo metropolitan region;
- § rendered consulting services relating to the Municipal Basic Sanitation Plan to the municipality of Barro Alto, located in the State of Goiás; and
- § created a special purpose company (ATTEND), in partnership with Estre Ambiental S.A., for the implementation of a structure to receive non-domestic water resources in the municipality of São Paulo, which will also have a pre-treatment water station.

In addition, in connection with the expansion of our business, we are evaluating and may consider creating an investment vehicle, Sabesp Participações, through which we may make equity investments.

We intend to continue to selectively seek new business opportunities to take advantage of our know-how, size and scale.

Establish efficient and competitive ways of attracting, retaining and motivating our personnel. We intend to become a reference in human resource management, providing our personnel with growth opportunities and recognition. We seek to raise workplace satisfaction levels by establishing programs for the professional and personal development of employees, particularly of those in managerial positions, setting attractive compensation packages and creating a healthy and collaborative work environment.

25

We believe that our overall strategy will enable us to meet the demand for high quality water and sewage services in the State of São Paulo, in other Brazilian states and abroad, while strengthening our results of operations and our financial condition and creating shareholder value.

State of São Paulo

The State of São Paulo is one of 26 states that, together with the Federal District of Brasília, constitute the Federative Republic of Brazil. The State of São Paulo is located in the southeastern region of the country, which also includes the States of Minas Gerais, Espírito Santo and Rio de Janeiro, and which is, according to IBGE, the most developed and economically active region of Brazil. The State of São Paulo is located on the Atlantic coast of Brazil, with the States of Rio de Janeiro and Minas Gerais to the north, the State of Paraná to the south and the State of Mato Grosso do Sul to the west.

The State of São Paulo occupies 3.0% of Brazil's land mass and encompasses an area amounting to approximately 96,000 square miles. According to the SEADE, the State of São Paulo had an estimated total population of 43.0 million as of December 31, 2011. The city of São Paulo, the State of São Paulo's capital, had an estimated population of 11.0 million, with 20.4 million inhabitants in the São Paulo metropolitan region, as of December 31, 2011. The São Paulo metropolitan region encompasses 39 cities and is the largest metropolitan region in the Americas and the third largest metropolitan region in the world, according to the United Nations' World Urbanization Prospects, 2009 Revision. The São Paulo metropolitan region accounted for approximately 47% of the population of the State of São Paulo as of December 31, 2011.

According to the IBGE, the GDP of the State of São Paulo was approximately R\$1.1 trillion in 2009, representing approximately 33% of Brazil's total GDP, and making it the largest economy of any state in Brazil based on GDP. According to the IBGE, the State of São Paulo is also the leading Brazilian state in terms of manufacturing and industrial activity, with a strong position in car manufacturing, pharmaceuticals, computer manufacturing, steel making and plastics, among other activities, as well as a leading position in the banking and financial services industries. The State of São Paulo is the most important exporting state in Brazil, according to the Brazilian Ministry of Development, Industry and Foreign Trade (*Ministério do Desenvolvimento, Indústria e Comércio Exterior*).

History

Until the end of the nineteenth century, water and sewage services in the State of São Paulo were generally provided by private companies. In 1875, the Province of São Paulo granted a concession for the rendering of water and sewage services to *Companhia Cantareira de Água e Esgotos*. In 1893, the government of the Province of São Paulo assumed responsibility for the rendering of water and sewage services from *Companhia Cantareira de Água e Esgotos* and formed the Office of Water and Sewers (*Repartição de Água e Esgotos*), a governmental agency. Since that time, water and sewage services in the São Paulo metropolitan region have been administered by the State government. Historically, water and sewage services in substantially all other municipalities of the State were administered by the municipalities directly either by municipal water and sewage departments or through *autarquias* of the municipal government. *Autarquias* are relatively autonomous public bodies with separate legal standing, assets and revenues, created by law to undertake administration of public services, which are considered to be better managed by a decentralized administrative and financial structure.

In 1954, in response to dramatic population growth in the São Paulo metropolitan region, the State government created the Department of Water and Sewers (*Departamento de Águas e Esgotos*), as an *autarquia* of the State. The Department of Water and Sewers provided water and sewage services to various municipalities in the São Paulo metropolitan region.

A major restructuring of the entities providing water and sewage services in the State of São Paulo occurred in 1968, with the creation of the Water Company of the São Paulo Metropolitan Region (*Companhia Metropolitana de Água de São Paulo*), or the COMASP, the purpose of which was to provide potable water on a wholesale basis for public consumption in the municipalities of the São Paulo metropolitan region. All assets relating to the production of potable water for the São Paulo metropolitan region previously owned by the Department of Water and Sewers were transferred to COMASP. In 1970, the Superintendence of Water and Sewers of the city of São Paulo (*Superintendência de Água e Esgoto da Capital*), or the SAEC, was created by the State government to distribute water and collect sewage in the city of São Paulo. All assets previously owned by the Department of Water and Sewers in connection with the water services were transferred to the SAEC. Also in 1970, the State created the Basic Sanitation Company of the São Paulo Metropolitan Region (*Companhia Metropolitana de Saneamento de São Paulo*), or the SANESP, to provide sewage treatment services for the São Paulo metropolitan region. All assets previously owned by the Department of Water and Sewers in connection with the sewage services were transferred to the SANESP. The Department of Water and Sewers was subsequently closed.

On June 29, 1973, pursuant to State Law n. 119, COMASP, the SAEC and the SANESP merged to form our Company with the purpose of implementing the directives of the Brazilian government set forth in the National Water Supply and Sanitation Plan (*Plano Nacional de Saneamento*). We were incorporated under the laws of Brazil as a limited company (*sociedade anônima*), for indefinite duration. The National Water Supply and Sanitation Plan was a program sponsored by the Brazilian government, which financed capital investments in, and assisted in the development of, state-controlled water and sewage companies. Since our formation, other State governmental and State-controlled companies involved in water supply and sewage collection and treatment in the State of São Paulo have been merged into us and the State has been our controlling shareholder as required by State Law n. 119. We thus have been integrated into the State governmental structure and our strategies have been formulated in conjunction with the strategies for the State Department of Water Resources and Sanitation. Additionally, most members of our Board of Directors and our management are appointed by the State Government.

The budget for our capital expenditures is subject to approval of the State legislative chamber. This approval is obtained simultaneously with the approval of the budgets of the Department of Sanitation, of the Department of Energy and of the State of São Paulo. The Company is also subject to supervision from the Court of Audit of the State of São Paulo (*Tribunal de Contas do Estado de São Paulo*), with regard to our accounting, financial, budgetary, operational and assets.

We provide water and sewage services directly to a large number of residential, commercial and industrial private consumers, on top of to a variety of public entities in 363 of the 645 municipalities in the State, including in the city of São Paulo, as well as providing treated water on a wholesale basis to six municipalities located in the São Paulo metropolitan region and to the municipality of Sumaré, in which we do not operate the distribution systems to consumers. Among these municipalities, we also provide sewage treatment services to five of them. Currently, we are a leading provider of water and sewage services in the world in number of clients, according to the 13th edition of the Pinstent Masons Water Yearbook (2011-2012).

In 1994, we were registered with the CVM as a publically-held company subject to rules issued by the CVM, including those relating to the periodic disclosure of extraordinary facts or relevant events. Our common shares have been listed on the BM&FBOVESPA under the ticker “SBSP3” since June 4, 1997.

In 2002, we joined the *Novo Mercado* segment of the BM&FBOVESPA, which is the listing segment in Brazil with the highest corporate governance requirements. During that same year, we registered our securities with the Securities and Exchange Commission, or SEC, and started trading our shares in form of American Depositary Receipts – level III (“ADRs”) on the New York Stock Exchange, or NYSE.

In 2004, a secondary offer of common shares held by the State of São Paulo was made simultaneously in the Brazilian and in the international market. On December 1, 2007, we became part of the BM&FBOVESPA Corporate Sustainability Index, or ISE, which reflects our high degree of commitment to sustainable environmental and social practices.

In December, 2007, Law No. 1,025 allowed for the creation of regulatory agencies for the supervision of water and sewage services. The same law created ARSESP, the regulatory agency that regulates and supervises the services we provide.

In July 2008, we announced that we would expand the area reached by our services, as well as including in our scope of services activities related to environmental and energy solutions, as required by the State Law No. 1,025. Since then, we have also been forming partnerships with private companies to consolidate our operations in the sanitation sector, in particular: (i) through a special purpose entity which provides services of water distribution and/or sewage

treatment for certain municipalities in the State; (ii) we entered into a consortium with the consultancy firm Latin Consult to provide consultancy services in certain cities in Panama and Honduras for the rational use of water and the adoption of a new commercial and operational management model; (iii) the production, supply and commercialization of reused water and (iv) the implementation and operation of a station for the preconditioning of non-domestic wastewater, sludge conditioning and other related activities.

Other partnership led to the creation of the following companies: Sesamm – Serviços de Saneamento de Mogi Mirim S.A., Águas de Andradina S.A., Saneáqua Mairinque S.A., Aquapolo Ambiental, S.A. Águas de Castilho S.A. e Attend Ambiental S.A. Although we do not necessarily hold a majority capital participation in these companies, shareholder agreements provide us with veto powers or qualified votes on certain matters those business associates may come across.

27

Corporate Organization

In 2005, we reorganized our corporate management structure. As a result, we currently have six management divisions, each of which is supervised by one of our executive officers.

The allocation of responsibilities among the executive officers is made by our board of directors, after an initial proposal made by the Chief Executive Officer, in accordance with our bylaws. The Chief Executive Officer is responsible for coordinating all management divisions in accordance with the policies and directives established by our board of directors and board of executive officers, including the coordination, evaluation and control of all functions related to Chief Executive Officer's office and staff, integrated planning, business management and organization, corporate communication, audit, ombudsman, and regulatory matters. The Chief Executive Officer represents our Company before third parties and some of its representation powers can be granted to attorneys-in-fact. The executive officers described below report to the Chief Executive Officer:

§ the Corporate Management Officer, who is responsible for marketing, human resources and quality control programs, legal affairs, information technology, asset management, legal and procurement, and contracts;

§ the Chief Financial Officer and Investor Relations Officer, who is responsible for financial planning, costs and tariffs, raising and allocating financial resources to all divisions within the Company, conducting capital markets and other indebtedness-related transactions and managing indebtedness levels, control department, accounting, corporate governance and investor relations;

§ the Technology, Enterprises and Environment Officer, who is responsible for the environmental planning and management, technological and operating, product quality control, developments and coordination and execution of special investment programs, projects and new businesses; and

§ the Chief Operating Officer of the São Paulo Metropolitan Region Division and the Chief Operating Officer of the Regional Systems Division, who are responsible for managing the operation, maintenance, execution of planning and works for the water and sewage supply systems including planning and works for our services rendered on a wholesale basis, sales and call center services, as well as the control of economic-financial and operational performance of its division. These Chief Operating Officers are also responsible for sanitation advisory services to autonomous municipalities and for the mediation and the negotiation with communities and local governments, aimed at aligning our interests with the interests of our clients.

Capital Expenditure Program

Our capital expenditure program is designed to improve and expand our water and sewage system and to increase and protect our water sources in order to meet the growing demand for water and sewage services in the State of São Paulo. Our capital expenditure program has four specific goals in the municipalities we serve: (i) to continue to meet the maximum demand for treated water; (ii) to expand the percentage of households connected to our sewage system; (iii) to increase the treatment of sewage collected; and (iv) to increase operating efficiency and reduce water losses.

From 2009 through 2011, our capital expenditure program totaled R\$ 6.4 billion, primarily to build up our infrastructure and for our efforts to reduce water losses. We have budgeted investments in the amount of R\$7.9 billion from 2012 through 2015. We invested R\$1.8 billion, R\$2.2 billion and R\$2.4 billion in 2009, 2010 and 2011, respectively.

The following table sets forth our planned capital expenditures for water and sewage infrastructure for the years indicated.

Planned Capital Expenditures

	2012	2013	2014	2015	Total
			<i>(in millions of reais)</i>		
Water	745.9	599.2	607.2	579.6	2,532
Sewage	926.7	991.4	845.9	368.2	3,132
Others	336.5	395.4	504.9	988.2	2,225
Total	2,009	1,986	1,958	1,936	7,889

Our capital expenditure program from 2012 through 2015 will continue to focus on achieving our targets by making regular investments in and expanding our infrastructure as well as making investments in the reduction of water losses throughout the 363 municipalities we served as of December 31, 2011.

Main Projects of Our Capital Expenditure Program

The following is a description of the main projects in our capital expenditure program.

Metropolitan System Investment Program

Metropolitan Water Program

Demand for our water services has grown steadily over the years in the São Paulo metropolitan region and has exceeded at times the capacity of our water systems. As a result, prior to September 1998, part of our customers in this region received water only on alternate days of the week. We refer to this as “rotation.” In order to remedy this situation, we implemented the Metropolitan Water Program (*Programa Metropolitano de Água*) to improve regular water supply to the entire São Paulo metropolitan region. This program terminated in 2000 and the rotation was eliminated, but we have maintained our investment projections for the region. During the second phase of the Metropolitan Water Program between 2006 and 2014, we plan to expand the infrastructure of water storage tanks by 210,000 cubic meters and to construct 44 water pumping stations and 240 kilometers of mains. The investment is expected to reach R\$2.7 billion and the construction is expected to expand the water production capacity by 13.2 cubic meters per second until 2014. We have been working on this project since 2006, and we expect to complete it by 2014. In 2011, we invested approximately R\$102.5 million, respectively, in this project.

The metropolitan region suffers from a water shortage, which requires us to obtain water from increasingly distant sources. In order to remedy this situation, we are currently developing a new supply system called São Lourenço that should be able to benefit a population of almost 1.5 million people. We have already concluded the project’s conceptual studies and are currently developing its infrastructural projects. We may propose a Public Private Partnership to the government of São Paulo.

In June 2008, we entered into a Public Private Partnership (*Parceria Público-Privada*), or PPP, with Cab Spat, a special purpose company whose main shareholders are Cab Ambiental and Galvão Engenharia S.A. Cab Spat will be responsible for (i) expanding the Taiaçupeba water treatment plant capacity from ten cubic meters per second to 15 cubic meters per second, (ii) building 17.7 kilometers of water connections and mains, (iii) building four water storage tanks with total capacity of 70,000 cubic meters, (iv) installing boosters, and (v) building pumping stations. The total investment in projects to be undertaken by Cab Spat during the first two years of the PPP is estimated at R\$320.0 million. Cab Spat will also perform maintenance on the dams of the Alto Tietê System, in connection with which Cab Spat will also provide civil engineering, electromechanical and operational services, as well as sludge treatment and the corresponding services regarding water adduction and water supply. The total value of the project is estimated at R\$1.0 billion. We intend to pay these investments over 15 years upon the completion of the contracted projects and services. In December 2011, the services were concluded and the system’s nominal capacity was increased from 10 to 15 cubic meters per second, directly benefiting 1.5 million people in the east region of the São Paulo metropolitan region, in addition to improving the reliability, flexibility and availability of the integrated water system that services the state’s metropolitan region. The increase in production will improve the east, north and west regions water supply levels since it will be possible to transfer water from the east system to other localities. In 2011, we invested approximately R\$ 121.4 million in this project.

Tietê Project

The Tietê river crosses the São Paulo metropolitan region and receives most of the region's run off and wastewater. The environmental status of the river reached a critical level in 1992. In an effort to reverse the situation, the State of São Paulo created a recovery program designed to reduce pollution of the Tietê river by installing sewage collection lines along the banks of the Tietê river and its tributaries. These lines collect raw sewage and deliver it to our sewage treatment facilities. We completed the first phase of the program between 1992 and 1998.

In connection with the first phase of the Tietê Project (*Projeto Tietê*), in June 1998, we completed the construction of three additional sewage treatment facilities and invested a total of US\$1.1 billion, of which US\$450.0 million was financed by the Inter-American Development Bank, or IADB, approximately US\$100 million by the *Caixa Econômica Federal*, or the Caixa, and approximately US\$550 million by us.

The second phase of the project was carried out from 2000 through 2008, with investments of approximately US\$500 million, of which US\$200.0 million were financed by the IADB, R\$60.0 million by the BNDES, and R\$180.0 million by the BNDES through another financial institution. In this phase, 290,000 sewage connections and more than 1,500 kilometers of sewage collections networks, branch collectors and interceptors were installed and/or built.

The main objective of this second phase was to continue expanding and optimizing the sewage systems of the São Paulo metropolitan region, primarily focusing on actions that allow for the delivery of a higher volume of raw sewage to the sewage treatment facilities that were built in the first phase of the Tietê Project. Upon the conclusion of the second phase of the project in 2008, we were able to collect approximately 5,000 liters of raw sewage per second and send it for treatment in the five sewage treatment plants of our integrated system. As part of the second phase of the Tietê Project, we implemented a geographic information system named SIGNOS. SIGNOS is a management information system which automates and integrates various business processes, including project management, maintenance, operations and customer service and maps out our entire municipal infrastructure in the São Paulo metropolitan region.

The first and second phases of the Tietê Project contributed to an increase from 70.0% to 84.0% in the sewage collection rate and an increase from 24.0% to 70.0% in the treatment of the sewage collected in the São Paulo metropolitan region. As a result, the sewage collection system benefited 15.8 million people (5.1 million more than the number of people served when the Tietê Project was initiated), and the sewage treatment benefited 11.1 million people (8.5 million more than the number of people served when the Tietê Project was initiated).

As of December 31, 2011, we owed US\$386.9 million to the IADB for the financing it provided. For further information on the agreement entered into with the IADB, see “Item 5.B. Liquidity and Capital Resources—Capital Sources.” We currently provide secondary treatment to approximately 68% of the sewage collected in the São Paulo metropolitan region. The five principal sewage treatment facilities in the São Paulo metropolitan region have an aggregate installed capacity of 18 cubic meters of sewage per second and currently treat an aggregate of 15.6 cubic meters of sewage per second. We plan to build additional collection lines to direct more raw sewage to our treatment facilities.

The third phase of the Tietê Project, designated as “the decontamination of the Tietê river,” aims at contributing to the recuperation of the water quality of the Tietê river basin through the expansion of the level of collection to 87.0% and treatment of sewage to 84.0% in the São Paulo metropolitan region. The total estimated cost of the third phase is approximately US\$1.1 billion, of which US\$600.0 million will be financed pursuant to the IADB Loan entered into on September 3, 2010. The program plan of the third phase comprises mainly (i) drainage collection (collection networks and home connections), (ii) removal and transport of the drainage for treatment (branch collectors and interceptors), and (iii) the construction of sewage treatment plants, not only of the integrated drainage system of the São Paulo metropolitan region, but also of various isolated systems in the same region, during a six-year period from 2010 to 2016. Approximately 43% of the work is already under execution and 25% is undergoing public bidding processes. After the third phase of the Tietê Project, the sewage collection system will benefit an additional 1.5 million people and the sewage treatment will benefit an additional 3.0 million people.

We are currently planning the fourth and final phase of the Tietê Project, which should take place between 2013 and 2018. The main objective of the fourth phase is to completely end the dumping of untreated sewage into the Tietê river in the area in which we are the water services provider.

Corporate Program for Water Loss Reduction

The objective of the Corporate Program for Water Loss Reduction (Programa Corporativo de Redução de Perdas) is to decrease water losses more efficiently by means of the integration and expansion of the existing initiatives in our business units. We began structuring the program in the second half of 2007 and finalized it in 2008. We have invested R\$1.0 billion in this project so far and anticipate investments of approximately R\$4.3 billion throughout the program's 11-year term, beginning in 2009. Funding will come from our own resources as well as from loan agreements entered with the Japan International Cooperation Agency (JICA), with Caixa Econômica Federal and with BNDES. The program aims to reduce the incidence of water loss from 436 liters per connection per day in December 2008 to 211 liters per connection per day in 2019, which is equivalent to reducing water losses from 27.8% in December 2008 to 15.0% in 2019. This goal will be revised based on the results reached so far and the expected reduction with the implementation of the Corporate Program for Water Loss Reduction in the 2012-2019 period.

In 2011, we invested approximately R\$326.7 million in this program. As of December 31, 2011, water losses were reduced to 25.6% from 26% in 2010.

New Life Program

The New Life Program (*Programa Vida Nova*) includes projects focused on the improvement and preservation of water reserves in the São Paulo metropolitan region and the urban development of the region, especially in the Guarapiranga and Billings mains. The resources will be mostly invested in the creation of infrastructure to collect sewage in the region, and to direct it to treatment plants, while avoiding its pouring directly into the springs. The program also includes protection activities of green areas and the urbanization of *favelas* (shantytowns) and is expected to directly benefit 50,000 families.

The State government, local authorities and the federal government will invest approximately R\$1.3 billion in the program. We will fund this program with R\$355.0 million. The State Secretariat for Sanitation and Water Resources coordinates the program with our involvement and that of the Urban Development Company of São Paulo (*Companhia de Desenvolvimento Habitacional e Urbano*), or the CDHU, and local governments in the region.

As of December 31, 2011, R\$45.5 million have been invested in this program by us, of which R\$29.4 million were invested in 2011.

Clean Stream Program

The Clean Stream Program (*Programa Córrego Limpo*) is a partnership between the State, through us, and the municipality of São Paulo, and aims to clean and decontaminate urban streams in the city of São Paulo, by improving the sewage sanitary system, the elimination of sewage through streams and rainwater galleries, the cleaning of streams and stream borders, as well as the removal and relocation of properties located in riverbanks. As of December 31, 2011, approximately R\$129.5 million had been invested in this program and 103 urban streams had been decontaminated, benefiting approximately 1.7 million people.

