

COMPANHIA DE SANEAMENTO BASICO DO ESTADO DE SAO PAULO-SABESP
Form 20-F
April 28, 2010

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

FORM 20-F

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

OR

**ý ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE
ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2008**

OR

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

For the transition period from _____ to _____

OR

**“ 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 Common Shares, without par value, as of December 31, 2008

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 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).

Yes No

Indicate by check mark whether the registrant has been subject to such filing requirements for the past 90 days.

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 Other

by the International Accounting Standards Board

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 x

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 x

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Presentation of Financial and Other Information

Our audited financial statements as of December 31, 2008 and 2007 and for the years ended December 31, 2008, 2007, 2006 are included in this annual report. The selected financial data as of December 31, 2006, 2005 and 2004 and for the years ended December 31, 2005 and 2004 is derived from our audited financial statements included in previously filed annual reports.

Our financial statements are presented in Brazilian *reais* and are prepared in accordance with accounting practices adopted in Brazil (Brazilian GAAP), which is based on Brazilian Corporate law No. 6,404 of December 15, 1976, as amended, including the provisions of Law No. 11,638/2007 and Provisional Measure No. 449/2008, converted into Law No. 11,941, dated May 27, 2009); accounting standards issued by the Brazilian Institute of Independent Auditors (*Instituto dos Auditores Independentes do Brasil*), or IBRACON; accounting standards issued by the Brazilian Federal Accounting Council (*Conselho Federal de Contabilidade*), or the CFC; accounting standards issued by the Accounting Standards Committee (*Comitê de Pronunciamentos Contábeis*) or the CPC, and the rules and regulations issued by the Brazilian Securities Commission (*Comissão de Valores Mobiliários*), or the CVM.

Similar to other Brazilian companies, we have the option of presenting our primary financial statements under Brazilian GAAP with a reconciliation to accounting principles generally accepted in the United States of America, or U.S. GAAP. Unless otherwise indicated, our financial statements and all financial data included in this annual report have been prepared in accordance with Brazilian GAAP.

The Brazilian Central Bank and the CVM set 2010 as the deadline for adoption of International Financial Reporting Standards, or IFRS, for the consolidated financial statements of financial institutions and publicly-held companies. On December 28, 2007, Law No. 11,638/07 was enacted, amending the Brazilian corporate law regarding the accounting practices adopted in Brazil. When we present our financial statements under IFRS to comply with this requirement and as Brazilian GAAP migrates towards IFRS, our financial statements under IFRS may be materially different from those actually presented under Brazilian GAAP.

Our Brazilian GAAP financial statements as of December 31, 2008 and 2007 and for the years ended December 31, 2008, 2007 and 2006 reflect the changes introduced by Law 11,638/07 and the new accounting standards issued by the CPC in 2008, which we retroactively applied beginning on January 1, 2006. Selected financial information presented as of and for the years ended December 31, 2005 and 2004 has not been represented on the basis of the new accounting policies introduced in 2008, as permitted by Brazilian GAAP. As a result, such information is not comparable to the financial information reported herein as of and for the years ended December 31, 2008, 2007 and 2006.

Brazilian GAAP differs in significant respects from U.S. GAAP. Note 28 to our financial statements provides a description of the differences between Brazilian GAAP and U.S. GAAP as they relate to our financial statements and a reconciliation from Brazilian GAAP to U.S. GAAP, for the periods presented therein, of our net income and shareholders' equity. This reconciliation includes, among other changes, adjustments for differences related to the accounting for past revaluations of property, plant and equipment, historical inflation accounting, accounting for pension and other employee benefits and account receivables from our controlling shareholder with respect to benefits granted according to law No. 4,819 of August 26, 1958.

All information 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 have not been audited.

In this annual report, references to *real*, *reais* or R\$ are to the Brazilian *real*, the official currency of Brazil. All references to U.S. dollars or US\$ are to the United States dollar, the official currency of the United States. As a result of the recent fluctuations in the *real*/U.S. dollar exchange rate, the commercial selling rate may not be indicative of current or future exchange rates. See *Item 3.A. Selected Financial Data Exchange Rates* for information regarding the *real*/U.S. dollar exchange rate since January 1, 2002.

Other Information

On August 15, 2008, we established a special purpose company called SESAMM – Serviços de Saneamento de Mogi Mirim S/A to provide sewage treatment services to the municipality of Mogi-Mirim. The company has a period of duration of 30 years from the date of execution of the concession agreement with the municipality of Mogi-Mirim. We have 36.0% of SESAMM's capital stock, which as of December 31, 2008 amounted to R\$10.7 million divided into 10,669,549 common shares with no par value.

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. Brazil refers to the Federative Republic of Brazil and State refers to the State of São Paulo, which is also our controlling shareholder. The terms federal government and Brazilian government refer to the federal government of the Federative Republic of Brazil and State government refers to the state government of the State of São Paulo.

In this annual report, the São Paulo metropolitan region means the area where the Metropolitan executive office operates, comprising 38 municipalities, including the city of São Paulo. The term Regional systems means the area where the Regional systems executive office operates, comprising 328 municipalities in the interior and coastline regions of the State of São Paulo. As of the date of this annual report, we provide water supply and sewage services to a total of 366 of the 645 municipalities in the State of São Paulo.

References to water coverage ratio in this annual report mean the ratio between the number of residences connected to the water supply network, divided by the number of urban residences in a certain area. References to sewage coverage ratio mean the ratio between the number of residences connected to the sewage collection network, divided by the number of urban residences in a certain area.

References to urban and total population in this annual report are estimated based on a research made by the State System Foundation Data Analysis (*Fundação Sistema Estadual de Análise de Dados*), or 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*).

Certain figures 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.