In 2012, we expect to decontaminate 45 additional urban streams, benefiting over 700 thousand people. The estimated capital expenditures for this program in 2012 is R\$36 million.

Regional Systems Investment Programs

We currently have a number of projects in progress and planned for the Regional systems, including projects relating to abstraction of water and collection, removal and final disposal of sewage. We invested R\$1,091.0 million, R\$943.7 million and R\$1,109.2 millions, in these projects in 2009, 2010 and 2011, respectively, and we have budgeted for additional capital expenditures of approximately R\$ 2.2 billion from 2012 through 2015.

Clean Wave Program

The main goals of the Clean Wave Program (*Programa Onda Limpa*) are to improve and expand the sewage systems in the municipalities comprising the Baixada Santista metropolitan region, increasing the sewage collection rate to 95.0%, and treating 100.0% of the collected sewage and thereby improving bathing water quality at 82 beaches in the region by 2013. On August 6, 2004, we entered into a credit agreement with the JBIC for the financing of this project, which is guaranteed by the Federative Republic of Brazil, for a total amount of R\$382.8 million. On October 1, 2008, the JICA incorporated the loan transactions of the JBIC. For further information on the agreement entered into with the JICA, see “Item 5.B. Liquidity and Capital Resources—Capital Sources.” As of December 31, 2011, we had invested approximately R\$1.6 billion in this program, R\$ 159.8 million of which during the year 2011. With the completion of construction of sewage treatment plants and installation of networks, we have prioritized the connection of costumers to the sewage collection system. Until the end of 2011, we had finished 63,000 connections of the total 123,000

expected.

Northern Coast Clean Wave Program

The Northern Coast Clean Wave Program (*Programa Onda Limpa Litoral Norte*) will expand the collection and treatment of sewage in the Northern coast of the State of São Paulo, intending to benefit 600 thousand people, including the local population as well as tourists that each year visit the region. By 2015, the program will increase the collection and treatment of sewage rate in the region from 36.0% to 85.0%, seeking to improve the health and well-being of the population, in addition to stimulating economic development through the increase in tourism in the region.

In 2011, we continued working on two sewage treatment plants in the city of São Sebastião and other sewage system projects in the cities of Ubatuba, Ilhabela and São Sebastião, which we expect to complete in 2013. Until 2011, R\$114.6 million had already been invested in this program, of which R\$ 24,6 million were invested in 2011.

31

Coastal Water Program

The Coastal Water Program (*Programa Água no Litoral*) is the main combination of long-term activities to expand water production capacity in the Baixada Santista metropolitan region and Southern Coast of the State of São Paulo. Almost three million people, including local population and tourists, are expected to benefit from this program. This program will enable us to increase the level of reliability of the systems, eliminating existing and potential deficiencies and irregularities in the water supply. It is also expected to permit us to expand our services to reach universal coverage in these regions, increase the availability of treated water and improve the quality of water available to the population. As of December 31, 2011, R\$472.7 million has been invested on this program and we expect to invest R\$1.1 billion in the program by 2013. The Mambu/Branco Water Production System is part of this program. It will increase water production to supply municipalities in the south of the Baixada Santista, increasing production from actual 0.6 cubic meter per second to 1.6 cubic meters per second. Additionally, the planned water treatment stations of Jurubatuba, Itú and Cubatão are also part of this program.

New Policies and Programs

Nossa Guarapiranga

In December 2011, we launched the Nossa Guarapiranga project, whose main objective is to recover water quality of the Guarapiranga basin, a water source for the São Paulo metropolitan region. We installed 11 drains to collect residue from rivers in the Guarapiranga basin. We plan to collect an average of 20 cubic meters of residue per day.

Pró-Conexão

In December 2011, the municipality of São Paulo approved a project to offer residences of low-income families subsidized connections to the sewage system. The project involves capital expenditure amounts of up to R\$349.5 million, 80% of which would be sustained by the government of the State of São Paulo, while 20% would be paid by us. We believe that this program will increase the efficiency of our sewage collection programs and help improve water quality of the region's rivers and basins, on top of improving the quality of life of low-income families.

We expect that the program will create 192 new thousand connections over the next 8 years and affect approximately 800 thousand people.

Water is Life

In November 2011, we created the program Water is Life which aims to provide sewage services to 41 low-income communities of non-urbanized areas of 20 municipalities in the regions of Alto Paranapanema and Vale do Ribeira. After installing the required infrastructure, an estimated capital expenditure of R\$6 million, we will be responsible for maintaining and operating the sewage systems to reach approximately 13 thousand people.

B. Business Overview

Our Operations

As of December 31, 2011, we provided water and sewage services to 363 municipalities in the State of São Paulo either under concession agreements, program agreements, under another form of legal arrangement or under no formal agreement. We also supply treated water on a wholesale basis to six municipalities located in the São Paulo metropolitan region and to the municipality of Sumaré. Pursuant to article 2 of our bylaws, our corporate purpose

includes the provision of water supply and sewage services, urban rain water management and drainage services, urban cleaning services and solid waste management services. In addition, our bylaws authorize us to carry out other related activities, including the planning, operation and maintenance of production systems, the storage, preservation and trading of energy, and the trading of services, products, benefits and rights that, directly or indirectly, result from our assets, projects and activities, and the right to operate a subsidiary anywhere in Brazil or abroad to provide the services mentioned above.

Because of the enactment of the Basic Sanitation Law, which regulates the basic sanitation industry in Brazil, we currently operate under two different contractual environments: (i) for the concession agreements that have already expired, we are currently renegotiating or will negotiate a new agreement that follows the terms and conditions of the Basic Sanitation Law, or program agreements; and (ii) for the concession agreements that have not expired, we will continue to operate under the terms and conditions of the previous concession agreements, except in circumstances where the Basic Sanitation Law is applicable even when the concession agreement is still valid. For further information on this topic, see “Government Regulation—Concessions—Public Consortia and Cooperation Agreement Law for Joint Management.”

The Basic Sanitation Law required water and sewage service providers, such as us, to execute a formal agreement by December 31, 2010 with every municipality to which they provide services without a valid legal and binding instrument. If we failed to enter into such formal agreements by December 31, 2010, the concessions would no longer be valid. As of December 31, 2011, 99 of our concessions were still in the process of regularization through the execution of formal agreements. See “3.D. Risks Factors—Risks Relating to Our Business—We cannot anticipate the effects that further developments of the Basic Sanitation Law and its interpretation will have on the basic sanitation industry in Brazil and on us” and “3.D. Risks Factors—Risks Relating to Our Business—We have not entered into formal agreements for the provision of water and sewage services with certain of the municipalities we serve, including municipalities in metropolitan regions, as required by the Basic Sanitation Law, and therefore we may not be able to enforce our rights to continue to provide services in these municipalities.”

Concessions

Pursuant to the Brazilian Constitution, the authority to develop public water and sewage systems is shared by the states and municipalities, with the municipalities having primary responsibility for providing water and sewage services to their residents. The Constitution of the State of São Paulo provides that the State shall assure the correct operation, necessary expansion and efficient administration of water and sewage services in the State of São Paulo by a company under its control.

According to the Basic Sanitation Law, existing concessions will remain in effect until payment of indemnification is made based on the valuation of investments. The Basic Sanitation Law provides that our new concession agreements be planned, supervised and regulated by the municipalities together with the State under a new model of associated management that will allow for better control, supervision, transparency and efficiency in the provision of public services.

As of December 31, 2011, we provided water and sewage services to 363 municipalities. Substantially all of these concessions have 30-year terms. Due to court orders, we temporarily suspended our services in five other municipalities (Araçoiaba da Serra, Cajobi, Iperó, Álvares Florence and Macatuba), that as of December 31, 2011 accounted for less than 0.1% of our gross revenues. In January 2011, we resumed the provision of our services to the municipality of Tarumã that had been previously suspended by a court order. For more information, see “Item 8.A. Financial Information—Consolidated Statements and Other Financial Information—Legal Proceedings—Concession-Related Legal Proceedings.” Between January 1, 2007 and December 31, 2011, we entered into contracts with 225 municipalities (including our services agreement with the city of São Paulo) in accordance with the Basic Sanitation Law, of which 25, were entered into in 2011. In addition to the contracts that have 30-year terms, the municipalities entered into cooperation contracts with the State of São Paulo, delegating the regulation and monitoring of the provision of services to the ARSESP. As of December 31, 2011, 99 of our concessions had expired and we have been in negotiation with these municipalities to execute program agreements to substitute the expired concessions. From January 1, 2012 through 2033, 39 concessions will expire. Despite these 99 concessions having expired in 2011, we are renegotiating them and we were continuing to provide water and sewage services to all 99 municipalities as of December 31, 2011. We have entered into an agreement with the State and city of São Paulo for the provision of water and sewage services in the city of São Paulo for a 30-year term expiring in June 2040, which in the year ended December 31, 2011 accounted for 51.4% of our gross revenues from sales and services (including revenues relating to the construction of concession infrastructure).

In February 2006, we created a new division to manage the renewal of expiring concessions. The main responsibility of this division, which reported directly to the Chief Executive Officer, was to renew and thus maintain the existing base of municipalities that we operate and formalize contracts under the new model of associated management. Following the increase in the demand for regulatory work, this division shifted its focus to regulatory matters and its

main roles currently involve centralizing communication with the regulatory agencies, driving business to the new regulatory regime and proposing matters in which we have an interest to the ARSESP.

In April 2011, we created a specific area in our Financial Economic and Investor Relations Office responsible for costs and tariffs, given the subject's importance to the continuation of our business. We also created a statutory Regulatory Affairs Committee. The committee is composed of our Chief Executive Officer, our Chief Financial and Investor Relations Officer, our Metropolitan Officer and our Regional System Officer and is responsible for defining the guidelines, strategies and regulatory recommendations for our Company and coordinating the work of the Regulatory Affairs Department.

The current concessions are based on a standard form of agreement between us and the relevant municipality. Each agreement received the prior approval of the legislative council of each municipality. The assets comprising the existing municipal water and sewage systems are transferred from the municipality to us in order for us to provide the contracted services. Until 1998, we acquired municipal concessions and the existing water and sewage assets in exchange for our common shares issued at book value. Since 1998, we have acquired concessions and water and sewage assets by paying the municipality an amount equal to the present value of 30 years of estimated cash flows, assuming at least 12% certain discount factor to us, from the concession being acquired. For reference purposes, the discount rate adopted in concession contracts was set by the ARSESP in 2011 at 8.6%.

The main provisions of the existing concession agreements are as follows:

- § we assume all responsibility for providing water and sewage services in the municipality;
- § according to the municipal laws authorizing the concession, we could collect tariffs for our services without prior authorization of the municipality. Tariff readjustments follow the guidelines established by the Basic Sanitation Law and the ARSESP;
- § as a general rule, to date, we are exempt from municipal taxes, and no royalty is payable to the municipality with respect to the concession;
- § we are granted rights of way on municipal property for the installation of water pipes and mains, and sewage lines; and
- § upon termination of the concession, for any reason, we are required to return the assets comprising the municipality's water and sewage system to the municipality and the municipality is required to pay us the non-amortized value of the assets, considered intangible since January 2008, relating to the concession. See Note 2.12 to our financial statements.

Under the concession agreements executed prior to 1998, the reimbursement for the assets may be through payment of either:

- § the book value of the assets; or
- § the market value of the assets as determined by a third-party appraiser in accordance with the terms of the specific agreement.

Since 1998, contracts that we have entered into with municipalities for the provision of sanitation services have been regulated by the Federal Concessions Law No. 8,987/1995. Generally, these contracts have a 30-year term, and the total value of the concession is set by the discounted cash flow method. Under this method, when the expected contractual cash flow is reached, the total value of the concession and assets is amortized to zero on our books and we receive no payment for the assets. If the concession is terminated prior to the end of the 30-year term, thereby interrupting the normal contractual cash flow, we are paid an amount equal to the present value of the expected cash flow over the years remaining in the concession, adjusted for inflation.

Federal Law No. 11,107, or the Federal Public Consortia and Cooperation Agreement Law, established the legal basis for the administration of public service contracts, giving municipalities responsible for sanitation services greater rights and obligations and setting out more clearly the provision of services and the responsibilities of the parties.

New agreements entered into following the expiry of concession agreements under the previous law will follow this new model. See “—Government Regulation—Concessions—Public Consortia and Cooperation Agreement Law for Joint Management.”

Our new agreement model follows the provisions of the Basic Sanitation Law. The main contractual provisions, among others, are joint execution of responsibilities related to planning, supervision and regulation of services and appointment of regulatory authority of services and periodic disclosure of accounts.

Furthermore, the economic and financial formulas in new agreements must be based on the discounted cash flow methodology and on the revaluation of returnable assets. Pursuant to the Basic Sanitation Law, our own preexisting assets will be returnable assets, but we will carry out all new investments and the municipalities will record them as assets. The municipalities will then transfer possession of these assets to us for our use and management and will also record a credit in the same amount of the assets recorded in our favor. According to Article 42 of the Basic Sanitation Law and the new agreement model, investments made during the contractual period are the property of the applicable municipality, which in turn generates receivables for us that are to be recovered through the operation of the services. These receivables may also be used as guarantees in funding operations.

Another important development was that the new agreement model includes exemptions from municipal taxes applicable on our operational areas and the possibility of the revaluation of our assets that existed prior to the execution of the program agreements in cases involving the early resumption of services by the concession authority.

Municipalities have the inherent power under Brazilian law to terminate concessions prior to their contractual expiration dates for reasons of public interest. The municipalities of Diadema and Mauá, two municipalities we previously served, terminated our concessions in February 1995 and December 1995, respectively. The municipality of Mauá terminated our concession with our consent. The municipality of Diadema had terminated our concession without our consent after asserting that we did not provide adequate water and sewage services. In 2011, the municipality of Diadema agreed with us to develop a share infrastructure for the provision of water and sewage services through a mixed-capital company called *Companhia de Água e Esgoto de Diadema*, or CAED. We are not yet able to predict when CAED will begin operations. Despite these developments, we currently serve the municipalities of Diadema and Mauá through the supply of water on a wholesale basis. The indemnities receivables related to the municipality of Mauá totaled R\$ 85.9 million are not being recognized in the financial statements due to the uncertainties in the collection. For further information on the lawsuits that arose out of these developments, see “Item 8.A. Financial Information—Consolidated Statements and Other Financial Information—Legal Proceedings.”

We currently do not anticipate that other municipalities will seek to terminate concessions due to our close relationship with municipal governments, recent improvements in the water and sewage services we provide, and the obligation of the municipality to repay us for the return of the concession as described above. However, we cannot be certain that other municipalities will not seek to terminate their concessions in the future. See “Item 3.D. Risk Factors—Risks Relating to Our Business—Municipalities may, under certain circumstances, terminate our concessions before their expiration and the indemnification may be inadequate to recover the full value of our investments.”

In addition, there is currently ongoing litigation with respect to municipalities that intend to expropriate our water and sewage systems, or to terminate concession agreements before paying us any indemnification. For a detailed discussion on these proceedings, see “Item 8.A. Financial Information—Consolidated Statements and Other Financial Information—Legal Proceedings—Concession-Related Legal Proceedings.”

Operations in the City of São Paulo and Certain Metropolitan Regions

As of December 31, 2011, 99 concessions had expired which jointly accounted for 23.8% of our gross revenues. We entered into 25 agreements in the year ended December 31, 2011, bringing the total number of program agreements entered into between 2007 and 2011 to 225. These 25 new agreements accounted for 2.9% of our total revenues and 3.3% of our intangible assets as of December 31, 2011.

The Basic Sanitation Law provides that, in case of termination of the relationship with the aforementioned municipalities, the municipalities should pay us an indemnity, in an amount to be appraised, notwithstanding the non-existence of a concession agreement.

On June 23, 2010, the State and the city of São Paulo entered into a convention with the intermediation and consent of our Company and of the ARSESP pursuant to which they agreed to jointly manage the planning of and investment in the basic sanitation system of the city of São Paulo, among other things. This agreement established that the State and the city of São Paulo would enter into an agreement with us, granting us exclusive rights in the provision of water and sewage services in the city of São Paulo. In addition, the agreement established the role of the ARSESP in regulating and overseeing our activities and established a management committee that will be responsible for planning the water and sewage services and for reviewing our investment plans. The management committee will be composed of six members appointed for two year terms. The State and the city of São Paulo will have the right to appoint three

members each. We are permitted to participate in the meetings of the management committee; however, we are not afforded any voting rights.

35

On June 23, 2010, we entered into a formal agreement with the State and the city of São Paulo to regulate the provision of water and sewage services in the city of São Paulo for a 30-year period, which may be extended for an additional 30-year period. The Municipal Law No. 14,934/2009 authorized the city of São Paulo to enter into an agreement with us. The agreement establishes, among other things, how specific amounts of gross revenues from the services we render should be allocated (after deduction of COFINS and PASEP). This agreement requires, among other things, (i) to invest at least 13.0% of the gross revenues from sales and services we obtain from the municipality of São Paulo, net of taxes on revenues in the improvement of water and sewage infrastructure in the city of São Paulo; (ii) that our investment plan must be compatible with the activities and programs included in the sanitation plan of the State, the sanitation plan of the city of São Paulo and, if necessary, the sanitation plan of the metropolitan region of São Paulo; and (iii) that we contribute 7.5% of the gross revenues we obtain from this agreement to the São Paulo Municipal Sanitation Fund. The investment plan under this agreement is not irrevocable and will be reviewed by our management committee every four years, especially with regards to investments to be executed in the subsequent period. In addition, the agreement provides that the ARSESP will ensure that the tariffs charged (a) will adequately compensate us for the services we provide and (b) can be adjusted to restore the original balance between each party's obligation and economic gain (*equilíbrio econômico financeiro*). Finally, the agreement envisages the remuneration of the net assets in operation, calculated preferably through asset valuation or by the monetarily updated book value, to be established by the ARSESP. The agreement also foresees the remuneration of the investments to be made by us, such that there will be no residual value at the end of the contract period. We currently have an investment plan in place that consider these obligations and also addresses the compatibility with the activities and programs included in the sanitation plan of the State and of the municipality of São Paulo and, if necessary, the plan of the metropolitan region of São Paulo.

Wholesale Operations

Water Services on a Wholesale Basis

We provide water services on a wholesale basis to six municipalities located in the São Paulo metropolitan region (Diadema, Mauá, Santo André, São Caetano do Sul, Guarulhos and Mogi das Cruzes) and to the municipality of Sumaré. The agreements to provide water services on a wholesale basis must comply with the Basic Sanitation Law, which regulates the stages of the provision of each service, designating them as interdependent activities whose provision requires the supervision of an independent agency, a specific registration for the activities' cost and assurance of payment among the several service providers in order to continue the provision of the services, in accordance with the rules to be published by the ARSESP. Our agreements currently comply with the provisions of the Basic Sanitation Law. In 2011, the revenues from these services were R\$203.5 million.

We are currently negotiating with the city of Diadema so as to liquidate the outstanding debts owed by Diadema and Saned to us. For further information on this outstanding debt, see Note 9 to our consolidated financial statements included elsewhere in this annual report.

Sewage Services on a Wholesale Basis

We provide sewage services on a wholesale basis to the municipalities of Mogi das Cruzes, Santo André, São Caetano, Mauá and Diadema. The negotiation of the agreement for the provision of sewage services on a wholesale basis with the municipality of Santo André had the intervention of the Public Prosecution Office, and in other municipalities the negotiation of the agreements was a result of our efforts concerning the environment and the awareness of the municipal public authorities regarding to environmental issues. Through these agreements, in 2011 we treated about 27.2 million cubic meters of sewage from these municipalities. This is an example of our social-environmental responsibility actions and our commitment to these actions. In 2011, the revenues from sewage

services on a wholesale basis were R\$21.1 million.

In December 2008, we entered into a five-year agreement for the collection and treatment of 20.0% of the sewage generated by the city of Guarulhos. Due to the complexity of the construction works related to the provision of these services, we have not yet started to provide the sewage services to the city of Guarulhos.

Description of Our Activities

As set forth in Article 2 of our bylaws, our corporate purpose is to render basic sanitation services with the goal of providing basic sanitation services to the entire population in the municipalities where we conduct our activities without harming our long-term financial sustainability. Our activities comprise water supply, sanitary sewage services, urban rainwater management and drainage services, urban cleaning services, solid waste management services and related activities, including the planning, operation, maintenance and commercialization of energy, and the commercialization of services, products, benefits and rights that directly or indirectly arise from our assets, operations and activities. We are allowed to act in a subsidiary form in other Brazilian locations and abroad. See “—Government Regulation—Concessions—Public Consortia and Cooperation Agreement Law for Joint Management.”

36

We set forth below a description of our activities.

Water Operations

Our supply of water to our customers generally involves abstraction of water from various sources, subsequent treatment and distribution to our customers' premises. In 2011, we produced approximately 2,992.0 million cubic meters of water. The São Paulo metropolitan region (including the municipalities to which we supply water on a wholesale basis) currently is, and has historically been, our core market, accounting for approximately 71% of water invoiced by volume in 2011.

The following table sets forth the volume of water that we produced and invoiced for the periods indicated.