Forward-Looking Statements Contained in this Annual Report

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 and other conditions in Brazil and in other emerging market countries;
- existing and future governmental regulation, including taxes on, and charges to, us;
- changes to tax laws in Brazil;
- inflation and currency devaluation 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 ability to continue to be able to pass on to our tariffs expenses that we incur in connection with the use of water;
- our capital expenditure program and other liquidity and capital resources requirements;
- changes in the Brazilian environmental law;
- limitations on our ability to increase and readjust tariffs;
- droughts, water shortages and climate events;
- power shortages or rationing in energy supply or significant changes in energy tariffs;
- our lack of formal concession agreements for the city of São Paulo and other municipalities, including the cities comprising the São Paulo metropolitan region;
- the right municipalities have to terminate our existing concession agreements prior to their expiration date;
- our ability to provide water and sewage services in additional municipalities and to maintain rights to provide the currently contracted services;
- the size and growth of our customers base;
- our ability to maintain universalization of water coverage ratio in the municipalities to which we provide water services and to increase sewage coverage ratio in the municipalities to which we provide sewage services;
- our level of indebtedness and limitations on our ability to incur additional indebtedness;

- our ability to access financing at attractive conditions in the future;

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- our costs relating to compliance with environmental laws and potential penalties for failure to comply with these laws;
- 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 ARSESP, regarding several aspects of our business; 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 identify 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

1.A. Directors and Senior Management

Not applicable.

1.B. Advisers

Not applicable.

1.C. Auditors

Not applicable.

ITEM 2. Offer Statistics and Expected Timetable

2.A. Offer Statistics

Not applicable.

2.B. Method and Expected Timetable

Not applicable.

ITEM 3. Key Information

3.A. Selected Financial Data

The selected financial data in this section as of December 31, 2008 and 2007 and for the years ended December 31, 2008, 2007 and 2006 has been derived from our audited financial statements, which appear elsewhere in this annual report. The selected financial data as of December 31, 2006, 2005 and 2004 and for the years ended December 31, 2005 and 2004 has been derived from our audited financial statements, which do not appear elsewhere in this annual report.

Our financial statements have been prepared in accordance with Brazilian GAAP, which differs in significant respects from U.S. GAAP (see Note 28 to our financial statements). You should read this selected financial data in conjunction with our financial statements and the related notes thereto included in this annual report.

The following table presents our selected financial data as of and for each of the periods indicated.

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As of and for the year ended December 31,
2004 **2005** **2006(1)** **2007(1)** **2008(1)(2)**
(as adjusted) (as adjusted)
(in millions of *reais*, except per share and per ADS data)

Brazilian GAAP**Statement of operations data:**

Net revenue from sales and services	4,397.1	4,953.4	5,527.3	5,970.8	6,351.7
Cost of sales and services	(2,253.4)	(2,376.4)	(2,616.8)	(2,695.7)	(2,831.8)
Gross profit	2,143.7	2,577.0	2,910.5	3,275.1	3,519.9
Selling expenses	(502.5)	(537.8)	(719.2)	(639.6)	(718.9)
Administrative expenses	(313.6)	(349.6)	(376.9)	(552.6)	(578.6)
Other operating expenses (income), net	(33.9)	(25.4)	(50.9)	(35.1)	(1,053.0)
Financial income (expenses), net	(503.7)	(447.0)	(563.3)	(560.9)	(707.5)
Income before income taxes and extraordinary item	790.0	1,217.2	1,200.3	1,486.8	461.9
Income tax and social contribution	(241.9)	(316.5)	(375.7)	(431.6)	(398.3)
Extraordinary item, net of income and social contribution taxes ⁽³⁾	(35.1)	(35.1)	(35.1)	-	-
Net income	513.0	865.6	789.4	1,055.3	63.6
Net income per 1,000 common shares (per share in 2007 and 2008) ⁽⁴⁾	18.01	30.40	27.72	4.63	0.28
Net income per ADS	4.50	7.60	6.93	9.26	0.56
Dividends and interest on shareholders' equity per 1,000 common shares (per share in 2008)	5.37	12.23	9.51	1.32	1.30
Number of common shares outstanding at year end (in thousands of shares) ^{(5) *}	28,479,578	28,479,578	28,479,578	227,836	227,836

(1) Our Brazilian GAAP financial statements as of December 31, 2008 and 2007 and for the years ended December 31, 2008, 2007 and 2006 reflect the changes introduced by Law 11,638/07 and the new accounting standards issued by the CPC in 2008, which we retroactively applied beginning on January 1, 2006. See Note 2(c) to our financial statements included elsewhere in this annual report for this amendment and other reclassifications to our Brazilian GAAP financial statements. Selected financial information presented as of and for the years ended December 31, 2005 and 2004 has not been represented on the basis of the new accounting policies introduced in 2008, as permitted under Brazilian GAAP. As a result, such information is not comparable to the financial information reported herein as of and for the years ended December 31, 2008, 2007 and 2006.

(2) Includes the proportional consolidation of SESAMM.

(3) The extraordinary item charged to income in the years ended December 31, 2004, 2005 and 2006 relates to the amortization (over a five-year period) of the actuarial liability recorded on December 31, 2001 upon first time recognition of the defined benefits pension plan. The presentation of the charge as an extraordinary item is consistent with the instructions of the CVM and Brazilian GAAP. For purposes of U.S. GAAP, the pension expense has been

treated as a payroll expense from the first year presented.

(4) After June 4, 2007 our common shares have been traded taking into account a reverse stock split of 125 common shares into one common share. To convert from *reais* per 1,000 common shares to *reais* per share, for 2004, 2005, 2006 and 2007 the price per 1,000 common shares must be divided by 1,000 and multiplied by 125.

(5) In 2007, we approved a reverse stock split of 125 common shares into one common share. Under U.S. GAAP, SFAS N° 128 requires the retroactive restatement of earnings-per-share computations for stock dividends, stock splits and reverse splits (see Note 28 to our financial statements).

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As of and for the year ended December 31,
2004 2005 2006(1) 2007(1) 2008(1)(2)
 (as adjusted) (as adjusted)
 (in millions of *reais*, except per share and per ADS data)

Brazilian GAAP**Balance sheet data:**

Cash and cash equivalents	105.6	280.2	328.2	465.0	625.7
Customer accounts receivables, net	1,227.9	1,332.5	1,407.9	1,486.7	1,456.2
Reimbursement for pension benefits paid	576.3	672.7	774.5	879.1	956.6
Short and long term receivables from shareholders, net ⁽³⁾	245.6	420.4	456.9	446.4	234.3
Property, plant and equipment, net	13,523.5	13,613.6	13,837.5	14,051.4	14,926.6
Intangible assets, net	517.4	502.5	495.1	516.5	815.4
Total assets	16,783.8	17,431.1	17,989.9	18,659.9	20,113.9
Total short term loans and financing	1,496.8	759.0	852.5	742.1	1,448.9
Total long term loans and financing	5,553.8	5,905.2	5,474.3	4,943.1	5,416.2
Interest on shareholders equity payable	152.9	348.2	270.8	680.3	275.0
Total liabilities	8,832.2	8,948.5	8,981.5	8,879.4	10,566.0
Shareholders equity	7,951.6	8,482.5	9,008.4	9,780.5	9,547.9

Other financial information:

Cash provided by operating activities	1,441.1	1,737.6	2,018.0	2,215.6	2,528.0
Cash used in investing activities	(675.5)	(643.2)	(847.2)	(881.7)	(1,555.2)
Cash used in financing activities	(941.1)	(919.7)	(1,122.8)	(1,197.1)	(812.1)
Capital expenditures	670.3	643.1	855.1	881.7	1,555.2
Depreciation and amortization	598.9	596.0	628.9	616.0	617.8

(1) Our Brazilian GAAP financial statements as of December 31, 2008 and 2007 and for the years ended December 31, 2008, 2007 and 2006 reflect the changes introduced by Law 11,638/07 and the new accounting standards issued by the CPC in 2008, which we retroactively applied beginning on January 1, 2006. See Note 2(c) to our financial statements included elsewhere in this annual report for this amendment and other reclassifications to our Brazilian GAAP financial statements. Selected financial information presented as of and for the years ended December 31, 2005 and 2004 has not been represented on the basis of the new accounting policies introduced in 2008, as permitted under Brazilian GAAP. As a result, such information is not comparable to the financial information reported herein as of and for the years ended December 31, 2008, 2007 and 2006.

(2) Includes the proportional consolidation of SESAMM.

(3) Short and long term receivables from shareholders, net represent amounts due from the State for water and sewage services. See Note 6 to our financial statements.

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As of and for the year ended December 31,
2004 2005 2006 2007 2008
(in millions, except per share and per ADS data)

U.S. GAAP

(in reais)

Statement of operations data:

Net revenue from sales and services	4,397.1	4,953.4	5,527.3	5,970.8	6,351.7
Gross profit	1,953.1	2,383.2	2,704.8	3,122.3	3,155.1
Selling expenses	(521.5)	(555.4)	(737.3)	(648.1)	(758.0)
Administrative expenses	(324.1)	(350.2)	(428.7)	(609.9)	(771.1)
Income from operations ⁽¹⁾	1,073.0	1,470.2	1,451.4	1,840.9	1,487.5
Financial income (expenses), net	(479.2)	(401.9)	(542.3)	(520.8)	(886.2)
Net income	417.5	791.2	622.5	925.4	444.1
Net income per common share- basic and diluted	1.83	3.47	2.73	4.06	1.95
Net income per ADS-basic and diluted	3.67	6.95	5.46	8.12	3.90
Weighted average number of common shares outstanding ⁽²⁾	227,836,623	227,836,623	227,836,623	227,836,623	227,836,623

Balance sheet data:

Property, plant and equipment, net	15,347.2	15,393.9	15,473.5	15,621.0	16,203.5
Intangible assets, net	517.4	502.5	495.1	507.8	815.4
Total assets	17,704.5	18,209.8	18,498.7	18,928.9	19,989.1
Short-term loans and financing	1,496.8	759.0	852.5	742.1	1,448.9
Long-term loans and financing	5,553.8	5,905.2	5,459.9	4,925.4	5,423.0
Interest on shareholders' equity payable	144.1	409.7	511.5	680.3	275.0
Total liabilities	11,339.7	11,388.4	11,200.5	11,037.3	12,009.4
Shareholders' equity	6,364.8	6,821.4	7,298.2	7,891.6	7,979.7

(1) Under U.S. GAAP, income from operations is determined before financial expenses, net.

(2) In 2007, we approved a reverse stock split of 125 common shares into one common share. Under U.S. GAAP, SFAS N° 128 requires the retroactive restatement of earnings-per-share computations for stock dividends, stock splits, and reverse splits (see Note 28 to our financial statements).

As of and for the year ended December 31,
2004 2005 2006 2007 2008 2009

Operating data (at period end):

Number of water connections (in thousands)	6,358	6,489	6,609	6,767	6,945	7,118
Number of sewage connections (in thousands)	4,747	4,878	5,002	5,167	5,336	5,520
Percentage of population with water connections (in percentages)	100	100	99	99	99	99
	78	78	78	79	79	80

Percentage of population with sewer connections (in percentages)						
Volume of water billed during period (in millions of cubic meters)	1,692	1,759	1,807	1,847	1,878	1,917
Water loss percentage during period (average)(in percentages) ⁽¹⁾	34.0	32.4	31.9	29.5	27.9	26.0
Water loss per connection (average) ⁽²⁾	547	520	511	467	436	402
Number of employees	17,735	17,448	16,978	16,850	16,649	15,103

(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/connections per day, according to the new method of measuring our water losses, based on worldwide market practice for the sector. See *Item 4.B. Business Overview Water Operations Water Losses*.

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Before March 2005, there were two principal legal foreign exchange markets in Brazil, the commercial rate exchange market and the floating rate exchange market. On March 4, 2005, the Brazilian National Monetary Council (*Conselho Monetário Nacional*), or the CMN, enacted Resolution No. 3,265, pursuant to which the floating rate market and the commercial market were unified under the denomination exchange market, effective as of March 14, 2005. The new regulation allows the purchase and sale of foreign currency and the international transfer of *reais* by any person or legal entity, regardless of the amount, provided, however, the transaction is legal and subject to certain regulatory procedures.