	Year ended December 31,		
	2009	2010	2011
	<i>(in millions of cubic meters)</i>		
Produced:			
São Paulo metropolitan region	2,091.7	2,164.4	2,182.8
Regional systems	753.2	787.9	809.2
Total	2,844.9	2,952.3	2,992.0
Invoiced:			
São Paulo metropolitan region	1,083.9	1,119.2	1,150.6
Wholesale	288.0	293.3	297.3
Regional systems	546.1	579.5	596.8
Reused water	0.8	0.3	0.3
Total	1,918.8	1,992.3	2,045.0

The difference between the volume of water produced and the volume of water invoiced generally represents both physical and non-physical water losses. See “—Water Losses.” In addition, we do not invoice:

- § water discharged for periodic maintenance of water mains and water storage tanks;
- § water supplied for municipal uses such as firefighting;
- § water consumed in our own facilities; and
- § estimated water losses associated with water we supply to *favelas* (shantytowns).

Seasonality

Although seasonality does not affect our results in a significant way, in general, higher water demand is observed during the summer and lower water demand during the winter. The summer coincides with the rainy season, while the winter corresponds to the dry season. The demand in the coastal region is increased by tourism, with the greatest demand occurring during the Brazilian summer holiday months.

Water Resources

We can abstract water only to the extent permitted by DAEE pursuant to water usage rights granted by it. Depending on the geographic location of the river basin or if the river crosses more than one state (federal domain), the approval of the National Water Agency (*Agência Nacional de Águas*), or ANA, a federal agency under the Ministry of the Environment is required. We currently abstract substantially all of our water supply from rivers and reservoirs, with a small portion being abstracted from groundwater. Our reservoirs are filled by impounding water from rivers and streams, by diverting the flow from nearby rivers, or by a combination of both methods.

In order to supply water to the São Paulo metropolitan region, we rely on 20 reservoirs of non-treated water and 192 reservoirs of treated water, which are located in the areas under the influence of the eight water producing systems comprising the interconnected water system of the São Paulo metropolitan region. The capacity of the water sources available for treatment in this area is 72 cubic meters per second. Total current installed capacity is 72.7 cubic meters per second, which can be treated from the interconnected water system of the São Paulo metropolitan region. Average verified production during 2011 on the interconnected water system of the São Paulo metropolitan region was 67.9 cubic meters per second. The Cantareira, Guarapiranga and Alto Tietê systems, as a whole, supplied 84.1% of the water we produced for the São Paulo metropolitan region in 2011.

In 2011, the Cantareira system accounted for 46.4% of the water that we supplied to the São Paulo metropolitan region (including the municipalities to which we supplied water on a wholesale basis), which represented 73.9% of our gross revenues from sales and services (excluding revenues relating to the construction of concession infrastructure) for the year. The authorization (*outorga*) for the Cantareira system to use the water in the Piracicaba water basin was renewed on August 6, 2004, for a ten-year period.

Water basin committees are authorized to charge both for water usage and the dumping sewage into water bodies. Since February 2003, we have been incurring expenses in connection with the use of water from the Paraíba do Sul river basin and, since January 2006, from the Piracicaba, Capivari and Jundiá river basins. At the end of 2010, we started to incur expenses in connection with the use of water from the Sorocaba and Médio Tietê river basins. In 2012 we may start to incur expenses in connection with the use of water from the Alto Tietê basin, where the São Paulo metropolitan region is located and from Baixada Santista, Baixo Tietê, Tietê/Jacaré and Tietê/Batalha river basins. The ARSESP has adjusted our tariffs according to the formula that we have used since 2003. According to the formula, “non-controllable” costs, such as costs related to water use, are passed on to our customers through our tariffs. Although we expect to continue to pass on these expenses to our customers through our tariffs, we are uncertain as to whether the river basin committees will change the terms of the charges currently applied and whether we will be able to pass on these costs to our customers. For more information on water usage regulation, see “—Water Usage.”

The following table sets forth the water production systems from which we produce water for the São Paulo metropolitan region:

Water production system:	Production Rate(1)	
	2010	2011
	<i>(in cubic meters per second)</i>	
Cantareira	32.7	31.5
Guarapiranga	13.0	12.6
Alto Tietê	10.9	13.0
Rio Claro	3.9	4.0
Rio Grande (Billings reservoir)	4.8	4.6
Alto Cotia	1.1	1.2
Baixo Cotia	0.8	0.9
Ribeirão da Estiva	0.1	0.1
Total	67.3	67.9

(1) Average of the twelve months ended December 31, 2010 and 2011.

We own all of the reservoirs in our production systems other than the Guarapiranga and Billings reservoirs and a portion of some of the reservoirs of the Alto Tietê system, which is owned by other companies controlled by the State. We currently do not pay any charges with respect to the use of these reservoirs. In December 2001, we entered into an agreement with the State whereby the State, among other things, agreed to transfer the remaining reservoirs in the Alto Tietê system to us. We accepted, on a temporary basis, the reservoirs in the Alto Tietê System as part of the payment until the State transfers the property rights with respect to the reservoirs to us. We are unable to predict whether and when these reservoirs will be transferred to us because the Public Prosecution Office of the State of São Paulo filed a civil public action alleging that a transfer to us of ownership of the Alto Tietê System reservoirs is illegal. See “Item 3.D. Risk Factors—Risks Relating to Our Control by the State of São Paulo—We may be required to

acquire reservoirs that we use and that are owned by a State-controlled company, or we may be required to pay substantial charges to the owner with respect to our use of these reservoirs.”

In January 2009, we began operating, monitoring and maintaining the reservoirs in the Alto Tietê system, formed by the Ponte Nova, Paraitinga, Biritiba, Jundiaí and Taiaçupeba reservoirs. See “Item 8.A. Financial Information—Consolidated Statements and Other Financial Information—Legal Proceedings—Other Legal Proceedings.”

In the cities of the countryside region, our principal source of water consists of surface water from nearby rivers and from wells. The coastal region is provided with water principally by surface water from rivers and mountain springs.

Statewide, we estimate that we are able to supply nearly all of the demand for water in all of the areas where we operate, subject to droughts and extraordinary climate events. We were able to meet the demand for water in the São Paulo metropolitan region, primarily as a result of our water conservation program, reductions in water losses, and the installation of new water connections. We installed 201,000, 189,400 and 207,900 new water connections in 2009, 2010 and 2011, respectively.

The interconnected water system of the São Paulo metropolitan region services 30 municipalities, of which 24 are operated directly by us under this system. Through this system, we serve the other six municipalities on a wholesale basis, and the distribution is made by other companies or departments related to each municipality.

In order to reach the final customer, the water is stored and transported through a complex and interconnected system. This water system requires permanent operational supervision, engineering inspection, maintenance, and quality monitoring and measurement control.

To ensure the continued provision of regular water supply in the São Paulo metropolitan region, we intend to invest R\$1.3 billion from 2012 to 2015 to increase our water production and distribution capacities as well as to improve the water supply systems. In 2011, our total investment in water supply systems amounted to R\$633.2 million.

Water Treatment

We treat all water at our water treatment facilities prior to placing it into our water distribution network. We operate 213 treatment facilities, of which the eight largest, located in the São Paulo metropolitan region, accounts for approximately 70% of all water we produced in 2011. The type of treatment used depends on the nature of the source and quality of the untreated water. Water abstracted from rivers requires extensive treatment, while water drawn from groundwater sources requires less treatment. All water treated by us also receives fluoridation treatment.

Water Distribution

We distribute water through our own networks of water pipes and mains, ranging in size from 2.5 meters to 100 millimeters in diameter. Storage tanks and pumping stations regulate the volume of water flowing through the networks to maintain adequate pressure and continuous water supply. The following table sets forth the total number of kilometers of water pipes and mains and the number of connections in our network as of the dates indicated.

	As of December 31,		
	2009	2010	2011
Water distribution pipes and mains (in kilometers)	63,732	65,379	66,389
Number of connections (in thousands)	7,118	7,295	7,461

More than 90.0% of the water pipes in our water distribution network are made of cast iron or polyvinylchloride, or PVC. Distribution pipes at customers' residences typically are made from high-density polyethylene tubing. Our water mains are mostly made of steel, cast iron or concrete.

As of December 31 2011, our water distribution pipes and mains included: (i) 33,997 kilometers in the São Paulo metropolitan region; and (ii) 32,392 kilometers in the Regional systems.

As of December 31, 2011, we had 384 storage tanks in the São Paulo metropolitan region with a total capacity of 1.8 million cubic meters, and 1,782 storage tanks in the Regional systems. As of that date, we had 124 treated water pumping stations in the São Paulo metropolitan region aqueduct system, including stations at treatment facilities, intermediate trunk transfer pumping stations and small booster stations serving local areas.

Water mains that require maintenance are cleaned and their lining is replaced. We are typically notified of water main fractures or breaks by the public through a toll-free number maintained by us. We consider the condition of the water

pipes and mains in the São Paulo metropolitan region to be adequate as of the date of this annual report. Due to age, external factors such as traffic, the dense population, and commercial and industrial development, water pipes and mains in the São Paulo metropolitan region are somewhat more susceptible to degradation than those in the Regional systems. To counter these effects, we have a maintenance program in place for water pipes and mains that is intended to address anticipated fractures and clogs due to brittleness and encrustation, and to help ensure water quality in the region. The new customers are responsible for covering the part of the costs of connecting to our water distribution network that are related to the connecting of customers water pipes that are more than 20 meters away from the water mains. Thereafter, the customer must cover the costs of connecting to the network from the customer's premises, including costs of purchasing and installing the water meter and related labor costs. We perform the installation of the water meter and conduct periodical inspections and measurements. After completion of installation, the customer is responsible for the water meter.

The following table sets forth projected new water connections for the periods indicated.

	2012	2013	2014	2015	2016	2017	2018	2019	2012-2019
São Paulo metropolitan region	88	90	88	83	86	84	82	81	682
Regional systems	70	71	72	76	74	75	76	77	588
Total	158	161	160	156	160	159	158	158	1,270

Water Losses

The difference between the amount of water produced and the amount of water invoiced generally represents both physical and non physical water losses. Water loss percentage represents the quotient of (i) the difference between (a) the total amount of water produced by us less (b) the total amount of water invoiced by us to customers minus (c) the volume of water set out below that we exclude from our calculation of water losses, divided by (ii) the total amount of water produced by us. We exclude the following from our calculation of water losses: (i) water discharged for periodic maintenance of water mains and water storage tanks; (ii) water supplied for municipal uses such as firefighting; (iii) water we consume in our facilities; and (iv) estimated water losses associated with water we supply to *favelas* (shantytowns).

Since 2005, we have used a method of measuring our water losses based on worldwide market practice for the industry. According to this measurement method, average water losses are calculated by dividing (i) average annual water loss by (ii) the average number of active water connections multiplied by 366. The result of this calculation is the number of liters of water lost per connection per day.

Using this calculation method, as of December 31, 2011, we experienced 469 liters/connections per day of water losses in the São Paulo metropolitan region and 280 liters/connections per day in the Regional systems, averaging 394 liters/connections per day. We plan to reduce total water losses from 394 liters/connections per day to 211 liters/connection per day between 2011 and 2019. Over the same period, in terms of percentage, we intend to reduce total water losses from 25.6% to 13.0%, however, this goal will be revised based on the results reached so far and the expected reduction with the implementation of the corporate program for water loss reduction in the 2012-2019 period.

Our strategy to reduce water loss has two approaches:

- § reduction in the level of physical losses, which result mainly from leakage, primarily by replacing and repairing water mains and pipes, and installing probing and other equipment, including strategically located pressure-regulating valves; and
- § reduction of non-physical losses, which result primarily from the inaccuracy of our water meters installed at our customers' premises and at our water treatment facilities, and from clandestine and illegal use, by upgrading and replacing inaccurate water meters and expanding our anti-fraud personnel.

We are taking measures to decrease physical losses by reducing response time to fix leakages to less than 24 hours and by better monitoring non visible water mains fractures. Among other initiatives, we have adopted the following measures to reduce physical water losses:

- § the introduction of technically advanced valves to regulate water pressure throughout the water mains in order to maintain the appropriate water pressure to the downstream consumption needs each day. These valves are programmed to respond automatically to variations in demand. During peak usage, the flow of water in the pipes is at its highest point; however, when demand decreases, pressure builds up in the water mains and the resulting stress on the network can cause significant water loss through cracks and an increase in ruptures of the pipes. The technically advanced valves are equipped with probes programmed to feed data to the valve in order to reduce or increase pressure to the water mains as water usage fluctuates. As of December 31, 2011, we had installed 1,783 valves at strategic points in the network, with 1,055 valves being installed in the São Paulo metropolitan region and 728 in the Regional systems;
- § the reconfiguration of interconnected water distribution to permit the distribution of water at lower pressure;

- § the implementation of routine operational leak detection surveys in high water pressure areas to reduce overall water losses;
- § the monitoring of and improved accounting with respect to water connections, especially for large volume customers;
- § regular checking on inactive customers and monitoring non-residential customers that are accounted for as residential customers and, therefore, billed at a lower rate;
- § preventing fraud with the use of new, more sophisticated water meters that are more accurate and less prone to tampering;
- § installing water meters where none are present; and
- § conducting preventive maintenance of existing and newly installed water meters.

Water Quality

We believe that we supply high quality treated water that is consistent with standards set by Brazilian law, which are similar to the standards set in the United States of America and Europe. Pursuant to the Brazilian Ministry of Health (*Ministério da Saúde*) regulations, we have significant statutory obligations regarding the quality of treated water. These laws set certain standards that govern water quality.

In general, the State of São Paulo has excellent water quality from underground or superficial water sources. However, high rates of population growth, increased urbanization and disorganized occupation of some areas of the São Paulo metropolitan region has reduced the quantity and quality of water available to serve the population in the southern area of the São Paulo metropolitan region and in the coastal region. Currently, we successfully treat this water to make it potable. We also work to recover the quality of water of mains and invest in improvements of our treatment systems to ensure the quality and availability of water for the upcoming years.

Water quality is monitored at all stages of the distribution process, including at the water sources, water treatment facilities and on the distribution network. We have 15 regional laboratories, one central laboratory, and laboratories located in all water treatment facilities that monitor water quality, as required by our standards and those set by statute. Our laboratories analyze an average of 50,000 samples per month on distributed water, with samples collected from residences. Our central laboratory located in the city of São Paulo is responsible for organic compound analysis using the chromatographic and spectrometric methods, as well as heavy metals analysis by atomic absorption technique. All of our laboratories have obtained the ABNT NBR ISO 9001 certification and our central laboratory and 11 of our regional laboratories have obtained the ABNT NBR ISO IEC 17025 accreditation (accreditation for general requirements for the competence of testing and calibration laboratories) awarded by the National Institute of Metrology, Standardization and Industrial Quality (*Instituto Nacional de Metrologia, Normalização e Qualidade Industrial*), or the INMETRO.

All chemical products used for water treatment are analyzed and follow strict specifications set out in recommendations made by the National Health Foundation (*Fundação Nacional de Saúde*), or NHF, the Brazilian Association of Technical Rules (*Associação Brasileira de Normas Técnicas*), or the ABNT, and the American Water Works Association, or the AWWA, to eliminate toxic substances that are harmful to human health. From time to time, we face problems with the proliferation of algae, which may cause an unpleasant taste and odor in the water. In

order to mitigate this problem, we work on: (i) fighting algae growth at the water source and (ii) using advanced treatment processes at the water treatment facilities, which involve the use of powdered activated carbon and oxidation by potassium permanganate. The algae growth creates significant additional costs for water treatment because of the higher volumes of chemicals used to treat the water. In 2011, we did not detect significant algae growth.

We participate in the New Life Program which includes a Water Source Program (*Programa Mananciais*), together with other organizations engaged in the promotion of urban development and social inclusion to mitigate the pollution problem in the São Paulo metropolitan region. In addition, we also participate in the Clean Stream Program to clean up important streams in city of São Paulo. Other initiatives also aimed at improving the water quality in our water sources located in the metropolitan region of São Paulo are Guarapiranga and *Pró-Conexão*. See “—Capital Expenditure Program—Main Projects of Our Capital Expenditure Program—Metropolitan System Investment Program—New Life Program and Clean Stream Program.”

We believe that there are no material instances where our standards are not being met. However, we cannot be certain that future breaches of these standards will not occur.

41

Fluoridation

As required by Brazilian law, we have adopted a water fluoridation program designed to assist in the prevention of tooth decay among the population. Fluoridation primarily consists of adding fluorosilicic acid to water at 0.7 parts per million. We add fluoride to the water at our treatment facilities prior to its distribution into the water supply network.

Sewage Operations

We are responsible for the collection and removal of sewage through our sewage systems and for its subsequent disposal with or without prior treatment. As of December 31, 2011, we collected approximately 86% of all the sewage produced in the municipalities in which we operate in the São Paulo metropolitan region. In addition, during the year ended December 31, 2011, we collected approximately 71% of all the sewage produced in the municipalities in which we operate in the Regional systems. During 2011 we accounted for approximately 82% of all the sewage produced in the municipalities in which we operated in the State of São Paulo. We installed 184,900, 233,500 and 246,400 new sewage connections in 2009, 2010 and 2011, respectively.

Sewage System

The purpose of our sewage system is to collect and treat sewage and to adequately dispose of the treated sewage. As of December 31, 2011, we were responsible for the operation and maintenance of 45,073 kilometers of sewage lines, of which approximately 23,645 kilometers are located in the São Paulo metropolitan region and 21,428 kilometers are located in the Regional systems, respectively.

The following table sets forth the total number of kilometers of sewage lines and the total number of sewage connections in our network for the periods indicated.

	As of December 31,		
	2009	2010	2011
Sewage lines (in kilometers)	42,895	44,287	45,073
Sewage connections (in thousands)	5,520	5,718	5,921

Our sewage system comprises a number of systems built at different times and constructed primarily from clay pipes and, more recently, PVC tubing. Sewage lines larger than 0.5 meters in diameter are primarily made of concrete. Our sewage system is generally designed to operate by gravitational flow, although pumping stations are required in certain parts of the system to ensure the continuous flow of sewage. Where pumping stations are required, we use sewage lines made of cast iron.

The public sewage system operated by us was structured in order to receive industrial sewage and sewage from non-domestic sources for treatment together with domestic sewage. Industrial sewage has physical, chemical and/or biological characteristics that are qualitatively different from household effluents. As a result, the discharge of industrial sewage into the public sewage system is subject to compliance with specific legal demands with the purpose to protect the sewage collection and treatment systems, the health of operators and the environment. The current environmental legislation establishes standards for the discharge of these effluents into the public sewage system. These standards are defined in Article 19A of State Decree No. 8,468 dated September 8, 1976. To ensure compliance with legislation, periodic audits of the sewage produced by all industrial clients are conducted, and we

also request self-monitoring reports from non-domestic sewage-producing sources.

The discharge of these effluents into the public sewage system is based on technical and administrative procedures. Before the discharge is permitted, we carry out acceptance studies that assess the capacity of the public sewage system to receive the discharge as well as the compliance with regulations. Upon the conclusion of these studies, the technical and commercial conditions for receiving the discharge are established, which are then formalized in a document signed by us and the effluent producer. Failure to comply with these conditions can lead to the application of penalties and the obligation of the effluent producer to conduct the necessary adjustments in a given time frame. Non-compliance with these penalties and adjustments may ultimately result in the suspension of the connection and notification of the environmental protection agency (*Companhia Ambiental do Estado de São Paulo*), or the CETESB, in order for the applicable measures to be taken. Effluents from our treatment facilities must comply with effluent limitation guidelines and observe the water quality of the receiving water bodies established by federal and state legislation. Effluent limitation guidelines consist of a set of parameters that must be verified before the effluents are discharged into a water body. Water quality standards are based on the classification of water bodies, and take into account the current or expected use of water. These standards will become more rigorous according to the importance of the use of water.

42

We considered the condition of the sewage lines in the São Paulo metropolitan region to be adequate as of the date of this annual report. Due to greater volume of sewage collected, a higher population and more extensive commercial and industrial development, the sewage lines in the São Paulo metropolitan region are more deteriorated than those of the Regional systems. To counter the effects of deterioration, we maintain an ongoing program for the maintenance of sewage lines intended to address anticipated fractures arising from obstructions caused by system overloads.

Unlike the São Paulo metropolitan region, the countryside region does not generally suffer obstructions caused by sewage system overload. The coastal region, however, experiences obstructions in its sewage lines primarily due to infiltration of sand, especially during the rainy season in the summer months. In addition, the sewage coverage ratio in the coastal region is significantly lower than in the other regions served by us, with approximately 99% of all residences in the coastal region currently connected to our sewage network as of December 31, 2011.

New sewage connections are made on substantially the same basis as connections to water lines: we assume the cost of installation for the first 20 meters of sewage lines from the sewage network to all customers' sewage connections and the customer is responsible for the remaining costs.

The following table sets forth projected new sewage connections for the periods indicated.

	2012	2013	2014	2015	2016	2017	2018	2019	2012-2019
São Paulo metropolitan region	99	102	117	126	145	144	148	81	962
Regional systems	106	105	114	101	104	118	118	113	879
Total	205	207	231	227	249	262	266	194	1,841

Sewage Treatment and Disposal

In 2011, approximately 86% and 75% of the sewage we collected in the São Paulo metropolitan region and the Regional systems, respectively, or 82% of the sewage we collected in the State of São Paulo, was treated at our treatment facilities and afterwards discharged into receiving water bodies such as inland waters and the Atlantic Ocean, in accordance with applicable legislation. Our sewage treatment facilities have a limited capacity. Flows in excess of this capacity are discharged directly, untreated, to inland waters and the Atlantic Ocean. We currently operate 481 sewage treatment facilities and nine ocean outfalls.