Since 1999, the Central Bank has allowed the *real*/U.S. dollar exchange rate to float freely, and, since then, the *real*/U.S. dollar exchange rate has fluctuated considerably. The *real* appreciated against the U.S. dollar in 2004, 2005, 2006 and 2007. In 2008, the *real* depreciated by 30.1% and in 2009, appreciated by 25.5% against the U.S. dollar. As of December 31, 2009, the exchange rate for U.S. dollars was R\$1.7412 per U\$1.00. In the past, the Central Bank has intervened occasionally to control unstable movements in foreign exchange rates. We cannot predict whether the Central Bank or the Brazilian government will continue to allow the *real* float freely or will intervene in the exchange rate market through the return of a currency band system or otherwise. The *real* may depreciate or appreciate against the U.S. dollar substantially in the future. For more information on these risks, see *Item 3.D. Risk Factors Risks Relating to Brazil*.

The following tables set forth the commercial selling rate, expressed in *reais* per U.S. dollar, for the periods indicated.

Year	Year-end	Average for year⁽¹⁾ (<i>reais</i> per U.S. dollar)	Low	High
2005	2.3407	2.4125	2.1633	2.7621
2006	2.1380	2.1679	2.0586	2.3711
2007	1.7713	1.9300	1.7325	2.1556
2008	2.3370	1.8335	1.5593	2.5004
2009	1.7412	1.9905	1.7024	2.4218

Month	Period-end	Average for period⁽²⁾ (<i>reais</i> per U.S. dollar)	Low	High
October 2009	1.7440	1.7384	1.7037	1.7844
November 2009	1.7505	1.7262	1.7024	1.7588
December 2009	1.7412	1.7503	1.7096	1.7879
January 2010	1.8748	1.7798	1.7227	1.8748
February 2010	1.8110	1.8416	1.8046	1.8773
March 2010	1.7810	1.7858	1.7637	1.8231
April 2010 (through April 22, 2010)	1.7626	1.7605	1.7446	1.7806

Source: Central Bank

(1) Represents the average of the exchange rates on the closing of each business day during the period.

(2) Represents the average of the lowest and highest rates in the month.

Exchange rate fluctuations will affect the U.S. dollar equivalent of the *real* price of our common shares on the São Paulo Stock Exchange (*Bolsa de Valores, Mercadorias e Futuros de São Paulo*), 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.

3.B. Capitalization and Indebtedness

Not applicable.

3.C. Reasons for the Offer and Use of Proceeds

Not applicable.

3.D. Risk Factors

Risks Relating to Brazil

The Brazilian government has exercised, and continues to exercise, significant influence over the Brazilian economy. This involvement, as well as Brazilian political and economic conditions, could adversely affect us and the market price of our 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 shares or American Depositary 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 controls and restrictions, such as those which were briefly imposed in 1989 and 1990;
- currency fluctuations;
- inflation;
- liquidity of the Brazilian capital and lending markets;
- tax and regulatory policies; and
- other political, social and economic developments in or affecting Brazil.

Uncertainty over whether the Brazilian government will implement changes in policy or regulation affecting these or other factors in the future 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 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 value of our shares or ADSs.

Brazil experienced extremely high rates of inflation in the past. Inflation and the Brazilian government's measures to fight 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 2006, 2007, 2008 and 2009 was 13.19%, 11.18% and 13.66% and 8.65%, respectively in line with the target rate set by the Brazilian Committee on Monetary Policy (*Comitê de Política Monetária*), or COPOM.

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The annual rate of inflation, as measured by the General Market Price Index (*Índice Geral de Preços Mercado*), or IGP-M index, has fallen from 9.95% in 2000 to 3.83% in 2006, increased to 7.75% in 2007 and increased to 9.81% in 2008. In 2009, there was a 1.71% deflation according to the IGP-M. 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 value of our 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 value of our shares or ADSs.

Exchange rate instability may adversely affect us and the market price of our 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 has 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* depreciated against the U.S. dollar by 9.3% in 2000, 18.6% in 2001 and 52.25% in 2002. The *real* appreciated 11.81%, 8.66% and 17.15% against the U.S. dollar in 2005, 2006 and 2007, respectively. In 2008, the *real* depreciated by 30.1% and in 2009, appreciated by 25.5% against the U.S. dollar. There can be no assurance that the *real* will not further depreciate against the U.S. dollar. As of December 31, 2008, the exchange rate was R\$2.3370 per US\$1.00. As of December 31, 2009, the exchange rate was R\$1.7412 per US\$ 1.00. On April 22, 2010, the exchange rate was R\$1.7626 per US\$1.00.

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 based 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\$2,281.0 million and R\$1,746.4 million as of December 31, 2008 and 2009, respectively, and we anticipate that we may incur substantial amounts of foreign currency-denominated indebtedness in the future. In 2008, our results of operations were negatively affected by the 31.9% depreciation of the *real* against the U.S. dollar, which amounted to R\$438.9 million. In 2009, our results of operations were positively affected by the 25.5% appreciation of the *real* against the U.S. dollar, which amounted to R\$395.4 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 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 value 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 value 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.

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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 our operating results, financial position and the price of securities issued by Brazilian companies.

Changes in Brazilian GAAP for the convergence to IFRS may adversely impact our results.

On December 28, 2007, the Brazilian government enacted law No. 11,638/07, as later supplemented by law No. 11,941/09, to amend Brazilian Corporate Law and introduce new accounting principles for the convergence of Brazilian GAAP to IFRS.

In 2009, the CPC issued several accounting standards approved by the CVM and the CFC, which are mandatory to all Brazilian publicly-held companies in 2010, including a retroactive application on financial statements for the year ended December 31, 2009, which will be presented for comparative purposes.

We are in the process of evaluating the potential effects of adoption of these new accounting rules, interpretations and guidelines, which may have a material impact on our financial statements, our profit and our dividends for the year ending December 31, 2010 and also for the year ended December 31, 2009, when presented for comparative purposes.

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 ours or from minority shareholders interests, and 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 22, 2010, 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, 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*.

Newly elected Governors of the State typically make significant changes in our board of directors and senior management and, historically, the chairman of our board of directors has been the Secretary of State for the State Secretariat for Sanitation and Energy (*Secretaria de Saneamento e Energia do Estado de São Paulo*).

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, 2008 and 2009, the amounts owed to us by the State for the provision of water and sewage services totaled R\$234.3 million and R\$169.5 million, respectively. With respect to payment of pensions on behalf of the State, as of December 31, 2008 the State owed to us R\$1,365.7 million, of which we made provisions for loss in the amount of R\$409.1 million, due to the current stage of the negotiations with the State and the uncertainty regarding the recovery of the amount. As of

December 31, 2009, the State owed to us R\$1,394.7 million with respect to payment of pensions on behalf of the State, of which we made provisions for loss in the amount of R\$471.6 million. Amounts owed to us by the State for water and sewage services and reimbursements for pensions paid may increase in the future.

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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 6 to our financial statements. Pursuant to these agreements, the amounts due with respect to water and sewage services could be settled through the application of dividends payable to the State by us to the repayment of amounts owed to us through December 2007. 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 the 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 to us R\$915.3 million (as of September 30, 2008) relating to payments of pension benefits made by us on its behalf. We accepted on a temporary basis the reservoirs in the Alto Tietê System as part of the payment in the amount of R\$696.3 million until the State transfers the property rights on the 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, starting in November 2008. 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. See *Item 8.A. Consolidated Statements and other Financial Information Legal Proceedings Other Legal Proceedings*. The agreement also established that the parties should endeavor their best efforts to settle the outstanding balance due to us by the State in the amount of R\$450.4 million and we were expecting the State to recognize that it owed to us this amount. 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, in 2008, we recorded a R\$409.1 million provision for losses and a R\$535.4 million provision for actuarial liability.

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 that 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.

We have a substantial amount of accounts receivable owed to us by the State and some State entities, and we cannot

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 was enacted on January 5, 2007. While it has been in effect for more than three years, it is still at early stages of implementation in Brazil and we continue to be unable to anticipate all the effects that it might have on our operations and business. There are still several uncertainties related to the Basic Sanitation Law interpretation. It is likely that the federal government will enact a presidential decree to regulate certain issues that remain unclear under the Basic Sanitation Law. We cannot anticipate what issues the presidential decree might regulate nor the effects that it would have on our business and operations, if any. If the federal government enacts a decree that contains unfavorable terms to us, we could have a material adverse effect.

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In addition, the new regulatory agency of the State of São Paulo for the basic sanitation industry, the ARSESP, has so far regulated our tariff structure and adjustments according to the same structure and adjustment formula that we ordinarily follow. Pursuant to a cooperation agreement among the State and some municipalities, the ARSESP also regulates our tariffs in municipalities that selected ARSESP to perform the task of regulating our tariffs. Since 2008, the ARSESP has been developing new concepts that might be included in the tariff structure and adjustment formula. The ARSESP expects to release a revised tariff structure and adjustments formula in 2011. We cannot anticipate additional changes that the ARSESP will implement on our tariff structure and adjustment formula nor the effects that these changes will have on us, in particular because our contractual rights under the concession agreements may not fully protect us due to its general open-ended nature. If the changes are unfavorable to us, we could have a material adverse effect. Moreover, the ARSESP also enacted certain rules establishing (i) the general conditions for the services we render, (ii) the communication process for any failure in our services and (iii) the penalties for deficiencies in the services. We are currently evaluating the enforceability and legality of these rules. The compliance with the rules enacted by ARSESP may adversely affect us.

Finally, under the Basic Sanitation Law we are required to have enforceable contractual arrangements with every municipality we serve by December 31, 2010. We may not be in a position to comply with this requirement depending on the final decision of the Brazilian Supreme Court with respect to the titularity of the basic sanitation services in the metropolitan regions. However, the Basic Sanitation Law does not provide for any penalty or fine in case of non compliance with this legal requirement. If any penalty or fine is duly imposed on us due to our non compliance with this legal requirement, we could have a material adverse effect. We are currently renegotiating 82 concession agreements with municipalities located outside the São Paulo metropolitan regions that expired since 2005. From 2010 through 2030, 80 concession agreements will expire. In addition, we do not hold formal concessions to provide water and sewage services to 32 municipalities located in metropolitan regions, including the city of São Paulo.

Our revenues depend mainly on the water and sewage services we render to the city of São Paulo. We do not hold formal concession agreements to provide these services to the city of São Paulo and several other municipalities that we serve, and therefore may not be able to enforce our rights to continue to provide services in these municipalities.

Our operations are concentrated in the city of São Paulo, with which we have not entered into a concession agreement. In the year ended December 31, 2008, the city of São Paulo accounted for 55.5% of our gross revenues and, as of December 31, 2008, 67.3% of our total assets. In addition, we do not hold formal concessions in 31 other municipalities in the State of São Paulo, including the municipality of Santos, which is located in the coastal region and has, as of December 31, 2009, a population of approximately 429,000 people, where we operate under a deed of authorization (*escritura pública de autorização*).

Because we do not hold concessions or contractual rights to provide services in some of these municipalities, we may not be able to effectively enforce our right to continue to provide services or face difficulties in being timely paid for the services we provide. In the future, our rights in respect of the city of São Paulo and these other municipalities could be modified or adversely affected by Brazilian federal, state or municipal governmental actions, judicial decisions or other factors.

From time to time, mayors of the city of São Paulo have initiated or proposed discussions with the State regarding entering into a formal concession agreement with us to provide water and sewage services in the city of São Paulo. For a detailed discussion of these initiatives, see *Item 4.B. Business Overview Government Regulation Concessions*.