We operate 490 activated sewage treatment facilities, of which the five largest, located in the São Paulo metropolitan region, have treatment capacity of approximately 18 cubic meters of sewage per second.

Sewage treatment in the Regional systems will vary according to the particularities of each area. In the countryside region, treatment consists largely of stabilization ponds where the organic matter is treated and discharged to receiving waters. There are 392 secondary treatment facilities in the countryside region that have treatment capacity of approximately 13.0 cubic meters of sewage per second.

The majority of sewage collected in the coastal region receives treatment and disinfection and is then discharged into rivers and into the Atlantic Ocean through our ocean outfalls. We have 75 sewage treatment facilities in the coastal region.

Our sewage collection system is currently not sufficiently extensive to transport all sewage collected by us to our treatment facilities. As a result, a portion of the sewage collected by us is discharged untreated into receiving waters. We are a party to a number of legal proceedings related to environmental matters. See “Item 8.A. Financial Information—Consolidated Statements and Other Financial Information—Legal Proceedings.” In addition, our capital expenditure program includes projects to increase the amount of sewage that we treat. See “Item 4.A. History and Development of the Company—Capital Expenditure Program” and “4.B Business Overview—Government Regulation—Environmental Regulation—Sewage Requirements.”

Sludge Disposal

In the São Paulo metropolitan region, the treatment process used by most treatment facilities is the activated sludge process, where there is a liquid phase and a solid phase which generates sludge. The activated sludge process was developed in England in 1914. It is widely used for the treatment of household and industrial sewage. The work consists of a system in which a biological mass grows, forms flakes, is continually re-circulated and put in contact with organic matter, always with the presence of oxygen (aerobic). The activated sludge process is strictly biological and aerobic, in which the raw sewage and the activated sludge are mixed, agitated and aerated in units known as secondary decanters where the solid part is separated from the treated wastewater. The settled sludge returns to the aeration tank or is removed for specific treatment.

Sludge removed from the primary and secondary treatment processes typically contains water and a very small proportion of solids. We use filter presses, belt presses and centrifugation machines to abstract the water from the sludge. In 2011, we produced 46,450 tons of sludge-dry base, of which 45,595 tons were discharged into landfills. The remaining portion of the sludge-dry base was used as fertilizer in forest and agriculture projects, fuel development and concrete manufacturing.

Sludge disposal must comply with State and Federal law requirements, such as Resolution No. 375 of August 29, 2006 of the CONAMA, Federal Law No. 12,305/2010, Federal Decree No. 7,404/2010, State Law No. 12,300/2006 and State Decree No. 54,645/2009.

Principal Markets in Which We Operate

As of December 31, 2011, we operated water and sewage systems in 363 of the 645 municipalities in the State of São Paulo. In addition, we currently supply water on a wholesale basis to six municipalities located in the São Paulo metropolitan region and the municipality of Sumaré with an urban population of approximately 3.7 million.

The following table provides a breakdown of gross revenues from water supply and sewage services by geographic market for the periods indicated.

	Year ended December 31,		
	2009	2010	2011
	<i>(in millions of R\$)</i>		
São Paulo metropolitan region	5,280.8	5,699.6	6,144.7
Regional systems	1,764.6	1,956.3	2,165.4
Total	7,045.4	7,655.9	8,310.1

The following table provides a breakdown of gross revenues from water supply and sewage services by category of activity for the periods indicated.

	Year ended December 31,		
	2009	2010	2011
	<i>(in millions of R\$)</i>		
Water supply	4,104.3	4,427.4	4,610.2
Sewage services	3,131.9	3,398.7	3,699.9
Adjustment to IFRS – revenue recognition (wholesale)	(190.8)	(170.2)	-
Total	7,045.4	7,655.9	8,310.1

Competition

We believe there are at least two reasons behind a possible increase in our participation in the domestic sanitation market. In the State of São Paulo, there are approximately 274 municipalities that operate their own water and sewage systems and that collectively have a population of approximately 13 million, or approximately 33% of the population

of the State of São Paulo, excluding the population of the municipalities to which we provide water services on a wholesale basis. Given our scale, we are well positioned to capture opportunities in these municipalities. In comparison to the companies providing water and sewage services outside the State of São Paulo, we believe we have technological advantages compared to other water and sewage services providers, which should result in our competitively advantageous position in regions outside the State of São Paulo.

The competition for municipal concessions arise mainly from the municipalities, as they may resume the water and sewage services that were granted to us and start providing these services directly to the local population. In this case, the municipal governments would be required to indemnify us for the unamortized portion of our investment. See “—Business Overview—Our Operations—Concessions.” In the past, municipal governments have terminated our concessions agreements before the expiration date. Furthermore, municipal governments have tried to expropriate our assets in an attempt to resume the provision of water and sewage services to local populations. See “Item 8.A. Financial Information—Consolidated Statements and Other Financial Information—Legal Proceedings.” We negotiate expired concession agreements and concession agreements to be expired with the municipalities in an attempt to maintain our existing areas of operations. In the State of São Paulo we face competition from private and municipal water and sewage service providers.

In recent years, we have also experienced an increasing level of competition in the market of water supply to large customers. Several large industrial customers located in municipalities served by us use their own wells to supply themselves with water. In addition, competition for the disposal of non-residential, commercial and industrial sludge in the São Paulo metropolitan region has increased in recent years as private companies offer stand-alone solutions inside the facilities of their customers. We have also established new tariff schedules for commercial and industrial customers in order to assist us in retaining these customers. For this group of customers, we have a special authorization from ARSESP to establish different tariff than the ones that agency establishes for regular consumers.

Billing Procedures

The procedure for billing and payment of our water and sewage services is basically the same for all customer categories. Water and sewage bills are based upon water usage determined by monthly water meter readings. Larger customers, however, have their meters read every 15 days to avoid non-physical losses resulting from faulty water meters. Sewage billing is included as part of the water bill and is based on the water meter reading.

The most part of the bills for water and sewage services are delivered to our customers in person, mainly through one of our employees or through independent contractors who are also responsible for reading water meters. The remainder, by judicial determination, is sent by mail. Water and sewage bills can be paid at some banks and other locations in the State of São Paulo. These funds are paid over to us after deducting average banking fees ranging from R\$0.29 to R\$1.15 per transaction for collection and remittance of these payments.

Customers must pay their water and sewage bills by the due date if they wish to avoid paying a fine. We generally charge a penalty fee and interest on late bill payments. In 2009, 2010 and 2011, we received payment of 94.7%, 95.5% and 94.8%, respectively, of the amount billed to our retail customers, and 93.9%, 95.5% and 94.7%, respectively, of the amount billed to those customers other than State entities, within 30 days after the due date. In 2009, 2010 and 2011, we received 110.1%, 97.1% and 96.0%, respectively, of the amount billed to the State entities. Amounts in excess of 100.0% reflect our recovery of amounts billed in prior years. With respect to wholesale supply, in 2009, 2010 and 2011, we received payment of 68.7%, 58.3% and 54.7%, respectively, of the amount billed within 30 days.

We monitor water meter readings by use of hand-held computers and transmitters. The system allows the meter reader to input the gauge levels on the meters into the computer and automatically print the bill for the customer. The hand-held computer tracks water consumption usage at each metered location and prepares bills based on actual meter readings. Part of the water meter monitoring for billing purposes is carried out by our own personnel, trained and supervised by us and part of it is carried out by third-party contractors that employ and train their own personnel whose training we supervise.

Tariffs

Tariff adjustments follow the guidelines established by the Basic Sanitation Law and the ARSESP. The guidelines also establish procedural steps and the terms for the annual adjustments. The adjustments have to be announced 30 days prior to the effective date of the new tariffs which occur in September, and last for a period of at least 12 months.

Tariffs have historically been adjusted once a year and for periods of at least 12 months. We increased our tariffs for water and sewage services by 6.8%, 9.0% and 6.7% in August 2004, 2005 and 2006, respectively. On September 2007, tariffs rose by 4.12%, except for water supply and sewage collection tariffs for consumption of more than 20 cubic meters in non-residential categories, which were adjusted by the cumulative inflation from August 2006

to July 2007 in the consumer price index (*Índice Nacional de Preços ao Consumidor Amplo*), or IPCA, index published by IBGE, which came to 3.74%.

See “—Government Regulation—Tariff Regulation in the State of São Paulo” for additional information regarding our tariffs.

With the publication of the Basic Sanitation Law, the regulation of basic sanitation services, including tariff regulation, became the responsibility of an independent regulator. To exercise this assignment, the State of São Paulo created the ARSESP, which regulates and supervises the services we provide to the State and also within the municipalities that have agreed to its jurisdiction through a cooperation agreement entered into by that municipality.

45

In regards to municipalities that have not explicitly selected the ARSESP as their regulator, the Basic Sanitation Law admits the possibility of that municipality creating other regulatory agencies of their own. In 2007, the municipality of Lins decided to create its own regulatory authority, although having revised this decision in 2010, transferring to ARSESP the regulation of the water activities performed in Lins, including for the setting of tariffs. The municipality of Lins has reserved, however, the power to ultimately approve the tariff set by the ARSESP. In 2011, the municipalities in which the hydrographic basins of the rivers Piracicaba, Capivari and Jundiaí are located have created a consortium for regulation and supervision of our activities in that area. See " Government Regulation—Tariff Regulation in the State of São Paulo " for additional information.

As of the date of this annual report, the ARSESP applied the adjustment formula for our tariffs that we established on August 29, 2003. This adjustment was developed to better reflect changes in our cost structure. According to this formula, the cost components of the Tariffs Adjustment Index, or IRT, are separated into two parts ("Part A" and "Part B"), where "Part A" encompasses all costs related to energy, water and sewage treatment materials; federal, state and local taxes; and financial compensation due to use of water resources. "Part B" encompasses all other costs and expenses. "Part B" relates to the difference between the gross operating revenue and the value of "Part A" for the same period. The adjustment of "Part A" is based on the effective cost variation observed in its components during the preceding 12-month period. "Part B" is adjusted by the IPCA index. The adjustment to the formula used by the ARSESP replaced the variable gross operating revenue for the variable cost of reference.

In September 2008, we adjusted our tariffs by 5.10% pursuant to the ARSESP's authorization. In August 2009, the ARSESP approved a 4.43% adjustment for our water and sewage tariffs, starting on September 11, 2009. In August 2010, the ARSESP approved a 4.05% adjustment for our water and sewage tariffs, starting on September 11, 2010. In 2011, we readjusted our prices in 6.83%, starting on September 11, 2011. This adjustment was valid for all municipalities served by us, except for the municipalities of São Bernardo do Campo, Lins and Magda, which have different rules and readjustment dates. The tariffs in the municipality of São Bernardo do Campo are adjusted pursuant a different methodology due to the difference between the tariffs charged in that municipality when we assumed the service and the tariffs we were charging in other metropolitan municipalities we serve. The adjustments in São Bernardo do Campo are set so that in September 2012 the tariff charged in this municipality and the tariff charged in the other municipalities of the region will be the same. With respect to the municipality of Lins, our tariff is adjusted in January according to the variation of the IPCA for the last twelve-month period ended November 30. In regards to Magda, adjustments are expected to be made by 2015.

Until the new tariff structure we propose is approved by the ARSESP, we will continue to use our current tariff structure. As such, we currently divide tariffs into two categories: residential and non-residential. The residential category is subdivided into standard residential, residential social and *favela* (shantytowns). The residential social tariffs apply to residences of low-income families, residences of persons unemployed for up to 12 months and collective living residences. The *favela* tariffs apply to residences in shantytowns characterized by a lack of urban infrastructure. The latter two sub-categories were instituted to assist lower-income customers by providing lower tariffs for consumption. The non-residential category consists of: (i) commercial, industrial and public customers; (ii) "not-for-profit" entities that pay 50.0% of the prevailing non-residential tariff; (iii) government entities that have entered into a water loss reduction agreement with us and pay 75.0% of the prevailing non-residential tariff; and (iv) public entities that have entered into program agreements, for municipalities with a population of up to 30,000 and with half or more classified according to their degree of social vulnerability by the Social Vulnerability Index of São Paulo (*Índice Paulista de Vulnerabilidade Social*), or IPVS, 5 and 6, of the SEADE, obtained through the analysis of the 2000 Census figures, and start to receive tariff benefits, in accordance with our normative ruling, for the category of public use, at the municipality level. The tariffs are equal to those offered to the commercial/entity of social assistance and that corresponds to 50.0% of the public tariffs without contractual provisions referred to in item (iv) above.

We established a new tariff schedule, effective May 2002, for commercial and industrial customers that consume at least 5,000 cubic meters of water per month and that enter into fixed demand agreements (take-or-pay) with us for at least one-year terms. In October 2007, the minimum volume for entering into these agreements was reduced from 5,000 cubic meters per month to 3,000 cubic meters per month. We believe this tariff schedule will help prevent our commercial and industrial customers from switching to the use of private wells. Since 2008, we have been authorized by the ARSESP to establish tariffs for non-residential customers, such as industrial and commercial customers, that consume more than 3,000 cubic meters per month, with a maximum tariff equal to the tariffs applicable to non-residential customers that consume more than 50 cubic meters per month. In 2010, the ARSESP authorized a reduction in the minimum volume of consumption for customers that enter into demand agreements with us to a minimum of 500 cubic meters per month.

We establish separate tariff schedules for our services in each of the São Paulo metropolitan regions and each of the countryside and coastal regions which comprise our Regional systems. Each tariff schedule incorporates regional cross-subsidies, taking into account the customers' type and volume of consumption. Tariffs paid by customers with high monthly water consumption rates exceed our costs of providing water service. We use the excess tariff billed to high-volume customers to compensate for the lower tariffs paid by low-volume customers. Similarly, tariffs for non-residential customers are established at levels that subsidize residential customers. In addition, the tariffs for the São Paulo metropolitan region generally are higher than tariffs in the countryside and coastal regions.

Sewage charges in each region are fixed and are based on the same volume of water charged. In the São Paulo metropolitan region and the coastal region, the sewage tariffs equal the water tariffs. In the countryside region, sewage tariffs are approximately 20.0% lower than water tariffs. Wholesale water rates are the same for all municipalities served. We also make available sewage treatment services to those municipalities in line with the applicable contracts and tariffs. In addition, various industrial customers pay an additional sewage charge, depending on the characteristics of the sewage they produce.

Each category and class of customer pays tariffs according to the volume of water consumed. The tariff paid by a certain category and class of customer increases progressively according to the increase in the volume of water consumed. The following table sets forth the water and sewage services tariffs by (i) customer category and class and (ii) volume of water consumed charged during the years and period stated in the São Paulo metropolitan region.

Customer Category Consumption	As of December 31,		
	2009 ⁽²⁾	2010 ⁽³⁾	2011 ⁽⁴⁾
Residential			
Standard Residential:			
0-10 ⁽¹⁾	1.36	1.42	1.52
11-20	2.13	1.22	2.37
21-50	5.32	5.54	5.92
Above 50	5.86	6.10	6.52
Social:			
0-10 ⁽¹⁾	0.46	0.48	0.51
11-20	0.80	0.83	0.89
21-30	2.82	2.93	3.13
31-50	4.03	4.19	4.48
Above 50	4.45	4.63	4.95
<i>Favela</i> (shantytown):			
0-10 ⁽¹⁾	0.35	0.37	0.39
11-20	0.40	0.42	0.45
21-30	1.33	1.38	1.47
31-50	4.03	4.19	4.48
Above 50	4.45	4.63	4.95
Non Residential			
Commercial/Industrial/Governmental:			
0-10 ⁽¹⁾	2.74	2.85	3.04
11-20	5.32	5.54	5.92
21-50	10.21	10.62	11.35

Above 50	10.63	11.06	11.82
Social Welfare Entities:			
0-10 ⁽¹⁾	1.37	1.42	1.52
11-20	2.67	2.78	2.97
21-50	5.13	5.34	5.70
Above 50	5.31	5.53	5.91
Government entities that employ the Rational Use of the Water Program (<i>Programa de Uso Racional da Água</i>), or PURA, with reduction agreement:			
0-10 ⁽¹⁾	2.05	2.14	2.28
11-20	3.99	4.15	4.43
21-50	7.67	7.98	8.53
Above 50	7.97	8.29	8.86

- (1) The minimum volume charged is for ten cubic meters per month.
- (2) From September 11, 2009 to September 10, 2010.
- (3) From September 11, 2010 to September 10, 2011.
- (4) Since September 11, 2011.

Both in 2010 and 2011, the average tariff calculated for the Regional systems was approximately 30% below the average tariff of the São Paulo metropolitan region.

Regarding the new tariff structure that ARSESP aims to implement, since 2008 it has been developing new concepts that might be included in the tariff structure and adjustment formula but it has so far regulated our tariff structure and adjustments according to the same structure and adjustment formula that we ordinarily follow.

On July 22, 2009, the ARSESP released a Technical Note (*Nota Técnica*) regarding the methodology for the tariff adjustment process and submitted it for public comments. On August 12, 2009, the ARSESP informed that the new methodology would not be applied for the 2009 adjustment. The ARSESP is currently working on the development and improvement of its new methodology and it expects to release a revised tariff structure and adjustments formula in 2012.

In March 2011, the ARSESP published the tariff review schedule and opened a public hearing for the proposed methodology for the calculation of the weighted average cost of capital (WACC). In May 2011, the ARSESP released a regulatory post-tax weighted average cost of capital of 8.06%. In October 2011, we presented to the ARSESP a detailed business plan that disclosed requested information regarding our income, expenses and capital expenditures, so that the ARSESP could set an adjustment formula for our tariffs. In January 2012, the ARSESP commenced a public consultation regarding our methodology for tariff revisions. The public consultation aims to: (i) set the initial framework for periodic tariff revisions for all municipalities we serve that are under the supervision of the ARSESP; (ii) discuss the criteria adopted to determine the cost of services, the tariff framework and the subsidies policy, among other issues; (iii) create a methodology, standards and procedures for future revisions and adjustments; and (iv) ensure the broad involvement of municipalities, concessionaires, consumers, investors and others.

In 2010, the ARSESP defined the rules to evaluate our asset base (Rule No. 156/2010). By August We have hired companies to conduct such an evaluation using this methodology and by August 2012, we will present to the ARSESP the evaluation of our asset base according to reposition cost and weighted by the respective usage ratio in accordance with ARSESP Rule No. 156/2010, on which our regulatory remuneration will be based. We will also present ARSESP with a detailed business plan that will serve as a basis for the final tariff methodology process to be released by the ARSESP in the near future. In September 2012, we expect to receive the ARSESP's preliminary average tariff proposal and the applicable efficiency gains factor that we will be required to include in the tariff structure proposal that the ARSESP will then request from us. By October 2012, we expect to be able to propose such tariff structure, and our preliminary average tariff, efficiency gains factor and tariff structure will then be submitted for public hearing. The ARSESP estimates that a final public hearing at which our preliminary average tariff, efficiency gains factor and tariff structure will be subjected to public scrutiny will be scheduled by November 2012. The aforementioned schedule may, however, suffer alterations or be subject to delays.

Marketing Channels

As of December 31, 2011, we were the concessionaire for the provision of water supply and collection, treatment and disposal of sewage services directly to end consumers for 363 municipalities of the State of São Paulo. We also supply water on a wholesale basis to six municipalities located in the São Paulo metropolitan region and the municipality of Sumaré. It is the responsibility of these municipalities to then distribute the water to end consumers. We provide sewage services to five of these municipalities. Because of our distribution infrastructure, end consumers to whom we offer water services on a wholesale basis cannot alternatively acquire such services directly from us. For more information on service concessions, see "4.B. Business Overview—Wholesale Operations."

Energy Consumption

Energy is essential to our operations, and as a result we are one of the largest users of energy in the State of São Paulo. In the year ended December 31, 2011, we used 1.76% of the total energy consumption in the State of São Paulo. To date, we have not experienced any major disruptions in energy supply. Any significant disruption of energy to us could have a material adverse effect on our business, financial condition, results of operations or prospects. See “Item 3.D. Risk Factors—Risks Relating to Our Business—We are exposed to risks associated with the provision of water and sewage services.”

48

Energy prices have a significant impact on our results of operations. An average increase in energy prices of 17.6% in 2003 negatively affected our results of operations in 2004. In 2011, 44% of our total energy consumption occurred within the “free market”, where we can more efficiently negotiate the supply of energy. This energy was provided by Companhia Energética São Paulo, or CESP, pursuant to a long-term contract expiring in October 2012. AES Tiête (39%) and Tractebel Energia S.A. (61%) have already been hired to provide these services for the remainder of 2012 and until 2015.

Insurance

We maintain insurance covering, among other things, fire or other damage to our property, office buildings and third-party liability. We also maintain insurance coverage for directors’ and officers’ liability (D&O insurance). We currently obtain our insurance policies by means of public bids involving major Brazilian and international insurance companies that operate in Brazil. As of December 31, 2011, we had paid a total aggregate amount of R\$9.3 million in premiums, covering R\$2.1 million on assets, third-party liabilities and D&O insurance. We do not have insurance coverage for business interruption risk because we do not believe that the high premiums for such insurance are justified by the low risk of major interruption of our activities. In addition, we do not have insurance coverage for liabilities arising from water contamination or other problems involving our water supply to customers and for environmental related liabilities and damages. We believe that we maintain insurance at levels customary in Brazil for our type of business.

Environmental Matters

Our environmental policy, which we revised in January 2008, established environmental management directives that allow us to become a contributing force to environmental sustainability and excellence. These directives are based on a systematic approach to the environment, which allow us to develop a plan that integrated economic, environmental and social dimensions of our work with sustainable use of natural resources.

In order to coordinate the environmental demands with the specific needs of the different places we operate, we have implemented 20 Environmental Management Centers (*Núcleos de Gestão Ambiental*), or NGAs. The NGAs are closely involved in operational matters, providing decision-making support at a local level and seeking to ensure that environmental guidelines are respected throughout our organization. In this manner, they help contribute to the ongoing improvement of our environmental performance.

We have the following environmental management programs:

- § execution of a Environmental Management System, or EMS, and acquisition of ISO 14001 certification to our sewage and water treatment facilities. We received the certifications for 50 sewage treatment facilities, including those located in the São Paulo metropolitan, countryside and coastal regions. 65 of our water treatment facilities and sewage treatment facilities have implemented the EMS, and we expect to extend it progressively to our remaining installations;
- § participation in the Carbon Disclosure Project (CDP) and adherence to the Carbon Disclosure Project CDP Supply Chain;
- § conception and formation of the Corporate Management of Greenhouse Gas Program (*Programa Corporativo de Gestão de Emissões de Gases de Efeito Estufa*);
- § the monitoring and controlling compliance with conduct adjustment terms and judicial agreements relating to the environment;
- §

formation and implementation of a corporate program for maintenance and regularization of environmental licenses and of granting water usage rights;

§ the implementation of the Environmental Education Program (*PEA SABESP*), including over one hundred environmental education actions and projects involving the community and other stakeholders ;

§ our institutional representation in the State and National Systems of Water Resources Management, including training of company representatives to participate in councils of the National and State Systems for the Management of Water Resources (*Sistemas Nacional e Estadual de Gerenciamento de Recursos Hídricos*), training of the representatives for participation in the process of establishing criteria for the charging of water usage, monitoring of water basin plans (*Planos das Bacias*), water bodies classification programs and the establishment or review of specific legislation on the matter;

§ the structuring of educational activities related to analyzing, managing, and communicating environmental risks;

§ implementation of the SABESP 3-Rs Program (*Programa SABESP 3Rs*) for the reduction, re-use and recycling of waste of administrative activities, a program involving the two largest administrative areas of our Company with plans to include all other administrative areas.

In addition to corporate environmental *management initiatives*, since 2008 we launched several projects to benefit the environment by engaging the community and third parties with non-governmental organizations, including:

- § Oil Recycling Program (*Programa de Reciclagem de Óleo de Fritura*), or PROL;
- § One million Trees in Cantareira (*Programa “Um Milhão de Árvores no Cantareira”*);
- § Green Hug (*Abraço Verde*);
- § Community Gardens (*Hortas Comunitárias*);
- § Program of Lectures on Environmental Management (*Ciclos de Conferências de Gestão Ambiental*);
- § Supporters of Sustainability (*Audiências de Sustentabilidade*);
- § ‘Nossa Guarapiranga’ Project (*Programa Nossa Guarapiranga*);
- § Water park in Campos do Jordão (*Parque Lagoinha*);
- § Environmental Support Actions (*ecomobilizações*);
- § First Green Building (*Primeiro Predio Verde Certificado*);
- § Recycling programs;
- § Radio Program ‘My Environment’ (*Meu Ambiente*);
- § Partnership with Abrafati in the a project for the cleaning of green areas (*Pintou Limpeza*);
- § Green Post (*Ecoposto Sabesp*);
- § Maintaining of environmentally protected areas;
- § Green Life Program (*Programa Verde Vida*);
- § Plant a Tree, a Child Is Born (*Nasce uma Criança Plante uma Árvore*);
- § Sustainable purchasing policy;
- § Reuse of scrap material from construction;
- § Support and sponsoring to environmentally important projects and initiatives;

§ Cyan Bank (*Banco Cyan*) program for the reduction of water consumption.

Climate Change Regulations: Reduction of Greenhouse Gases (GHG)

We are required to comply with laws and regulations related to climate change, including international agreements and treaties to which Brazil is a signatory.

The São Paulo State Climate Change Policy (Law No. 13,798), enacted on November 9, 2009, seeks to reduce global emissions of carbon dioxide by 20.0% by 2020 compared with 2005 levels. Brazil's Climate Change Policy (Law No. 12,187), enacted on December 29, 2009, establishes a voluntary national commitment to reduce Brazil's currently projected GHG emissions for 2020 by a percentage between 36.1% and 38.9%. If legislation requires us to reduce our emissions, we may do so by transforming biogas from the treatment of sewage into energy, for example, which may lead to potential economic gains.

We have begun significant initiatives, such as the corporate program for water loss reduction and the implementation of small hydroelectric power plants, to reduce GHG emissions during the coming years. We recently launched the Aquapolo project, the fifth largest project in the world to use reclaimed water production for industrial purposes, which uses treated sewage as input. This project, capable of producing 1,000 liters per second (Ps) of reclaimed water, will increase the supply of treated water for the São Paulo metropolitan region and may potentially reduce GHG emissions. Our investments in the Aquapolo project amounted to approximately R\$252 million. We created our inventory of GHG emissions for the year 2008 and are verifying our inventories for the years 2009 and 2010. Moreover, we are developing a management program for GHG emissions. The program includes studies of impacts and risks related to climate change and the study of potential scenarios based on our emissions of GHG.

At this point, it is still not possible to predict if climate change policies will provide opportunities or generate new costs for us. Reducing our emissions of carbon dioxide will involve costs and expenses in implementing more stringent control mechanisms, adopting pollution prevention measures and actions to minimize the generation of GHGs. We may not receive financial incentives to offset all or part of these costs. In addition, if limitations in GHG emissions affect our supply chain and increase our costs, we may not be able to pass on these costs to our end consumers. See “4.B. Business Overview—Tariffs.”

Regulation of GHG emissions could also benefit us in the short term, since we may be able to obtain subsidies, financial investments and tax incentives for projects to protect and restore water sources, conserve water, treat sewage, conserve energy, increase energy efficiency, and promote self-generated energy, among other projects that seek to reduce the impact of climate change.

Carbon Disclosure Project

§ *Carbon Disclosure Project Investors.* We participate in the Carbon Disclosure Project – CDP, a global initiative focused on the financial risks related to climate change. Through this project, main international institutional investors ask the world’s largest companies to demonstrate that they are managing carbon effectively. We have received and responded the project’s questionnaires since 2006. The companies that opt to have their answers disclosed to the public, such as our case, have their answers published in an international website of public interest. The questionnaire asks mainly questions related to the aspects of climate change and corporate governance, the physical, financial and regulatory effects of climate change, and opportunities that affect or could positively or negatively affect us.

§ *Carbon Disclosure Project Supply Chain.* On December 2010, we adhered to the Carbon Disclosure Project – CDP Supply Chain 2011. The project seeks to encourage the adoption of a standard methodology by our main suppliers of goods and services to measure risks related to climate change and GHG emissions. We have invited 97 of our main suppliers of goods and services to join the CDP Supply Chain, from which 20% have joined the project.

Physical Effects of Climate Change

Since our financial performance is closely linked to climate patterns that influence in the availability of water (in terms of quantity and quality of water resources), extreme weather conditions may adversely affect our business and operations. If long-term climate change causes significant alterations in environmental conditions, such as an increase in the frequency of extreme weather conditions, this could affect the quality and quantity of water available for abstraction, treatment and supply, affecting the costs of services and tariffs.

An increase in heavy rainfall can impact water quality and the regular operation of water sources, including abstraction of water from our dams, through increased soil erosion, silting, pollution and eutrophication of aquatic ecosystems. In addition, increased flows of rainwater into sewage systems may overwhelm the capacity of sewage treatment plants. We may need to build larger reservoirs, since it is not feasible to increase the size of our existing reservoirs, or increase operational capacity by further automating our existing equipment. To increase automation, we would need to purchase and operate tools to measure dam levels and volumes, river output and the rain in hydrographic basins, create mathematical models for real time operations, and train technicians to operate these systems. As an alternative, we may need to implement new production systems.

In the case of prolonged periods of drought, for example, reduced water levels in dams can cause an increase in the concentration of plant matter by increasing eutrophication and, consequently, increasing water treatment costs and operational complexity. In addition, prolonged periods of drought in watersheds such as the São Paulo metropolitan

region, where most of our production is concentrated, may result in the growth of vegetation in the reservoir flooding areas, which can impact water quality due to the accumulation of organic matter. In such cases our production costs may increase, affecting our financial margins and the quality of water we produce. Droughts also lower reservoir levels available for hydroelectric plants, which may lead to power shortages, particularly since hydroelectric power accounts for most of Brazil's electric energy supply. A lack of rainwater could lead to instability in domestic water supplies and in sewage collection and treatment services, which could damage our reputation. In addition, because we are one of the largest consumers of electricity in the State of São Paulo, a potential increase in electricity tariffs due to a shortage of hydroelectric power could have a significant economic impact on us.

We are also the concessionaire for water and sewage services for all the coastal municipalities of the State of São Paulo. A rise in the sea level would result in increased salinity of inland water supplies, which may affect water treatment in these areas. Rising sea levels may also increase infiltration rates and alter the runoff regime of the sewage systems, which may affect the sanitary system.

Extreme climate changes may also affect the extraction, production and transportation of the materials necessary for our operations, such as water treatment materials, and may lead to an increase in the cost of these materials. A rise in air temperature could also increase consumer demand for water, increasing the need to expand both water supply and sewage treatment.

See “Item 3.D. Risk Factors—Risks Relating to Our Business—The enactment of new laws and regulations relating to climate change and the change in existing regulation, as well as the physical effects of climate change, may result in increased liabilities and increased capital expenditures, which could have a material adverse effect on us”.

Government Regulation

Basic sanitation services in Brazil are subject to an extensive federal, state and local legislation and regulation that, among other matters, regulates:

- § the granting of concessions to provide water and sewage services;
- § the development of public private partnerships;
- § the need of a public bidding process for the appointment of private water and sewage services providers;
- § the need of setting up an agreement for the appointment of public water and sewage services providers;
- § the joint management of public services through cooperation, allowing for a program agreement without the need for a public bidding process for the service provider, subject to the condition that the planning, execution and monitoring activities are not executed by the service provider;
- § minimum requirements for water and sewage services;
- § water usage;
- § water quality and environmental protection; and
- § governmental restrictions on the incurrence of indebtedness applicable to state-controlled companies.

General

Pursuant to Article 23 of the Brazilian Constitution, water and sewage services are the joint responsibility of the federal government, the states and the municipalities. Article 216 of the Constitution of the State of São Paulo provides that, by law, the State must provide the conditions for efficient management and adequate expansion of water

and sewage services rendered by its agencies and State-controlled companies or any other concessionaire under its control. State law authorized our formation to plan, provide and operate water and sewage services in the State and also acknowledged the autonomy of the municipalities.

Pursuant to Article 175 of the Brazilian Constitution, the rendering of public services, such as water and sewage services, is the responsibility of the applicable public authority. However, any such public authority has the right to render these services directly or through a concession granted to a third party.

In Brazil, there are three federal legal regimes for contracting water and sewage services: (i) public concessions, regulated by Law No. 8,987/1995, which require a prior public bidding process; (ii) administration of public services through cooperation agreements between the federal government and local public authorities at State and municipal level without the need for a public bidding process, regulated by the Public Consortia and Cooperation Agreement Law; and (iii) public-private partnerships, regulated by Law No. 11,079/2004, used to grant concessions to private companies to provide public services and used in relation with construction works associated with the provision of public services. Until 2005, we had adopted the regime for public concessions. Following the entry into force of the Public Consortia and Cooperation Agreement Law, we adopted the administration of public services through cooperation agreements, which can be used alongside the other two regimes.

The Public Consortia and Cooperation Agreement Law and the Basic Sanitation Law have caused significant impacts in the development of the state sanitation policy and the regulatory structuring of the industry.

Because we are the legal concessionaire for the State of São Paulo for water and sewage services, serving approximately 59% of the State's population and providing sanitation services through concession agreements, the Consortium Law affects us on the expiry of our concession agreements entered into in the 1970s when the Brazilian Sanitation Plan (*Plano Nacional de Saneamento*), or PLANASA, was created. The Consortium Law has caused important changes in the relationship among municipalities, states and public sanitation service providers, most notably in mixed capital companies, such as us, because of the implementation of the program agreements as a substitute for concession agreements.

In addition, the Basic Sanitation Law in its role as a general guideline for the development of the Brazilian sanitation industry, addresses the conditions for the delegation of water and sewage services, the exercise of ownership by the granting authority and the regulatory conditions for the industry. The Basic Sanitation Law also provides for a significant amendment to Article 42 of the Concessions Law, which establishes the termination of concessions prior to the expiration date and the reversibility conditions for unamortized assets. The amendment requires that the service provider be compensated for unamortized assets, prioritizing an agreement between the parties setting out the criteria for calculation and payments of indemnity.

The Basic Sanitation Law

On January 5, 2007, the Federal Law No. 11,445, or the Basic Sanitation Law, was enacted, establishing nationwide guidelines for basic sanitation and seeking to create appropriate solutions for the situation of each state and municipality, facilitating the technical cooperation between the state and municipalities. In addition, the federal government will enact its public policy to facilitate access to financing alternatives that are compatible with the costs and terms of the sanitation industry, in substitution of the PLANASA model. On June 21, 2010, the federal government enacted Federal Decree No. 7,217, regulating the Basic Sanitation Law. See "Risk Factors—Risks Relating to our Business—We cannot anticipate the effects that further developments of the Basic Sanitation Law and its interpretation will have on the basic sanitation industry in Brazil and on us."

The Basic Sanitation Law establishes the following principles for basic sanitation public services: universalization, integrality, efficiency and economic sustainability, transparency of actions, social control and integration of infrastructure and services with the management of water resources. It does not define the ownership of the sanitation services, but establishes the minimum liability for the exercise of ownership, such as the development of the sanitation plan, definition of the person responsible for regulation and control, establishment of the rights and obligations of the users and of the social control mechanisms. It also defines the regionalized performance of the services (*i.e.*, one single provider serves two or more owners, for which there may be one plan for the combination of services).

In addition, the Basic Sanitation Law defines the guidelines and objectives of the federal basic sanitation policy to be observed when securing public funds generated or operated by agencies or entities of the federal government, and foresees the possibility of having subsidies as an instrument of social policy to ensure access to basic sanitation services to everyone, particularly the low-income population. The subsidies may be granted either directly, through tariffs or indirectly, depending on the characteristics of the beneficiaries and on the source of the funds.

Furthermore, the Basic Sanitation Law also provides that the sanitation services may be interrupted by the service provider, in the event of default of payment of the tariffs by the customer, among other reasons, after written notice, as long as minimum health requirements are met.

The Basic Sanitation Law also establishes the criteria for the reversal of assets at the time of termination of the agreement and with regard to the concessions, such as those that have expired or are effective for an indefinite term, or those that were not formalized by an agreement. In addition, the Basic Sanitation Law provides the basis for calculating the amount of an indemnity due, which must be calculated by a specialized institution chosen by mutual agreement between the parties.

53

Pursuant to the Basic Sanitation Law, the parties of the concession may enter into an agreement with respect to the payment of the indemnification due to the concessionaire. However, in the absence of an agreement, the Basic Sanitation Law establishes that the indemnification must be paid in no more than four equal and successive annual installments, with the first installment payable by the last business day of the fiscal year in which the assets are reversed.

Tariff Regulation in the State of São Paulo

The tariffs for our services are subject to Federal and State regulation.

On December 16, 1996, the governor of the State of São Paulo issued a decree which approved the existing tariff system and allowed us to continue to set our own tariffs. We used to set our tariffs based on the general objectives of maintaining our financial condition and preserving “social equality” in terms of the provision of water and sewage services to the population while providing a return on investment. The governor’s decree also directs us to apply the following criteria in determining our tariffs:

- § category of use;
- § capacity of the water meter;
- § characteristics of consumption;
- § volume consumed;
- § fixed and floating costs;
- § seasonal variations of consumption; and
- § social and economic conditions of residential customers.

With the enactment of the Basic Sanitation Law and Federal Consortium Law, we are prohibited from planning, overseeing and regulating services, which includes determining the tariff policy to be adopted. Such activities are to be exercised by the owner of the concession. Other than the responsibility for planning, the remaining activities may not be delegated.

The current tariff structure maintains different tariff schedules, depending upon whether a customer is located in the São Paulo metropolitan region or the Regional systems. There are four levels of volume consumed for each category of customer, except for the residential social and *favelas* (shantytowns). The residential social tariffs apply to residences of low income families, residences of persons unemployed for up to 12 months and collective living residences. The favela tariffs apply to residences in shantytowns characterized by a lack of urban infrastructure. The latter two sub categories were instituted to assist lower income customers by providing lower tariffs for consumption. Customers are billed on a monthly basis. Water and sewage bills are based upon water usage determined by monthly water meter readings. Larger customers, however, have their meters read every 15 days to avoid nonphysical losses resulting from faulty water meters. Sewage billing is included as part of the water bill and is based on the water meter reading. We are also authorized to enter into individual contracts with certain customers, such as municipalities, to supply water or sewage services on a wholesale basis.

Before the enactment of the Basic Sanitation Law in 2007, we were subject to a federal law which limited the return on assets for water and sewage services to 12.0% per annum. Return on our assets was calculated using operating income (before financial and certain other expenses) measured against our operational assets (property, plant and equipment and certain other assets), based on our financial statements prepared in accordance with the accounting practices adopted in Brazil, or Brazilian GAAP. The Basic Sanitation Law revoked this law and extinguished this rule. Pursuant to the Basic Sanitation Law, tariff regulation is to be performed by an independent regulatory entity. Municipalities can either create their own regulatory agency or delegate tariff regulation to the ARSESP. With respect to the criteria to calculate the return on assets, on July 30, 2010, the ARSESP adopted a new methodology for the calculation of return on assets, which uses the replacement cost of the assets (assuming replacement with new assets) as a basis for the calculation. Although the ARSESP has proceeded with public consultations on tariff methodology and has indicated that it will implement the new methodology by 2012, we cannot assure you when the new rules will be enacted. Meanwhile, the ARSESP has not altered the tariff formula and has continued to apply the same methodology as in prior years.

Since 2008, the ARSESP has been developing new concepts in the tariff structure and adjustment formula. In July 30, 2010, the ARSESP published Resolution No. 156 establishing the methodology and general criteria for the definition of our regulatory asset base, in order to move forward with the tariff review process and to define the initial parameters of the auditing process that the ARSESP will have to conduct pursuant to the terms of the Basic Sanitation Law. The methodology has been defined and, in general terms, assets will be evaluated by reposition costs and weighted by the respective usage ratio.

In March 2011, the ARSESP published the tariff review schedule and opened a public hearing for the proposed methodology for the calculation of the weighted average cost of capital (WACC). In May 2011, the ARSESP released a regulatory post-tax weighted average cost of capital of 8.06%. In October 2011, we presented to the ARSESP a detailed business plan that disclosed requested information regarding our income, expenses and capital expenditures, so that the ARSESP could set an adjustment formula for our tariffs.

In January 2012, the ARSESP commenced a public consultation regarding our methodology for tariff revisions. The public consultation aims to: (i) set the initial framework for periodic tariff revisions for all municipalities we serve that are under the supervision of the ARSESP; (ii) discuss the criteria adopted to determine the cost of services, the tariff framework and the subsidies policy, among other issues; (iii) create a methodology, standards and procedures for future revisions and adjustments; and (iv) ensure the broad involvement of municipalities, concessionaires, consumers, investors and others.

In 2010, the ARSESP defined the rules to evaluate our asset base (Rule No. 156/2010). We have hired companies to conduct such an evaluation using this methodology and by August 2012, we will present to the ARSESP the evaluation of our asset base according to reposition cost and weighted by the respective usage ratio in accordance with ARSESP Rule No. 156/2010, on which our regulatory remuneration will be based. We will also present ARSESP with a detailed business plan that will serve as a basis for the final tariff methodology process to be released by the ARSESP in the near future. In September 2012, we expect to receive the ARSESP's preliminary average tariff proposal and the applicable efficiency gains factor that we will be required to include in the tariff structure proposal that the ARSESP will then request from us. By October 2012, we expect to be able to propose such tariff structure, and our preliminary average tariff, efficiency gains factor and tariff structure will then be submitted for public hearing. The ARSESP estimates that a final public hearing at which our preliminary average tariff, efficiency gains factor and tariff structure will be subjected to public scrutiny will be scheduled by November 2012. The aforementioned schedule may, however, suffer alterations or be subject to delays. We cannot anticipate the additional changes that the ARSESP will implement on our tariff structure and adjustment formula or the effects that these changes will have on us. If the changes are unfavorable to us, they could materially and adversely affect us.

Furthermore, since Law No. 11,445 permits municipalities to create their own regulatory agencies rather than being subjected to overview by the ARSESP, a number of municipalities created their own regulatory agencies. The municipality of Lins, which had decided in 2007 to create its own regulatory authority, revised this decision in 2010 and transferred the regulation of the water activities performed in Lins, including the setting of tariffs to the ARSESP. Lins has retained, however, the power to ultimately approve the tariff set by the ARSESP. The municipalities of São Bernardo do Campo and Magda retained the power to readjust the tariffs applied therein. Additionally, the municipalities in which the hydrographic basins of the rivers Piracicaba, Capivari and Jundiá are located have created a consortium for regulation and supervision of our activities in that area. As this entity has recently been created, we cannot predict how it may implement regulatory changes that may affect our activities. If other municipalities create new agencies, we will be subject to their regulation, supervision and limitations to our services. See "Risk Factors—Risks Relating to Our Business—We cannot anticipate the effects that further developments of the Basic Sanitation Law and its interpretation will have on the basic sanitation industry in Brazil and on us".