We cannot anticipate the effects that further developments of the Basic Sanitation Law and its interpretation will have

The Basic Sanitation Law sets December 31, 2010 as the deadline for water and sewage service companies, such as us, to regularize the provision of water and sewage services to municipalities, in case there is no formal concession agreement to provide services to municipalities. We cannot anticipate the terms and conditions of these concession agreements and their effect on the provision of our services in these municipalities.

In addition, it remains uncertain whether state or municipal governments have the authority to plan and regulate basic sanitation services rendered to metropolitan regions, as well as the right to execute concession and program agreement. This issue is under discussion at the Brazilian Supreme Court, in a suit initiated by third parties. If the Brazilian Supreme Court grants this authority to municipal governments, under certain circumstances, we may be required to cease our operations in certain areas of the São Paulo metropolitan region in the event that certain municipalities opt to use another water and sewage service provider. This uncertainty also creates an obstacle for us to enter into formal agreements with city of São Paulo because we are unable to anticipate which governmental authority will be deemed to have the authority to do so.

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On November 14, 2007, we entered into an agreement with the city of São Paulo to establish the conditions for the provision of water and sewage services, and environmental utility services in the city of São Paulo. The scope of this agreement may be limited by the Brazilian Supreme Court, but it will remain effective with respect to the services that remain under the authority of the city of São Paulo. In December 2008, the São Paulo city council approved in an initial vote the proposed law No. 558/08, which authorizes the Executive Power to legally bind the city of São Paulo to an agreement with ARSESP and us in order to ensure stability in the rendering of services. This project was approved in the first week of June 2009, authorizing the Executive Power to execute the agreement for a 30-year period. This period can be extended for an additional 30-year period. However, we will be required to offer minimum guarantees and certain services to the city of São Paulo, as part of the provision of water and sewage services. See *Item 4.B. Business Overview Our Operation Operations in the São Paulo Metropolitan Region and Other Metropolitan Regions*. A draft of the agreement was submitted to a public hearing. We cannot anticipate the final results of the public hearing or when the agreement will be executed.

We cannot assure you when or whether there will be changes to the conditions under which we currently provide water and sewage services to these municipalities with which we do not hold formal concession agreements. We cannot anticipate the effects of the Brazilian Supreme Court decision on the provision of our services in the city of São Paulo and in these other municipalities located in metropolitan regions, either of which may cause a material adverse effect on us.

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 may become subject to substantial water-related and sewage-related charges imposed by governmental water agencies of the State and of the federal government related to the abstraction of water from, or dumping of sewage into, water resources controlled by these agencies, which we may not be able to pass on to our customers. See *Item 4.B. Business Overview Government Regulation Water Usage* ;
- the degradation of watershed areas may affect the quantity and quality of water available to meet our costumers 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. These constraints may also have an adverse effect on our capability 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* ;
- 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;
- we are exposed to eventual droughts that may adversely affect our 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. See *Item 5.A. Operating and Financial Review and Prospects Factors Affecting Our Results of Operations Effects of Drought* ; and

We cannot assure you when or whether there will be changes to the conditions under which we currently provide w

- 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.

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

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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.

At the end of 2008 and 2009, we were a provider of water and sewage services to 365 and 366 municipalities, respectively. Since 2007, we have entered into 174 30-year term program agreements with municipalities, of which 14 were entered into in 2009. These 174 municipalities accounted for 8.2% of our total revenues for the year ended December 31, 2009 and 8.7% of our total assets as of December 31, 2009. By December 31, 2009, 82 of our concession agreements had expired and are under renegotiation. These 82 municipalities accounted for 12.1% of our total revenues for the year ended December 31, 2009 and 12.9% of our total assets as of December 31, 2009. From 2010 to 2030, 80 concession agreements will expire. These 80 concession agreements accounted for 9.1% of our total revenues for the year ended December 31, 2009 and 6.4% of our total assets as of December 31, 2009. The remaining 32 concession agreements have indefinite terms and account for 65.7% of our total revenues for the year ended December 31, 2009 and 72.0% of our total assets as of December 31, 2009.

We cannot assure that these municipalities will continue to require our services and enter into new concession agreements or program agreements with us. 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 case 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 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 case certain 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 Public Consortia Law and Cooperation Agreement 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.

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In 1997, the municipality of Santos enacted a law expropriating our water and sewage systems in Santos. There are pending legal proceedings discussing the expropriation carried out by this municipality. 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. We and the municipality of Diadema settled the lawsuit in 1996, but 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 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. In addition, it indicates our intent to develop a share infrastructure for the provision of water and sewage services. This memorandum of understanding stayed the collection proceedings we had filed against the municipality of Diadema. We continue to provide water and sewage services to the city of Santos and supply water on a wholesale basis to the city of Diadema. For further information on these lawsuits, see Item 8.A. 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 new 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 may also be 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. Nevertheless, we cannot anticipate the effects of the new 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\$8.6 billion in the period from 2009 through 2013. We recorded R\$1.7 billion and R\$1.8 billion in 2008 and 2009, respectively, 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.

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

We are also subject to financial covenants limiting our ability to incur additional indebtedness, whether denominated in *reais* or foreign currency. For further information on these covenants, see *Item 5.B. Operating and Financial Review and Prospects*. These financial covenants may prevent us from completing our capital expenditure program, which could have a material adverse effect on us.

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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 and environmental covenants relating to the protection of human health and the environment. These laws and regulations limit or prohibit emissions or spills of effluents and toxic substances, such as raw sewage, produced in connection with our operations. Current and past disposal and emissions practices may result in the need for us to clean up or retrofit our facilities at substantial costs and could result in substantial liabilities. 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 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. We are a party to a number of civil public actions related to environmental matters, with regard to which we are unable to calculate our estimated amount of potential liability. 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. Any unfavorable judgment in relation to these 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. Consolidated Statements and other Financial Information Legal Proceedings*.

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. 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\$1,468.8 million as of December 31, 2009 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. 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 50.4% of the aggregate market capitalization of the BM&FBOVESPA as of December 31, 2009. The top ten stocks in terms of trading volume accounted for approximately 45.8%, 53.14% and 50.4% of all shares traded on the BM&FBOVESPA in 2007, 2008 and 2009, respectively.