Consumer Relations in the State of São Paulo

Pursuant to the Basic Sanitation Law, in 2009, the ARSESP enacted certain rules establishing (i) the general conditions for the services we render, (ii) the communication process for any failure in our services; (iii) penalties for deficiencies in the provision of basic sanitation services; and (iv) procedures for confidential treatment of our clients' private information. We are currently evaluating the enforceability and legality of some of these rules. Implementation of these rules started during 2011 and is expected to continue for the next few years. The implementation of these rules will impact our commercial and operations processes and may adversely affect us as described below and in other ways we cannot currently predict.

In particular, regarding changes to the general conditions for our services, in 2011 the ARSESP altered the standard contract that we are required to use in our relationships with retail costumers. The ARSESP changed the rule regarding the collection of water and sewage tariff, requiring that collection be directed to the consumer of our services, rather than to the owner of the served property, as used to be the case. We estimate that this change will affect ongoing legal disputes, particularly those regarding collection procedures, as well as business discussions in general. However, we are not currently able to predict the impact of this change on our business, as the change is still being implemented.

55

Regarding changes to the communication process for the reporting of failures, the ARSESP has modified the rules and standards for supervision and reporting of incidents. We have implemented these requested changes. Currently, part of the reporting of incidents occurs online, through the Incident Reporting System (“*Sistema de Comunicação de Incidentes*”) established by the ARSESP, implementing more transparency and control in our operations.

We are attentive to these regulatory changes, have been working toward meeting the ARSESP’s requirements and recommendations, and have presented technical, legal and factual reasons for any conduct that the ARSESP may find irregular. As a result we are subject to few regulatory infractions and to limited fines. See “Risk Factors—Risks Relating to Our Business—We cannot anticipate the effects that further developments of the Basic Sanitation Law and its interpretation will have on the basic sanitation industry in Brazil and on us”.

Concessions

Concessions for providing water and sewage services are formalized by agreements executed between the state or municipality, as the case may be, and a concessionaire to which the performance of these services is granted in a given municipality or region. Our concessions normally have a contractual term of up to 30 years. However, our concessions in general can be revoked at any time if certain standards of quality and safety are not met, or in the event of default of the terms of the concession agreement.

A municipality that chooses to assume the direct control of its water and sewage services must terminate the current relationship by duly compensating the service provider. Subsequently, the municipality will be in charge of rendering services or of conducting a public bidding process to grant the concession to potential concessionaires, including agreements with public companies directly. Although the Constitution of the State of São Paulo determines that the relevant municipality would have to pay us for the unamortized book value of the assets related to the concession and assume any corresponding debt, with the exclusion of any amounts that have been paid to us by the municipality, upon termination or non-renewal of the concession, the payment for termination may not be effected immediately, and any termination could negatively affect our cash flows, operating results and financial situation. See “Item 3.D. Risk Factors—Risks Relating to Our Business—Municipalities may, under certain circumstances, terminate our concessions before their expiration and the indemnification may be inadequate to recover the full value of our investments.”

The Federal Concessions Law No. 8,987/1995 and the State Concessions Law No. 7,835/1992 require that the granting of a concession by the government be preceded by a public bidding process. However, the Federal Public Bidding Law No. 8,666/1993, which establishes the rules for the public bidding process, provides that a public bidding process can be waived under certain circumstances, including in the case of services to be provided by a public entity created for such specific purpose on a date prior to the effectiveness of this law, provided that the contracted price is compatible with what is practiced in the market. Furthermore, a provision of the Federal Public Bidding Law, as amended by the Public Consortia and Cooperation Agreement Law, provides that the program contracted can be executed with waiver of a public bidding process.

In the majority of municipalities where we operate, the new contracts have been formalized pursuant to the provisions of the Federal Public Bidding Law that allows the public bidding process to be waived under certain circumstances. However, due to the discussion over whether the State or municipal authorities have the right to grant rights to provide basic sanitation services in municipal areas, negotiations of the terms of our new contract for the provision of water and sewage services in the city of São Paulo, were more complicated. See “Related Party Transactions Agreement with the State and the City of São Paulo”.

On June 18, 2009, Municipal Law No. 14,934/2009 was enacted and this law revoked Law No. 13,670/2003, which had originally created the discussion on whether the State or the Municipality was the one with the powers to grant

and monitor formal concessions for water and sewage services in the city of São Paulo. Although the new law authorized the city of São Paulo to enter into an agreement with us, because the issue of authority between the State or municipal government remain under judicial review, on June 23, 2010, we entered into a formal agreement with both the State and the city of São Paulo to regulate the provision of water and sewage services in the city of São Paulo for a 30-year period, which may be extended for an additional 30-year period.

Public Consortia and Cooperation Agreement Law for Joint Management

56

On April 6, 2005, the federal government enacted Federal Law No. 11,107, or the Federal Public Consortia and Cooperation Agreement Law, which regulates Article 241 of the Brazilian Constitution. This statute provides general principles to be observed when a public consortia enters into contracts with the Brazilian political divisions and subdivisions (the federal government, states, the Federal District and municipalities) aiming at the joint management of public services of common interests.

Federal Decree No. 6,017/2007 details the conditions of establishment of joint management and the execution of the program agreement regulating the Public Consortia and Cooperation Agreement Law. This federal legislation introduces significant changes in the relationship among municipalities, states and companies providing public sanitation services, prohibiting the latter from exercising activities of planning, oversight and regulation, including tariff regulation, of the services and creating the program agreement for contracting entities whose share control is held by one of the Brazilian political divisions and subdivisions upon waiver of the public bidding process and compliance with concession legislation, as applicable.

On January 13, 2006, the Governor of the State of São Paulo enacted State Decree No. 50,470, amended by State Decrees No. 52,020, dated July 30, 2007, and No. 53,192, dated July 1, 2008, which provide for the rendering of water and sewage services in the State of São Paulo. According to these decrees, we may enter into agreements with municipalities in connection with the provision of water and sewage services by means of the so-called “program agreement without a public bidding process”. In addition, these decrees establish that we will continue to render services in the areas covered by the concession granted by the State.

Based on these statutes, in January 2007 we executed our first program agreement with the municipality of Lins, located in the State of São Paulo. Subsequently, we formalized agreements with other municipalities in the State of São Paulo. These other municipalities transferred the oversight and regulation of our services to the State of São Paulo through a cooperation agreement.

On June 8, 2006, the State of São Paulo enacted Decree No. 50,868 creating the Commission for the Regulation of Sanitation Service of the State of São Paulo (*Comissão de Regulação do Serviço de Saneamento do Estado de São Paulo – CORSANPA*) to regulate sanitation services. The Commission for the Regulation of Sanitation Service of the State of São Paulo is directly subordinated to the State Secretariat for Sanitation and Water Resources.

The main duty of the Commission for the Regulation of Sanitation Service of the State of São Paulo was conducting studies for the creation of a regulatory agency for the basic sanitation industry and the presentation of legal and regulatory measures. The completion of such duties resulted in the publication of supplementary Law No. 1,025 of December 7, 2007, which created the ARSESP. Furthermore, Supplementary Law No. 1,025/2007 maintained the State Sanitation Council (*Conselho Estadual de Saneamento – CONESAN*), created by Supplementary Law No. 7,750/92, as an advisory council to define and implement the state basic sanitation policy, and the State Sanitation Fund (*Fundo Estadual de Saneamento - FESAN*). The State Sanitation Fund is connected to the State Secretariat for Sanitation and Water Resources, and collects and manages resources that support State-approved programs, as well as the development of technology, management and human resources and a sanitation information system, in addition to other support programs.

The ARSESP regulates the basic sanitation services that belong to the State, relating to the federal and municipal jurisdictions and prerogatives, and is responsible for:

§ the compliance with and enforcement of state and federal basic sanitation legislation;

- § the publication of the organizational platform for the services, indicating the types of services provided by the State, as well as the equipment and facilities that compose the system;
- § the acceptance, where applicable, of the legal attributions of the jurisdictional authority;
- § the establishment, in accordance with the tariff guidelines defined by Decree No. 41,446/96, of tariffs and other methods that provide compensation for our services, adjustment and review of such tariffs and methods to ensure the financial-economic balance of services and low-cost tariffs through mechanisms that increase service efficiency and lead to the distribution of productivity gains to society; and
- § the approval, oversight and regulation (including tariff issues) of the sewage treatment and wholesale water supply agreements entered into between the state supplier and other suppliers, pursuant to Article 12 of the Basic Sanitation Law.

With respect to municipal basic sanitation, the ARSESP oversees and regulates services (including tariff issues) that have been delegated by municipalities to the State as a result of cooperation agreements, that authorize program agreements between the municipalities and us for as long as it is convenient to the municipality's public interest.

For its services, the ARSESP charges 0.50% of the annual total invoice from sales and services (excluding revenues relating to the construction of concession infrastructure) of the municipality. This fee is collected from municipalities that have a signed program agreement with us and the municipalities located in the metropolitan regions.

In connection with the scope of our services, Supplementary Law No. 1,025/2007 expanded the range of services that we can render, with the inclusion of urban rainwater drainage and management, urban cleaning and solid waste management, as well as the operation of power generation, storage, conservation and sales activities, for our own or third-party use.

In addition, the rules simplified the process for the expansion of our business in Brazil and abroad, authorizing us:

§ to participate in the controlling block or the capital of other companies;

§ to create subsidiaries, which may become majority or minority shareholders in other companies; and

§ to establish partnerships with national or foreign companies, including other state or municipal basic sanitation companies in order to expand our activities, share technology and expand investments related to basic sanitation services.

Public-Private Partnerships

The PPP is a form of agreement with the public administration used for the concession of services to private enterprises, as well as for construction works coupled with the provision of services. PPPs are regulated by the State of São Paulo through Law No. 11,688, which was enacted on May 19, 2004. PPPs may be used for: (i) implantation, expansion, improvement, reform, maintenance, or management of public infrastructure; (ii) provision of public services; and (iii) exploitation of public assets and non-material rights belonging to the State.

Payment is conditional upon performance. The payment may be collected through: (i) tariffs paid by users; (ii) use of resources from budget; (iii) assignment of credits belonging to the State; (iv) transfer of rights related to the commercial exploitation of public assets; (v) paper of assets; (vi) paper from public debts; and (vii) other revenues.

In our case, payment is conditional upon performance and is collected through the use of resources from the budget.

Public Financing

In January 2007, the President of Brazil announced a new Growth Acceleration Plan, known as the “PAC”, which includes major investments in infrastructure services, including the provision of water and sewage, housing, as well as highways, airports, ports and energy services, that would benefit the poor population of Brazil. PAC calls for a total investment of R\$504.0 billion through 2010, including a R\$40.0 billion investment in the sanitation sector. The majority of the investment of the PAC would be provided by State-owned companies and the private sector, while the rest would come from the federal government. Of the amounts dedicated to the sanitation sector, we have obtained various loans from the BNDES and Caixa Econômica Federal totaling R\$2.8 billion, the proceeds of which are being used to fund various projects. See “Item 5. Operating and Financial Review and Prospects—Liquidity and Capital Resources—Indebtedness Financing.”

Public Bidding Procedures

Pursuant to the Federal Public Bidding Law, the public bid process commences with publication by the granting authority in a federal, state or municipal official newspaper, as the case may be, and another leading Brazilian newspaper. The publication announces that the granting authority will carry out a public bidding contest pursuant to provisions set forth in an *edital* (invitation to bid). The invitation to bid must specify, among other terms: (i) the purpose, duration and goals of the bid; (ii) the participation of bidders, either individually or forming a consortium; (iii) a description of the qualifications required for adequate performance of the services covered by the bid; (iv) the deadlines for the submission of the bids; (v) the criteria used for the selection of the winning bidder; and (vi) a list of the documents required to establish the bidder's technical, financial and legal capabilities.

58

The invitation to bid is binding on the granting authority. Bidders may submit their proposals either individually or in consortia, as provided for in the invitation to bid. After receiving proposals, the granting authority will evaluate each proposal according to the following criteria, which must have been set forth in the invitation to bid:

- § the technical quality of the proposal;
- § lowest cost or lowest public service tariff offered;
- § a combination of the criteria above; or
- § the largest amount offered in consideration for the concession.

The provisions of State Law No. 6,544 of November 2, 1989, as amended, or the State Public Bidding Law, parallel the provisions of the Federal Public Bidding Law. The Federal and State bidding laws will apply to us in the event that we seek to secure new concessions. Moreover, these bidding laws currently apply to us with respect to obtaining goods and services from third parties for our business operations or in connection with our capital expenditure program, in each case subject to certain exceptions.

Water Usage

State law establishes the basic principles governing the use of water resources in the State of São Paulo in accordance with the State constitution. These principles include:

- § rational utilization of water resources, ensuring that its primary use is to supply water to the population;
- § optimizing the economic and social benefits resulting from the use of water resources;
- § protection of water resources against actions which could compromise current and future use;
- § defense against critical hydrological events which could cause risk to the health and safety of the population or economic and social losses;
- § development of hydro-transportation for economic benefit;
- § development of permanent programs of conservation and protection of underground water against pollution and excessive exploitation; and
- § prevention of soil erosion in urban and rural areas, with a view to protecting against physical pollution and silting of water resources.

Under State law, implementation of any project that involves the use of surface or underground water requires prior authorization or licensing from the competent government authority. In order to implement these principles, authorizations granting a right of use are required from the relevant public authority for water usage (whether for collection, release of effluents or otherwise), modification of the regime and modification of the quality or the quantity of the existing water. In the case of rivers under the federal government's domain (rivers crossing more than one state), ANA is the public authority which grants the authorization. With respect to the rivers under a state's domain,

the applicable state authority has jurisdiction to grant the right of use. In the State of São Paulo, DAEE is the public authority responsible for granting such authorizations. DAEE has, as its objectives, establishing (i) a policy for the use of water resources with a view to developing the water business of the State, and (ii) plans, studies and projects related to the use of water resources, directly or by means of agreements with third parties.

Our main operating units have been granted water usage rights; however, we also have several operating units where water grants are not fully in place. To help obtain the remaining water grants, we have established a corporate program for the legalization and maintenance of grants.

In July 2000, ANA was established to develop the National System for Water Resources Management. According to existing law, the hydrographic basins committees are authorized to charge users, such as us, for the abstraction of water from, or dumping of sewage into, water bodies controlled by these agencies. Since 2003 and as of December 31, 2011, we have paid R\$93.3 million to ANA and the State Secretariat for the Environment (*Secretaria do Estado do Meio Ambiente*), and these agencies have used these amounts to pay for expenses related to the National and the State Systems for the Management of Water Resources (*Sistema Nacional e Sistema Estadual de Gerenciamento de Recursos Hídricos*) and principally to sponsor studies, programs, projects and constructions provided for in the Water Basin Plan (*Plano de Bacia*). Resources for these projects may be loaned or provided to governmental agencies and corporations, including us, for use in projects related to the conservation and recovery of water resources.

State Law No. 12,183, which was enacted on December 29, 2005, established the basis for charging for the use of the water resources under the domain of the State of São Paulo. To apply such charging, the law provides for, among other provisions, the formulation of criteria by the basin committees, the creation of basin agencies and the organization of a registered list of water resource users. The basin committee's proposals regarding the criteria to calculate the amounts to be charged at each basin must be approved by the State Water Resource Council, and formalized by a decree issued by the State Governor.

Water Quality

Administrative Rule No. 2,914/2011, issued by the Ministry of Health of the federal government, provides the standards for potable water for human consumption in Brazil. This rule is similar to the U.S. Safe Drinking Water Act and the regulations enacted by the U.S. Environmental Protection Agency, which establishes rules for sampling and limits related to substances that are potentially hazardous to human health.

In compliance with Brazilian law, the physical-chemical, organic and bacteriological analyses carried out for water quality control follow the methodologies of the Standard Methods for Water and Wastewater (21st edition) of the American Water Works Association.

Decree No. 5,440/2005 provides that the quality of water must be disclosed to consumers. We have been complying with this regulation by publishing the required information in monthly bills and annual reports delivered to all consumers that we serve.

Environmental Regulation

The implementation and operation of water and sewage systems are subject to strict federal, state and municipal laws and regulations on environmental and water-resource protection. The National Environmental Council (*Conselho Nacional de Meio Ambiental*), or the CONAMA, is the federal agency responsible for the regulation of potentially polluting activities. In the State of São Paulo, the Companhia Ambiental do Estado de São Paulo, or CETESB, is the governmental entity responsible for the control, supervision, monitoring and licensing of polluting activities, pursuant to State Law No. 997 of 1976 and State Law No. 13,542 of 2009. The CETESB regulates the control of environmental pollutants.

The control and environmental planning instruments are defined by several legal instruments, such as State Law No. 997/1976, which regulates the environmental pollution control; the CONAMA Resolution No. 05/1988, which requires licensing of sanitation projects that cause significant alterations to the environment; the CONAMA Resolution No. 237/1997, which regulates (i) environmental licenses, (ii) the federal, state and local jurisdiction over environmental issues, (iii) the list of activities subject to licensing; and (iv) environmental impact studies and reports; State Decree No. 47,400/2002 and related articles from State Law No. 9,509/1997 regarding environmental licensing; and State Decree No. 8,468/76, the CONAMA Resolution No. 357/2005, the CONAMA Resolution No. 397/08 and the CONAMA Resolution No. 430/11 and the granting of rights for using and interfering with water resources (*Portaria Departamento de Águas e Energia Elétrica 717/96*). Projects with significant environmental impact are subject to specific studies prepared by multidisciplinary teams that present a series of recommendations focused on minimizing the environmental impact. These studies are then submitted for analysis and approval by the government authorities. The licensing process is composed of three stages, including the following licenses:

§ preliminary license – granted in the planning stage, approving the location and concept and attesting to the project's environmental feasibility;

§ installation license – authorizing the beginning of works for the installation of the project, subject to compliance with approved plans, programs and projects, including environmental control measures and other necessary technical requirements; and

§ operation license – authorizing the operation of a unit or activity, subject to compliance with the technical requirements contained in the installation license.

We have established a program (*Programa Corporativo de Manutenção e Regularização de Licenciamento Ambiental*) to obtain all necessary licenses in an effort to bring us into full compliance with environmental regulations within five years. As of the date of this annual report, we were not in possession of all licenses required in connection with our operations. Our failure to obtain such licenses may result in the imposition of fines and penalties. With respect to new operations, feasibility and environmental compliance are carried out throughout the project.

60

Sewage Requirements

State law sets forth regulations regarding pollution control and environmental preservation in the State of São Paulo. State law establishes the conditions and limitations for waste discharge that impacts water, air and soil. According to this law, in areas in which there is a public sewage system, all effluents of a “polluting source” must be discharged to such system. It is the responsibility of the polluting source to connect itself to the public sewage system. All effluents to be discharged are required to meet the standards and conditions established by the applicable environmental law, which allows such effluents to be treated by our treatment facilities and discharged in an environmentally safe manner. Effluents that do not comply with such criteria are prohibited from being discharged into the public sewage system. State legislation also establishes that liquid effluents, except those related to basic sanitation, be subjected to pre-treatment so that they meet the required mandatory levels before being discharged into the public sewage system. National sanitation guidelines are also established in Article 45 of Federal Law No. 11,455/2007.

The CETESB is authorized under State law to monitor discharges of pollutants into the environment and to enforce the requirements of State law. The CETESB is responsible for issuing preliminary installation and operation licenses granted to the pollution sources, including sewage treatment facilities.

The CETESB also regulates the discharge of effluents into water bodies and must approve all of our treatment facilities in accordance with federal and state regulations. State and federal water resource legislation establish the charging of fees for the discharge of treated effluents into water bodies. This provision is already in force in relation to some water basins, and is in different stages of implementation in remaining basins. See “—Government Regulation—Water Usage.”

Governmental Restrictions on Incurrence of Debt

On June 30, 1998, the CMN issued Resolution No. 2,515/98 amending certain conditions that must be observed with respect to the external credit operations (i.e., foreign currency borrowings) of states, the Federal District of Brasilia, municipalities and their respective *autarquias* (agencies), foundations and non-financial companies, including us. This resolution provides, among other things, that, with certain exceptions applicable to the importation of goods and services:

- § the proceeds of external credit operations must be exclusively used to refinance outstanding financial obligations of the borrower, with preference given to those obligations that have a higher cost and a shorter term, and, until used for such purposes, the proceeds shall remain deposited, as directed by the Central Bank, in a pledged account; and
- § the total amount of the contractual obligation must be subject to monthly deposits in a pledged account, equal to the total debt service obligation, including principal and interest, divided by the number of months that the obligation is to be outstanding.

The CMN resolution further provides that the requirements described above do not apply to financing transactions involving multilateral or official organizations such as the International Bank for Reconstruction and Development, or IBRD, the IADB or the JICA. The Central Bank regulation implementing this resolution provides, among other things, that the account referred to in the first bullet point above must be an account opened in a federal financial institution, which is to hold such funds until released for the purpose of refinancing outstanding obligations of the borrower. The Central Bank regulation further provides that the account described in the second bullet point above must be an escrow account to be opened in a federal financial institution and to secure the payment of principal and interest on the external debt.

Our foreign currency-denominated transactions are also subject to the approval of the National Secretariat of Treasury (*Secretaria do Tesouro Nacional*) and the Central Bank. After reviewing the financial terms and conditions of the transaction, the National Secretariat of Treasury and the Central Bank will issue an approval for the closing of the foreign exchange transaction relating to the entry of the funds into Brazil and, following such entry and at our request, an electronic certificate of registration through which all scheduled payments of principal, interest and expenses will be remitted by us. The electronic certificate of registration grants the borrower access to the market for foreign exchange.

Lending Limits of Brazilian Financial Institutions

The CMN Resolution No. 2,827 of March 30, 2001, as amended, limits the amount that Brazilian financial institutions may lend to public sector companies, such as us. Financing of projects which are put up for international bid and any financing in *reais* provided to the Brazilian counterpart of such international bids are excluded from these limits.

61

Scope of Business

State Law No. 12,292, dated of March 2, 2006, amended State Law No. 119, dated of June 29, 1973, which created our Company, authorizes us to provide water and sewage services outside São Paulo (in other states of Brazil and other countries). This law also authorizes us to own interests in other public or private-public companies and Brazilian or international consortiums. In addition, this law permitted us to incorporate subsidiaries and enter into a partnership with or acquire interests in a private company with a corporate purpose related to the sanitation business.

C. Organizational structure

Not applicable.

D. Property, Plant and Equipment

Our principal property, plant and equipment comprise administrative facilities which are stated at historical costs less depreciation. The reservoirs, water treatment facilities, water distribution networks consisting of water pipes, water mains, water connections and water meters, sewage treatment facilities, and sewage collection networks consisting of sewer lines and sewage connections are recorded as intangible assets (concession assets). As of December 31, 2011, we operated through 66,389 kilometers of water pipes and mains and 45,073 kilometers of sewer lines. As of that same date, we operated 212 water treatment facilities and 490 sewage treatment facilities, as well as 16 water quality control laboratories.

We own our headquarters building and all other major administrative buildings. We have pledged some of our properties as collateral to the federal government in connection with a long-term financing transaction we have entered into with the IBRD that was guaranteed by the federal government. We have also pledged part of our assets in the amount of R\$249.0 million as collateral as of December 31, 2011, with respect to our indebtedness under the Special Program for Payment of Federal and Social Security Related Taxes in Installments (*Programa de Parcelamento Especial para Impostos Federais e Previdenciários*), or PAES program.

As of December 31, 2011, the total net book value of our property, plant and equipment and intangible assets (including concession assets) was R\$20,498.1 million.

All of our material properties are located in the State of São Paulo.

ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The following management's discussion and analysis of financial condition and results of operations should be read in conjunction with our audited consolidated financial statements included elsewhere in this annual report. The consolidated financial statements included elsewhere in this annual report have been prepared in compliance with IFRS as issued by the IASB. This annual report contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those discussed in the forward-looking statements as a

result of various factors, including, without limitation, those set forth in “Risk Factors.”

In the following discussion, references to increases or decreases in any period are made by comparison with the corresponding prior period, except as the context otherwise indicates.

A. Operating and Financial Review and Prospects

Overview

As of December 31, 2011, we operated water and sewage systems in the State of São Paulo, including in the city of São Paulo, Brazil’s largest city, and in 363 municipalities in the State of São Paulo, which represented 56.3% of all municipalities in the State. We also provided water services on a wholesale basis to six municipalities located in the São Paulo metropolitan region and to the municipality of Sumaré in which we did not operate water systems.

The São Paulo metropolitan region, which includes the city of São Paulo, is our most important service region. With a total population of approximately 20.4 million, the São Paulo metropolitan region accounted for 75.6%, 74.5% and 73.9% of our gross revenue from sales and services in 2009, 2010 and 2011 (excluding revenues relating to the construction of concession infrastructure), respectively. 60.6% of the concession intangible assets reflected on our balance sheet as of December 31, 2011 was located in this region. In an effort to respond to demand in the São Paulo metropolitan region and because the region represents the principal opportunity to increase our net revenue from sales and services, we have concentrated a major portion of our capital expenditure program to expand the water and sewage systems and to increase and protect water sources in this region. Our capital expenditure program is our most significant liquidity and capital resource requirement.

Factors Affecting Our Results of Operations

Our results of operations and financial condition are generally affected by our ability to raise tariffs, general economic conditions in Brazil and, in some previous periods, meteorological conditions.

In 2008, our net income was strongly affected by the global financial and economic crisis, which began in 2008 and whose effects were still present in 2009, resulted in a depreciation of the Brazilian *real* against the U.S. dollar, which adversely affected our obligations denominated in foreign currency.

In order to ensure its economic and financial strength, we have been working on increasing our efficiency and productivity gains. For this reason, we have attempted to reduce costs. In 2009, we decreased our staff by 9.3% pursuant to an Agreement for the Adjustment of Conduct (*Termo de Ajustamento de Conduta*), or TAC, with the State Public Attorney's Office (*Ministério Público Estadual*). Pursuant to the TAC, we laid off retirees who were still working for us and laid off employees representing approximately 2% of our workforce. Our results of operations for the 2009, 2010 and 2011 fiscal years were also affected by a provision for severance payments in the amount of R\$146.6 million for employees who resigned in 2009, R\$19.0 million for employees who resigned in 2010 and R\$47.0 million for employees who resigned in 2011.

In 2011, our costs and expenses increased 15.7% compared to a decrease of 25% in our net income. In 2011, the volume invoiced increased 3.1% compared to 2010. The other increases are mainly related to depreciation and amortization, wages, the agreement with São Paulo and credits write-off, which amount to R\$216.2 million, R\$405.5 million, R\$166.4 million and R\$112.1 million, respectively.

Effects of Tariff Increases

Our results of operations and financial condition are highly dependent upon our ability to increase tariffs for our water and sewage services. Since the enactment of the Basic Sanitation Law in 2007, as a general rule, regulatory agencies will be responsible for setting, adjusting and reviewing tariffs, taking into consideration, among other factors, the following:

- § political considerations arising from our status as a State-controlled company;
- § anti inflation measures enacted by the federal government from time to time; and
- § when necessary, the readjustment to maintain the original balance between each party's obligation and economic gain (*equilíbrio econômico-financeiro*) under the agreement.

Readjustment of our tariffs continues to be set annually and depend on the parameters established by the Basic Sanitation Law and the ARSESP. The guidelines also establish procedural steps and the terms for annual adjustments. The annual adjustments must be announced 30 days prior to the effective date of the new tariffs, which take effect in September and remain in place for a period of at least 12 months. See "4.B. Business Overview—Tariffs."

The following table sets forth, for the periods indicated, the percentage increase of our tariffs, as compared to three inflation indexes:

	Year ended December 31,		
	2009	2010	2011

Increase in average tariff(1)	4.4%	4.1%	6.8%
Inflation – IPC – FIPE	3.7%	6.4%	5.8%
Inflation – IPCA	4.3%	5.9%	6.5%
Inflation – IGP-M	(1.7)%	11.3%	5.1%

(1) Since 2007, tariff readjustments have taken effect in September, one month after the readjustment announcement.

Sources: Central Bank, *Fundação Getulio Vargas*, or FGV, and *Fundação Instituto de Pesquisas Econômicas*.

Effects of Brazilian Economic Conditions

As a company with all of its operations in Brazil, our results of operations and financial condition are affected by general economic conditions in Brazil, particularly by exchange rate fluctuations, inflation rates and interest rate levels. For example, the general performance of the Brazilian economy affects our cost of capital and inflation affects our costs and margins. The Brazilian economic environment has been characterized by significant variations in economic growth rates.

General Economic Conditions

The year 2008 was characterized by the worsening of the global financial and economic crisis. As a result, the *real* depreciated by 32.0% against the U.S. dollar in 2008. Nonetheless, at December 31, 2008, Brazil had R\$206.8 billion in currency reserves and a trade surplus of R\$24.8 billion. The average unemployment rate in Brazil's principal metropolitan regions was 6.8% in 2009. The crisis' main effect on the Brazilian economy was a decline in expectations for economic activity in 2009 and, to a lesser extent, in 2010. The year of 2011 was marked by the economic crises in the Euro zone. In Brazil, there was a depreciation of 12.6% of the Brazilian real against the US dollar and Brazilian GDP increased by 2.7%.

In 2009, Brazilian GDP decreased 0.2% in comparison with 2008. Nonetheless, at that same year Brazil had US\$239.1 billion in currency reserves and its trade surplus was US\$25.3 billion. The average unemployment rate in Brazil's principal metropolitan regions remained stable at 6.8% in 2009.

In 2010, Brazilian GDP increased 7.5% in comparison with 2009. At that same year, Brazil had US\$288.6 billion in currency reserves and its trade surplus was US\$20.3 billion. The average unemployment rate in Brazil's principal metropolitan regions was 6.7% in 2010.

In 2011, Brazilian GDP increased 2.7% in comparison with 2010. At that same year, Brazil had US\$352 billion in currency reserves and its trade surplus was US\$29.8 billion. The average unemployment rate in Brazil's principal metropolitan regions was 6% in 2011.

Interest Rates

High domestic interest rates result in increases in our financial expenses and also negatively affect our ability to obtain financing, on a cost-effective basis, in the domestic capital and lending markets. As a result, we may continue to require substantial amounts of foreign currency-denominated indebtedness in order to satisfy our liquidity and funding requirements, which may increase our exposure to exchange rate fluctuations, as discussed below.

The official interest rate set by the Central Bank, the SELIC overnight rate, was 13.66% as of December 31, 2008. In 2009, in order to boost the economy, the Central Bank reduced the official interest rate significantly, reaching 8.65% as of December 31, 2009. In 2010, the Central Bank increased interest rates, and the official interest rate, as defined by the SELIC overnight rate target, was 10.66% as of December 31, 2010. As of December 31, 2011, the SELIC overnight rate, was 10.91%. We have not utilized any derivative financial instruments or any hedging instruments to mitigate interest rate fluctuations. We do, however, continually monitor market interest rates in order to evaluate the possible need to refinance our debt.

Inflation

Inflation affects our financial performance by increasing our costs of services rendered and operating expenses. In addition, all of our *real*-denominated debt is indexed to take into account the effects of inflation. Most of our *real*-denominated debt provides for inflation-based increases in the respective principal amounts of that indebtedness, which are determined by reference to the daily government reference interest rate (*Taxa Referencial*), or TR, plus an agreed margin. We cannot assure you that our tariffs will be increased, in future periods, to offset, in full or in part, the effects of inflation.

Currency Exchange Rates

We had total foreign currency-denominated indebtedness of R\$3,053.4 million as of December 31, 2011, of which R\$189.4 million relates to our short-term foreign currency-denominated obligations. In the event of significant devaluations of the *real* in relation to the U.S. dollar or other currencies, the cost of servicing our foreign currency-denominated obligations would increase as measured in *reais*, particularly as our tariff and other revenue are based solely in *reais*. In addition, any significant devaluation of the *real* will increase our financial expenses as a result of foreign exchange losses that we must record. For example, the 32.0% devaluation of the *real* in 2008 increased our financial expenses and negatively affected our overall results of operations for the year. In contrast, the 25.5% appreciation of the *real* against the U.S. dollar in 2009 led to a foreign exchange gain of R\$528.4 million. In 2010, the 4.3% appreciation of the *real* against the U.S. dollar led to a foreign exchange gain of R\$66.1 million. In 2011, the 12.6% depreciation of the *real* against the U.S. dollar led to a foreign exchange loss of R\$382.3 million.

We manage our indebtedness portfolio closely to decrease the cost of servicing our indebtedness as a whole and our exposure to exchange rate fluctuations. We do not speculate in foreign currencies, and we do not have any exposure to derivatives tied to foreign currencies.

The following table shows the fluctuation of the *real* against the U.S. dollar, the period-end exchange rates and average exchange rates as of or for the periods indicated:

	Year ended December 31,		
	2009	2010	2011
Depreciation (appreciation) of the <i>real</i> versus U.S. dollar	(25.5)%	(4.3)%	12.6%
Period-end exchange rate – US\$1.00	R\$1.741	R\$1.666	R\$1.876
Average exchange rate – US\$1.00(1)	R\$1.994	R\$1.759	R\$1.675

(1) Represents the average for period indicated.

Source: Central Bank.

From time to time, we may enter into forward exchange transactions to mitigate foreign currency exposure. In addition, we have monitored, overseen and controlled our foreign currency-denominated indebtedness, taking advantage of market opportunities to improve the profile of our indebtedness and reduce our costs. As of December 31, 2011, we had no outstanding forward exchange transactions.

Effects of Climate Change (Drought and Intense Rainfalls)

We operate in a region of Brazil that has been prone to droughts, although historically droughts have not impacted all of our water supply systems equally. Brazil experienced a prolonged and severe drought during 2000 and 2001. As a result, from mid-June to mid-September of 2000, we rationed water in the south of the São Paulo metropolitan region, affecting approximately 3.5 million people, or approximately 20% of the total population of this region, which reduced our total water production by approximately 8%. From April 2001 through January 2002 and from October to December 2003, we also rationed water in certain regions of the São Paulo metropolitan region, but on a much smaller scale. This rationing on a smaller scale caused our total water production volume to be reduced by only 0.8%. The effects of the drought continued to affect our systems through 2004. Due to the water usage reduction bonus program that we operated from March to September 2004, when rainfall was extremely low and our reservoirs were at correspondingly low levels, and the return to normal rainfall levels that occurred throughout 2004 and early 2005, the conditions of our reservoirs improved in 2005. In 2006, rainfall was sufficient to enable us to maintain our reservoirs at levels reflecting the historic average. In 2007 and 2008, rainfall exceeded the levels of previous years, increasing the volume of water held in our reservoirs and thereby providing a cushion to meet demand. In 2009, rainfall levels were higher than the historic average and by the end of 2009, our reservoirs had a utilization rate of 87.0%, compared to a 50.0% and 41.0% utilization as of December 31, 2008 and 2007, respectively. In 2011, rainfall levels were slightly lower than historical averages and occurred during unusual times of year. As of December 31, 2011, our reservoirs had a utilization rate of 62.8%, compared to a 74.4% utilization as of December 31, 2010.

Critical Accounting Estimates and Assumptions

We make estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results. The estimates and assumptions that have a significant risk of causing material adjustment to the carrying amount of our assets and liabilities within the next financial year are addressed below.

Allowance for Doubtful Accounts

We record an allowance for doubtful accounts in an amount that our management considers sufficient to cover probable losses, based on an analysis of customer accounts receivable, in accordance with the accounting policy stated in Note 2.8 to our consolidated financial statements as of and for the years ended December 31, 2009, 2010 and 2011. Provisions for the allowance for doubtful accounts are included in selling expenses, net of recoveries. The net charge to this allowance was R\$117.4 million, R\$232.5 million and R\$120.4 million in 2009, 2010 and 2011, respectively.

The methodology for determining the allowance for doubtful accounts requires significant estimates, considering a number of factors, including historical collection experience, current economic trends, estimates of forecast write-offs, the aging of the accounts receivable portfolio and other factors. While we believe that the estimates used are reasonable, actual results could differ from those estimates.

Fair Value of Financial Instruments

In accordance with Brazilian GAAP, management estimates the fair value of financial instruments using information available in the market and appropriate estimating methodologies. Management uses considerable personal judgment to interpret the information available in the market when developing estimates of fair value. Therefore, the estimates presented may not necessarily indicate the value that would be obtained for the financial instruments if they were realized on the market. The use of different market assumptions and/or estimating methodologies could have a material effect on the estimated fair values.

Indemnities Receivable

Indemnities receivable is a long-term asset representing amounts receivable from the municipalities of Diadema and Mauá as indemnification for their unilateral termination of our water and sewage service concessions in 1995. As of each of December 31, 2009 and 2010, this asset amounted to R\$146.2 million. In 2011, the Company decided to record a provision for losses related to the amount receivable from Mauá due to the uncertainty and recognized only the amount receivable from Diadema, since there is an ongoing negotiation. The amount receivable from Diadema amounted as of December 31, 2011, to R\$60.3 million.

Prior to their termination, pursuant to our concession contracts, we invested in the construction of water and sewage systems in these municipalities to meet our concession service commitments. Upon the unilateral termination of the concessions by the municipalities of Diadema and Mauá, our assets were impounded by the municipal authorities, which took on the responsibility of providing water and sewage services in these areas. At that time, we reclassified our property, plant and equipment balances relating to the impounded assets as long-term assets (indemnities receivable) and recorded impairment charges to reduce the carrying value of the assets to the estimated recoverable amounts which we had contractually agreed as fair compensation with these municipal authorities.

Our rights to recover these amounts are being disputed by the municipalities, and no amounts have been received to date. Based on the advice of legal counsel, we continue to believe that we have the right to receive those amounts, and we continue to monitor the status of the legal proceedings. The ultimate amounts to be received however, if any, will most likely be subject to a final court decision. Therefore, actual amounts received could differ from those recorded. For more information, see Note 9 to our consolidated financial statements as of and for the years ended December 31, 2011, 2010 and 2009.

Valuation of Long-Lived Assets

As of December 31, 2011, we had property, plant and equipment and intangible assets of R\$356.5 million and R\$20,141.7 million, respectively.

We review long-lived assets, primarily buildings, water and sewage system assets and concession intangible assets to be held and used in our business, for the purpose of determining and measuring impairment on a recurring basis or when events or changes in circumstances indicate that the carrying value of an asset or group of assets may not be recoverable. According to IFRS, we evaluate possible impairment by determining whether projected future operating income is sufficient to absorb the depreciation or amortization of long-lived assets, within the context of the balance sheet as a whole.

Studies supporting the write-offs for obsolescence and abandonment of projects are conducted in the accounting period of the write-offs based on discounted cash flow projections, and approved by our board of directors. We monitor the carrying value of our property, plant and equipment on an on-going basis and adjust the net book value to

assure future projected operations will be sufficient to recover the carrying value of the assets.

In evaluating impairment of our long-lived assets, we make significant assumptions and estimates regarding matters that are inherently uncertain, including projections of future operating income and cash flows, future growth rates and the remaining useful lives of the assets, among other factors. In addition, projections are computed over an extended period of time, which subjects those assumptions and estimates to an even larger degree of uncertainty. While we believe that the estimates we use are reasonable, the use of different assumptions could materially affect our valuations.

Amortization of Intangible Assets

Amortization is calculated when the intangible assets are available for use in the necessary condition established by the Company.

66

Amortization reflects the period over the expected future economic benefits generated by the intangible asset and can be the period of the contract, depending on the contract. The utilization of the assets is related to the useful life of the assets constructed by the Company and amortization of the intangible assets is considered in the calculation of the tariff.

Amortization of the intangible assets finishes when the asset is totally consumed or is alienated, not being considered in the calculation of the tariff any longer, whichever occurs first.

Depreciation of Property, Plant and Equipment

Depreciation of our property, plant and equipment, primarily buildings, water and sewage service and other assets acquired, is provided using the straight-line method based on the estimated useful lives of the underlying assets. While we believe that our estimates of current remaining estimated lives is reasonable, the use of different assumptions and estimates and changes in future circumstances, could affect the remaining useful lives of our asset, which could have a significant impact on our results of operations in the future.

Provision for Contingencies

As of December 31, 2011, we were party to judicial and administrative proceedings, relating to civil, environmental and tax matters, amounting to R\$1,571.8 million (excluding the amount of R\$120.7 million related to court deposits) with respect to which we considered the risk of loss as probable. As of that date, proceedings with respect to which we considered the risk of loss as possible amounted to R\$2,621.8 million, and those with respect to which we considered the risk of loss as remote amounted to R\$19,958.3 million.

We are a party to a number of legal proceedings involving significant monetary claims. These legal proceedings include, among other types, disputes with customers and suppliers and tax, labor, civil, environmental and other proceedings. For a more detailed discussion of these legal proceedings, see Note 15 to our consolidated financial statements as of and for the years ended December 31, 2009, 2010 and 2011. We accrue for probable losses resulting from these claims and proceedings when we determine that the likelihood that a loss has occurred is probable and the amount of such loss can be reasonably estimated. Therefore, we are required to make judgments regarding future events for which we often seek the advice of legal counsel. As a result of the significant judgment required in assessing and estimating these provisions for contingencies, actual losses realized in future periods could differ significantly from our estimates and could exceed the amounts which we have provisioned.

Pension Plans

The present value of the pension obligations depend on a number of factors that are determined on an actuarial basis using a number of assumptions. The assumptions used in determining the net cost (income) for pensions include the discount rate. Any changes in these assumptions will impact the carrying amount of pension obligations.

We determine the appropriate discount rates at the end of each year, which is the interest rate that should be used to determine the present value of estimated future cash outflows expected to be required to settle the pension obligations.

Other key assumptions for pension obligations are based in part on current market conditions. Additional information on the pension plans under Plan G0 and G1 is disclosed in Note 16.

Differences in actual experience or changes in assumptions could affect the carrying amount of pension obligations and expenses recognized in our results.

Certain Transactions with Controlling Shareholder

Reimbursement Due from the State

Reimbursement due from the State for pensions paid represent supplementary pensions (Plan G0) that we pay, on behalf of the State, to former employees of State-owned companies which merged to form our Company. These amounts must be reimbursed to us by the State, as primary obligor.

In November 2008, we entered into the third amendment to the agreement with the State relating to payments of pension benefits made by us on its behalf. The State acknowledged that it owed us an outstanding balance of R\$915.3 million as of September 30, 2008, relating to payments of pension benefits made by us on its behalf. We provisionally accepted, but it is not recognized in our books, the reservoirs in the Alto Tietê System as partial payment in the amount of R\$696.3 million, subject to the transfer of the property rights of these reservoirs to us. Since November 2008, the State has been paying the remaining balance in the amount of R\$219.0 million in 114 successive monthly installments. See Note 8 to our consolidated financial statements as of and for the years ended December 31, 2009, 2010 and 2011 and “Item 7. Major Shareholders and Related Party Transactions.”