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

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 Brazilian National Monetary Council (*Conselho Monetário Nacional*), 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 fixed 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 by-laws may limit the ability of a holder of our ADSs to enforce liability under U.S. securities laws.

Under our by-laws, 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 by-laws. 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 common shares or ADSs may face difficulties in protecting his or her interests as a shareholder because

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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 by laws that limit the exercise by ADR holders of their voting rights through the depositary 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 depositary, 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 depositary to do so. To exercise their voting rights, ADR holders must then instruct the depositary as to voting the common shares represented by their ADSs. Due to these procedural steps involving the depositary, the process for exercising voting rights may take longer for ADR holders than for holders of common shares. ADSs for which the depositary fails to receive timely voting instructions will not be voted at any meeting.

ITEM 4. Information on the Company

4.A. History and Development of the Company

Overview

Companhia de Saneamento Básico do Estado de São Paulo SABESP is a *sociedade de economia mista*, a mixed capital company of unlimited duration, incorporated on September 6, 1973, with limited liability, duly organized and operating under Brazilian Corporate Law. 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. As set forth in Article 2 of our by laws, our corporate purpose is to render basic sanitation services aiming at the universalization in the State of São Paulo 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 operate, in a secondary subsidiary form, in other Brazilian locations and abroad. See *Item 4.B. Business Overview Government Regulation Public Consortia Law and Cooperation Agreement 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 2009, according to the 11th edition of the Pinstent Masons Water Yearbook. 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 Brazilian Institute of Geography and Statistics (*Instituto Brasileiro de Geografia e Estatística*), or 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. We had consolidated net revenue from sales and services of R\$6,730.5 million and consolidated net income of R\$1,373.9 million for the year ended December 31, 2009. We had total consolidated assets of R\$21,565.2 million and shareholders' equity of R\$10,527.6 million as of December 31, 2009.

We provide water and sewage services to a broad range of residential, commercial, industrial and governmental customers in 366 of the 645 municipalities in the State of São Paulo, including the city of São Paulo. We also supply water on a wholesale basis to six municipalities in the São Paulo metropolitan region in which we do not operate water systems. For the year ended December 31, 2009, the São Paulo metropolitan region (including the municipalities to which we provide water on a wholesale basis) and the Regional Systems accounted for 75.6% and 24.4% of our gross revenue from sales and services, respectively.

As of December 31, 2009, we provided water services to approximately 23.4 million people, approximately 60% of the urban population of the State of São Paulo, and effectively had a water coverage ratio of 100% through 63,732 kilometers of water pipes and mains to approximately 7.1 million water connections. As of December 31, 2009, we provided sewage services to approximately 19.6 million people through 42,896 kilometers of sewer lines to approximately 5.5 million sewage connections. In addition, we currently supply water on a wholesale basis to six municipalities with a total estimated urban population of approximately 3.3 million.

The State, our controlling shareholder, is required by law to own at least one-half plus one of our common shares. The State currently owns 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 Energy 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 Council for Protection of Capitals of the State (*Conselho de Defesa de Capitais do Estado de São Paulo*), or CODEC, a State agency presided over by the Secretary of the State Treasury (*Secretaria da Fazenda*) and reporting directly to the State governor.

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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 Energy as a whole. Our 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 are one of the largest water and sewage services provider in the world. We provide water services directly to approximately 23.4 million people and supply water on a wholesale basis to an additional urban population of 3.3 million people. As of December 31, 2009, we effectively had a water coverage ratio of 100%. We also provide sewage services directly to approximately 19.6 million people, achieving a sewage coverage ratio of 80% as of December 31, 2009. From 2004 through 2009, our net revenue from sales and services has increased by an average of 8.89% per year. 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 and have well-trained personnel and a specialized structure that 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 42.4 million as of December 31, 2009. The city of São Paulo had an estimated population of 10.9 million as of December 31, 2009, with 20.2 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\$902.8 billion in 2007, representing approximately 34% of Brazil's total GDP. The State of São Paulo generates more revenue from water and sewage services than any other Brazilian state.

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 16 of our water quality control laboratories operate in accordance with the NBR ISO 9001, which follows the highest international standards. From our 16 laboratories, 13 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 NBR/IEC ISO 17.025. 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.

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 place 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 the ISE, and, as of the date of this annual report, we remain the only company from the sanitation industry to be part of this index, which reflects our high degree of commitment to sustainable environmental and social practices.

Expansion opportunities. We had a sewage coverage ratio of 80.0% as of December 31, 2009, and plan to increase our sewage coverage ratio to 90.0% by 2018 by adding over 1.6 million sewage connections. In addition, there are municipalities in the State of São Paulo representing an aggregate population of approximately 16.4 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 place us in a privileged position to expand (i) our sewage services to municipalities in which we provide only water services and (ii) our water and sewage services to municipalities in which we do not yet operate, not only in the State of São Paulo but also in other states of Brazil and abroad.

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 water services, social, economic and environmental sustainability. 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:

Reduce operating costs and increase productivity and profitability. We intend to make our best efforts to reduce operating costs and increase productivity and profitability. To achieve this goal, we plan to improve the management of our assets, as well as to continue to reduce our total salary and payroll expenses by decreasing the number of our employees, automating some of our operations, streamlining operational processes, implementing integrated planning and further investing in internal technological research and development. We will also 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 possession or property rights over utilities relating to water and sewage systems.

Ensure the quality and availability of our services in our existing service area. Our goal is to maintain an effective water coverage ratio of 100% coupled with a high standard of quality and availability. We intend to continue to effectively have a water coverage ratio of 100% and meet population growth by adding 1.4 million water connections by 2018 and to increase our sewage coverage ratio to 90% by 2018. To ensure the quality and availability of our services, we also intend to improve customer relations by shortening response times for customer installations as well as through a focused public relations program to enhance our image. 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.