Accounts Receivable from the State for Water and Sewage Services Rendered

Certain of these accounts receivable have been overdue for a long period, and we do not reserve against such accounts receivable as we fully expect to recover these amounts and loss is not considered probable. We have entered into agreements with the State with respect to these accounts receivable. For further information on these agreements, see Note 8 to our consolidated financial statements as of and for the years ended December 31, 2009, 2010 and 2011 and “Item 7. Major Shareholders and Related Party Transactions.”

Use of Certain Assets Owned by the State

We currently use certain reservoirs in the Billings and Guarapiranga reservoirs which are owned indirectly by the State. We currently do not pay any fees with respect to the use of these reservoirs. However, we are responsible for maintaining and meeting the operating costs of these reservoirs. If these facilities had not been made available for our use, we would have had to obtain water from more distant sources, which would be more costly. The State does not incur operating costs on our behalf.

The arrangement for use of the Billings and Guarapiranga reservoirs is provided for through a grant issued by the DAEE. We have a right to use these reservoirs so long as we remain responsible for maintaining and meeting their operating costs.

Results of Operations

The following table sets forth, for the periods indicated, certain items in our statement of operations, each expressed as a percentage of net revenue from sales and services:

	Year ended December 31,					
	2009	2010		2011		
	<i>(in millions of reais, except percentages)</i>					
Net revenue from sales and services	8,579.5	100.0%	9,231.0	100.0%	9,941.6	100.0%
Cost of sales and services	(5,087.3)	(59.3)%	(5,194.5)	(56.3)%	(6,031.1)	(60.7)%
Gross profit	3,492.2	40.7%	4,036.5	43.7%	3,910.5	39.3%
Selling expenses	(610.4)	(7.1)%	(712.9)	(7.7)%	(619.5)	(6.2)%
Administrative expenses	(717.1)	(8.4)%	(653.2)	(7.1)%	(846.6)	(8.5)%
Other operating income (expenses), net	(44.4)	(0.5)%	1.8		(90.1)	(0.9)%
Operating profit	2,120.3	24.7%	2,672.2	28.9%	2,354.3	23.7%
Finance cost, net	(10.0)	(0.1)%	(379.4)	(4.1)%	(633.6)	(6.4)%
Profit before income tax and social contribution	2,110.3	24.6%	2,292.8	24.8%	1,720.7	17.3%
Income tax and social contribution	(602.6)	(7.0)%	(662.3)	(7.2)%	(497.3)	(5.0)%
Net income for the year	1,507.7	17.6%	1,630.5	17.7%	1,223.4	12.3%

Year Ended December 31, 2011 Compared to Year Ended December 31, 2010***Net Revenue from Sales and Services***

Net revenue from sales and services increased by R\$710.6 million, or 7.7%, to R\$9,941.6 million in 2011 from R\$9,231.0 million in 2010. This increase was principally due to the increase in tariff rates to 6.83% in September

2011 from 4.05% in September 2010 and the 3.1% increase in sales volume.

Cost of Sales and Services

The cost of sales and services increased by R\$836.6 million, or 16.1%, to R\$6,031.1 million in 2011 from R\$5,194.5 million in 2010. As a percentage of net revenue from sales and services, cost of sales and services increased to 60.7% in 2011 from 56.3% in 2010.

The increase in costs of sales and services was principally due to the following factors:

§ an increase of R\$216.2 million, or 41.3%, as a result of our increased amortization expense related to our intangible assets for the services contract entered into with the municipality of São Paulo as well as to 99 expired or informal agreements, which are in the process of being formalized as program agreements. During 2011, we had a full year of the amortization of intangible assets related to the services contract entered into with the municipality of São Paulo in 2010 and relating to those 99 expired or informal agreements. Under the aforementioned agreements, the related intangible assets generate greater amortization expense as they are amortized to zero (instead of a residual guaranteed amount reimbursed by the granting municipality at the end of the previous respective concession contracts). This increase is also due to the beginning of operations in 2011 of sites that had previously been under construction;

- § an increase of R\$198.9 million, or 20.2%, in salaries and related charges as a result of: (i) the R\$61.2 million adjustment in 2010 of actuarial calculation due to the migration of employees from defined benefit plan to defined contribution plan “*SabesprevMais*”; (ii) an increase of R\$18.1 million due to the payment of termination fees related to the terminated employees security fund (“*Fundo de Garantia por Tempo de Serviço*” or “FGTS”) incurred as a result of increased layoffs in 2011; (iii) 8% salary readjustments since May 2011, which had a total impact of R\$81.3 million; and (iv) the increase of R\$21.6 million from the 2011 Cost of Sales and Services figure due to the higher expense relating to the profit sharing program as compared to 2010.
- § an increase of R\$166.4 million, or 82.1%, in general expenses, mainly due to the R\$158.8 million provision (corresponding to 7.5% of the gross revenue of capital after deduction of COFINS and PASEP) pursuant to the agreement with the municipality of São Paulo;
- § an increase of R\$65.1 million, or 10.8%, in costs of outsourced services, mainly due to (i) water and sewage systems maintenance, which amounted to R\$16.9 million; (ii) the R\$14.7 million increase in the Alto Tietê PPP designated amount for the contract’s second year, and the initiation of operations in September 2011; (iii) maintenance, in the amount of R\$9.2 million, of water and sewer networks and connections in order to minimize losses and meet project deadlines set forth by the ARSESP; (iv) the transport of mud in the amount of R\$7.1 million as a result of increased demand for water treatment, which causes increased quantities of mud to be transported; (v) an increase of R\$6.3 million resulting from socio-environmental services established together with the municipality of São Paulo; (vi) R\$4.4 million in costs related to mail and telegrams for the delivery of water bills in certain areas via post following judicial decisions; and (vii) vehicle rentals in the amount of R\$2.8 million as part of the second phase of the renovation of our fleet. The increase in costs of outsourced services was partially offset by a decrease in telephone and data transmission charges in the amount of R\$5.7 million, mainly due to the execution of a contract with Telecomunicações de São Paulo S.A. (“TELESP”), which involves landlines and long-distance data transfers as well as corporate cellular phones at lower costs to us.
- § an increase of R\$53.9 million, or 10.2%, in the cost of electric energy due to the increase in consumption and higher energy tariffs.
- § an increase of R\$18.3 million, or 13.4%, in water-treatment products, mainly due to: (i) an increase of approximately 43% in the consumption of polyaluminium chloride, readjusted by approximately 11%. This product was used principally in the Guaraú water treatment station in place of aluminum sulfate, guaranteeing maximum outflow without compromising the quality of the treated water. This increase was partially offset on R\$2.0 million by the decrease of the use of activated charcoal due to climate conditions, as well as due to the decelerated proliferation of algae in the reservoirs of the Alto Tietê System and Guarapiranga/Billings.
- § an increase of R\$12.4 million, or 9.1%, in product-related expenses, mainly in connection with the maintenance of our water and sewer structure (in the amount of R\$7.4 million) and with the increased expenses with fuel and lubricants for vehicles (in the amount of R\$1.8 million), resulted from an increase of 22% in the fuel price and from the expansion of our vehicle fleet.

Gross Profit

As a result of the factors discussed above, gross profit decreased by R\$126.0 million, or 3.1%, to R\$3,910.5 million in 2011 from R\$4,036.5 million in 2010. As a percentage of net revenue from sales and services, gross profit decreased to 39.3% in 2011 from 43.7% in 2010.

Selling Expenses

Selling expenses decreased by R\$93.4 million, or 13.1%, to R\$619.5 million in 2011 from R\$712.9 million in 2010. As a percentage of net revenue from sales and services, selling expenses decreased to 6.2% in 2011 from 7.7% in 2010.

The decrease in selling expenses was primarily due to the following factors:

- § a decrease of R\$112.1 million, or 48.2%, in credit write-offs, mainly as a result of additional provisions established in 2010 of R\$34.2 million related to private clients and R\$139.1 million related to public municipal entities (R\$54.8 million of which related to the municipality of São Paulo);
- § a decrease of R\$14.1 million, or 6.5%, in expenses with outsourced services mainly related to the agreement with municipality of São Paulo and the R\$34.4 million decrease in the provision established in 2011 for new services to be provided under that agreement, and a R\$4.9 million increase resulting from services provided to satisfy the schedule for implementing the Rationed Water Use Program (“*Programa de Uso Racional da Água*” or “PURA”) in city schools. This decrease was partially offset by the following increases: (i) R\$11.1 million in billing services, mainly resulting from new billing technology related to the reading of usage, issuance of bills and delivering bills, in addition to an increase in the number of connections and adjustments of the contracts in the metropolitan region of São Paulo; and (ii) expenses in the amount of R\$3.3 million relating to services for the collection of credits.
- § an increase of R\$19.1 million, or 10.4 %, in the personnel salaries and related charges as a result of: (i) the R\$ 9.3 million adjustment in 2010 of the actuarial calculation due to the migration of employees from defined benefit plan to defined contribution plan “Sabesprev Mais”; (ii) a R\$ 1.4 million increase due to the payment of termination fees related to the terminated employees security fund (“Fundo de Garantia por Tempo de Serviço”) incurred as a result of increased layoffs in 2011; (iii) 8% salary readjustments since may 2011, which had a total impact of R\$ 3.9 million.
- § an increase of R\$9.1 million, or 13.0%, in general expenses, mainly due to (i) water bills for banking institutions in the amount of R\$4.2 million; and (ii) the R\$3.3 million increase in tax provisions relating to the services rendered in the cities of São José dos Campos, Pindamonhangaba and Botucatu, resulting from increased collection during 2011 as compared to 2010;
- § an increase of R\$3.5 million, or 89.6%, in depreciation and amortization expenses, mainly due to the adjustment in amortization of intangible assets in connection with the agreement with the municipality of São Paulo.

Administrative Expenses

Administrative expenses increased by R\$193.4 million, or 29.6%, to R\$846.6 million in 2011 from R\$653.2 million in 2010. As a percentage of net revenue from sales and services, administrative expenses increased to 8.5% in 2011 from 7.1% in 2010.

The increase in administrative expenses was primarily due to:

- § an increase of R\$187.4 million, or 79.6%, in salaries and related charges, mainly due to (i) the covering of actuarial liability in the amount of R\$157.5 million related to the supplementary pension plan (plan G0) of the State of São Paulo (based on the non-recurring actuarial calculation performed on December 31, 2010); (ii) the cover of actuarial liability in the amount of R\$22.2 million related to the supplementary pension plan (plan G0) of the State of São Paulo for 2011; (iii) a R\$3.0 million increase due to the payment of termination fees related to the terminated employees security fund (“*Fundo de Garantia por Tempo de Serviço*” or “FGTS”) incurred as a result of increased layoffs in 2011; and (iv) 8% salary readjustments since May 2011, which had the total impact of R\$9.1 million;
- § an increase of R\$36.7 million, or 21.3%, in general expenses due to (i) the need for larger contingency provisions in the amount of R\$59.7 million, particularly in connection with environmental issues in the municipalities of Guareí and Paraguaçu Paulista. This increase was partially offset by the R\$17.9 million provisioning made in 2010 for losses relating to third party claims;
- § a decrease of R\$24.8 million, or 16.5%, in services provided by third parties in connection with a variety of matters, including: (i) a decrease of R\$18.4 million in advertisement campaigns due to the termination of certain advertisement agreements; (ii) a R\$5.5 million decrease due to reorganization and management performance related to the work of consultants and specialized service providers;

§ a decrease of R\$3.1 million, or 12.2%, in depreciation expenses due to the decreased immobilized assets of the controlling shareholder.

Other Operating Income (Expenses), Net

Other operating income (expenses), net decreased by R\$91.9 million in 2011, to R\$90.1 million expense in 2011 from R\$1.8 million income in 2010. This increase was primarily due to the provision made in the amount of R\$85.9 million related to assets used for our concession in the municipality of Mauá, and to the write-off of assets in the amount of R\$35.3 million.

Finance Cost, Net

Finance cost, net, consists primarily of interest on our indebtedness and foreign exchange losses (or gains) in respect of our indebtedness, offset partially by interest income on cash and cash equivalents and inflation based indexation accruals, mainly relating to agreements entered into with some customers to settle overdue accounts receivable.

Finance cost, net increased by R\$254.2 million, or 67.0%, to R\$633.6 million in 2011 from R\$379.4 million in 2010. As a percentage of net revenues from sales and services, finance cost, net increased to 6.4% in 2011 from 4.1% in 2010.

The increase was principally due to:

- § an increase in foreign exchange loss related to loans and financing of R\$448.5 million as a result of the 12.6% depreciation of the *real* against the U.S. dollar in 2011, compared to an appreciation of 4.3% of the *real* against the U.S. dollar in 2010;
- § a decrease of R\$46.0 million in monetary indexation, mainly due to (i) a higher expense in 2010 amounting to R\$20.0 million, due to the alteration of the unit price of our eleventh debentures issuance between their issuance date and their effective offering date in 2010; (ii) the depreciation of the *real* against the Japanese Yen upon the disbursement by Japan International Cooperation Agency (JICA) of R\$14.0 million in 2011; and (iv) a decrease in the volume of refinancing of debt in 2011 as compared to 2010, amounting to a decrease of R\$12.0 million;and
- § other monetary revisions relating to our contracts in the amount of R\$41.2 million.

The increase in finance cost, net was partially offset by:

- § an increase of R\$153.5 million in interest income and other financial income due to the increase in our cash and cash equivalents;
- § a decrease of R\$95.5 million in financial expenses relating to judicial proceedings as a result of the lower interest income regarding the proceedings involving clients and service providers in 2011; and
- § a decrease of R\$33.6 million in interest expenses mainly due to the amortization of our eighth and ninth debentures in June and October 2011, respectively.

Income before Income Taxes

As a result of the factors discussed above, income before income taxes decreased by R\$572.1 million, or 24.9%, to R\$1,720.7 million in 2011 from R\$2,292.8 million in 2010. As a percentage of net revenue from sales and services, our income before income taxes increased to 17.3% in 2011 from 24.8% in 2010.

Income Taxes

Income taxes decreased by R\$165.0 million, or 24.9%, to R\$497.3 million in 2011 from R\$662.3 million in 2010. The increase was primarily due to a decrease in taxable income in 2011.

Net Income

As a result of the factors discussed above, net income decreased to R\$1,223.4 million in 2011 from R\$1,630.5 million in 2010. Net profit margin decreased to 12.3% in 2011 from 17.7% in 2010.

71

Year Ended December 31, 2010 Compared to Year Ended December 31, 2009

Net Revenue from Sales and Services

Net revenue from sales and services increased by R\$651.5 million, or 7.6%, to R\$9,231.0 million in 2010 from R\$8,579.5 million in 2009.

Net revenue from sales and services relating to water services increased by R\$125.4 million, or 3.3%, to R\$3,942.9 million in 2010 from R\$3,817.5 million in 2009. This increase was principally due to:

§ an average 3.8% increase in the volume of water invoiced 2010; and

§ the effect of the 4.43% tariff increase in September 2009, and the 4.1% tariff increase in September 2010.

Net revenue from sales and services relating to sewage services increased by R\$244.5 million, or 8.4%, to R\$3,157.5 million in 2010 from R\$2,913.0 million in 2009. This increase was principally due to:

§ an average 4.5% increase in the volume of sewage services invoiced in 2010; and

§ the effects of the 4.43% tariff increase in September 2009 and the 4.1% tariff increase in September 2010.

Gross revenue from construction increased by R\$90.9 million, or 4.5%, to R\$2,130.7 million in 2010 from R\$2,039.8 million in 2009.

Cost of Sales and Services

The cost of sales and services increased by R\$107.2 million, or 2.1%, to R\$5,194.5 million in 2010 from R\$5,087.3 million in 2009. As a percentage of net revenue from sales and services, cost of sales and services decreased to 56.3% in 2010 from 59.3% in 2009.

The increase in costs of sales and services was principally due to the following factors:

§ an increase of R\$157.6 million, or 349.3%, in general costs on the provision of water and sewage services, of which R\$167.2 million relates to a fee to the Fund of Environmental Sanitation and Infrastructure of the municipality of São Paulo which had to be paid according to the terms of the agreement with the State and the city of São Paulo executed on June 23, 2010. This fee represents 7.5% of the gross revenue of the São Paulo municipality as from the date of execution of the agreement;

§ an increase of R\$71.4 million in construction costs in 2010;

§ an increase of R\$51.2 million, or 9.3%, in outsourced services, mainly due to (i) the maintenance of water and sewage structure amounting to R\$18.4 million, (ii) pavement and maintenance of side-walks amounting to R\$14.2 million, and (iii) transportation of water and mud amounting to R\$8.4 million; and

§ an increase of R\$45.8 million, or 9.5%, in the electricity expense mainly due to (i) an increase of 5.2% in the electricity tariff, and (ii) an increase of 1.9% in the electricity consumption.

The increase in costs of sales and services was partially offset by:

§ a decrease of R\$196.8 million, or 16.7%, in salaries and related charges, mainly due to (i) a R\$113.5 million decrease as a result of the reduction in our staff pursuant to the TAC, with the State Public Attorney's Office (*Ministério Público Estadual*). Pursuant to the TAC, we laid off retirees who were still working for us and laid off approximately 2% of our workforce; (ii) decrease in actuarial liability due to the migration from defined benefit plan to defined contribution plan amounting to R\$79.3 million and (iii) a decrease of R\$13.6 million related to adjustment in the profit sharing program for 2010;

§ a decrease of R\$14.7 million, or 2.7%, in depreciation and amortization expenses.

Gross Profit

As a result of the factors discussed above, gross profit increased by R\$544.3 million, or 15.6%, to R\$4,036.5 million in 2010 from R\$3,492.2 million in 2009. As a percentage of net revenue from sales and services, gross profit increased to 43.7% in 2010 from 40.7% in 2009.

Selling Expenses

Selling expenses increased by R\$102.5 million, or 16.8%, to R\$712.9 million in 2010 from R\$610.4 million in 2009. As a percentage of net revenue from sales and services, selling expenses increased to 7.7% in 2010 from 7.1% in 2009.

The increase in selling expenses was primarily due to the following factors:

§ an increase of R\$115.1 million, or 98.1%, in the allowance for doubtful accounts related to municipal public entities; and

§ an increase of R\$11.8 million, or 5.8%, in outsourced services expenses, principally due to (i) a R\$9.7 million provision related to future payment to the City Hall of São Paulo (*Prefeitura Municipal de São Paulo*), or PMSP, pursuant to the agreement we entered into with PMSP on June 23, 2010; (ii) R\$9.4 million in billing services, mainly related to an increase in network connections and the utilization of new technologies, which resulted in an increase in outsourcing expenses; and (iii) R\$4.7 million related to increase in fraud control expenses.

The increase in selling expenses was partially offset by a R\$28.2 million, or 13.3%, decrease in salaries and related charges in 2010, due mainly to: (i) the reduction in our staff pursuant to the TAC, which resulted in a decrease of R\$15.5 million in 2010; (ii) gain from the migration of employees from defined benefit plan to defined contribution plan “*SabesprevMais*” amounting to R\$13.3 million; and (iii) R\$13.8 million decrease resulting from the implementation of the PURA program.

Administrative Expenses

Administrative expenses decreased by R\$63.9 million, or 8.9%, to R\$653.2 million in 2010 from R\$717.1 million in 2009. As a percentage of net revenue from sales and services, administrative expenses decreased to 7.1% in 2010 from 8.4% in 2009.

The decrease in administrative expenses was primarily due to:

§ a decrease of R\$96.8 million, or 36.0%, in general expenses due to a reduction in contingency provisions mainly related to customer claims in 2010;

§ a decrease of R\$11.5 million in termination expenses resulting from the 2009 staff reduction pursuant to the TAC; and

§ a decrease of R\$13.9 million in actuarial calculation due to the migration of employees from defined benefit plan to defined contribution plan “*SabesprevMais*.”

The decrease in administrative expenses was partially offset by:

§ an increase in actuarial liability related to the payment by us on behalf of the State of São Paulo of pension plan (plan G0) amounting to R\$31.7 million due to a decrease in the discount rate from 6.6% to 6.0%;

§ an increase of R\$19.2 million related to the deficit in defined benefit plan, paid to the employees who migrated to the defined contribution plan “*SabesprevMais*.”

Other Operating Income (Expenses), Net

Other operating income (expenses), net increased to R\$1.8 million income in 2010 from R\$44.4 million expenses in 2009. The increase was due to the reclassification of the expenses related to the pension plan paid by us on behalf of the State of São Paulo (plan G0), which had been recorded as other operating expenses, net 2009, as administrative expenses in 2010.

73

Finance Cost, Net

Finance cost, net, consists primarily of interest on our indebtedness and foreign exchange losses (or gains) in respect of our indebtedness, offset partially by interest income on cash and cash equivalents and inflation based indexation accruals, mainly relating to agreements entered into with some customers to settle overdue accounts receivable.

Finance cost, net increased by R\$369.4 million, or 3,694.0%, to R\$379.4 million in 2010 from R\$10.0 million in 2009. As a percentage of net revenues from sales and services, finance cost, net increased to 4.1% in 2010 from 0.1% in 2009.

The increase was principally due to:

§ an increase in foreign exchange loss related to loans and financing of R\$470.6 million as a result of the 4.3% appreciation of the *real* against the U.S. dollar in 2010, compared to an appreciation of 25.5% of the *real* against the U.S. dollar in 2009;

§