Maintain and continue to expand our existing service areas. We intend to maintain our operating base through the execution of new concession or program 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. Since 2007, we have entered into 174 30-year term program agreements with municipalities, of which 14 were entered into in 2009. These 174 municipalities accounted for 8.2% of our total revenues for the year ended December 31, 2009 and 8.7% of our total assets as of December 31, 2009. By December 31, 2009, 82 of our concession agreements had expired and are under renegotiation. These 82 municipalities accounted for 12.1% of our total revenues for the year ended December 31, 2009 and 12.9% of our total assets as of December 31, 2009. From 2010 to 2030, 80 concession agreements accounting for 9.1% of our total revenues for the year ended December 31, 2009 and 6.4% of our total assets as of December 31, 2009 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\$8.6 billion between 2009 and 2013, 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 16.4 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.

Seek selective opportunities to expand our business. In 2007, a change in our by-laws 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. We have recently (i) entered into a consultancy agreement with *Instituto Costarricense de Acueductos y Alcantarillados*, a Costa Rican company; (ii) executed five agreements with certain regional basic sanitation companies to exchange technology; (iii) executed a memorandum of understanding with three municipalities to operate a landfill; (iv) entered into a partnership agreement with OHL to provide sewage treatment services to the municipality of Mogi-Mirim through a special purpose company; (v) executed two cooperation agreements with Mekorot National Water Company, an Israeli corporation, and Sociedade General Aguas de Barcelona S/A Agbar, a Spanish corporation, which will allow us to exchange know-how and learn future opportunities; (vi) organized a bidding process for the use of small hydroelectric power plants in our water treatment stations in Guaraú and Vertedouro Cascata; (vii) been selected in an international public bidding process in Panama to render consulting services relating to a program of rational use of water and to the implementation of a new model for commercial and operating management of IDAAN, the corporation in charge of the sewage services in the central provinces of Panama pursuant to a three-year term agreement in the amount of US\$8.8 million. We were the first company in the basic sanitation industry in Brazil to win a public bidding process abroad. We intend to continue to selectively seek new business opportunities to take advantage of our know-how, size and scale.

Continue to prudently manage our levels of indebtedness. We intend to continue to fund our working capital needs and estimated capital expenditure programs with diversified sources of financing, such as Brazilian public banks, domestic and international multilateral agencies, and development banks. We will continue to seek market opportunities for low-cost financing and restructuring of our indebtedness if and when advantageous and appropriate to us. Our total financial indebtedness increased by 20.8%, from R\$5,685.2 million in 2007 to R\$6,865.1 million in 2008. As of December 31, 2009, our total financial indebtedness totaled R\$6,560.0 million. In addition, in 2008, our total foreign denominated indebtedness recorded a 83.6% increase, from R\$1,242.3 million to R\$2,281.0 million, as a result of the depreciation of the *real* versus the U.S. dollar, the AB Loan financing contracted with Inter-American Development Bank, or the IADB, and the amortization of international financing installments.

Improve operating efficiency and reduce water losses. We seek to reduce both real water losses and commercial water losses. To achieve long term and more consistent results, we have created a company-wide program to reduce water losses. After a series of discussions with local and international institutions to obtain funding for the program, we have been successful in obtaining funding for the first two years of the program (2009 and 2010) with the Brazilian Development Bank (BNDES) and are at advanced stages of negotiation with the Government of Japan through the Japan International Cooperation Agency (JICA) for the funding of the next three years (2011 to 2013) of the program. Our focus is to renew our infrastructure in order to reduce real water losses, mainly through the implementation of supply centers and districts of water measurement, which are water supply districts with a smaller number of connections. These measures will enable us to detect and repair leaks more efficiently. The program will also reduce commercial water losses by upgrading and replacing inaccurate water meters and by increasing supervision of irregular water consumption in active and inactive water connections. We reduced our water losses from 27.9% in 2008 to 26.0% in 2009.

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, 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 is, according to IBGE, the most developed and economically active region of Brazil, and which includes the States of Minas Gerais, Espírito Santo and Rio de Janeiro. 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.

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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 population of 42.4 million as of December 31, 2009. The city of São Paulo, the State of São Paulo's capital, had an estimated population of 10.9 million, with 20.2 million inhabitants in the São Paulo metropolitan region, also as of December 31, 2009. The São Paulo metropolitan region encompasses 38 cities and is the third largest metropolitan region in the Americas and the fifth largest metropolitan region in the world, according to the United Nations' World Urbanization Prospects, 2007 Revision. The São Paulo metropolitan region accounted for approximately 48.0% of the population of the State of São Paulo as of December 31, 2009.

According to the IBGE, the GDP of the State of São Paulo was approximately R\$902.8 billion in 2007, representing approximately 34.0% of the Brazil's total GDP, making it the largest economy of any state in Brazil, based on the GDP. The State of São Paulo is the leading Brazilian state in terms of manufacturing and industrial activity, also according to IBGE, 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 1877, 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 the *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, which purpose 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 Superintendency 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 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 SANESP.

The Department of Water and Sewers was subsequently closed.

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On June 29, 1973, COMASP, SAEC and 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*). 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.

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 by-laws. 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 performing the coordination, evaluation and control of all functions related to Chief Executive Officer's office and staff, strategic 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 the 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, 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, quality control, developments and coordination and execution of special investment programs, projects and new businesses.
- the Chief Operating Officer of the São Paulo Metropolitan Region Division and the Chief Operating Office 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, aiming at aligning our interests with the interests of our clients.

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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 2000 through 2009, our capital expenditure program totaled R\$9.6 billion, primarily to build up our infrastructure and for our efforts to reduce water losses. We have budgeted investments in the amount of approximately R\$8.6 billion from 2009 through 2013. We invested R\$904.9 million, R\$921.1 million, R\$1.7 billion and R\$1.8 billion in 2006, 2007, 2008 and 2009, respectively.

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

	Planned Capital Expenditures					
	2009	2010	2011	2012	2013	2009-2013
	(in millions of reais)					
Water	577	590	664	653	668	3,152
Sewage	859	948	835	867	827	4,336
Others	214	212	254	228	231	1,139
Total	1,650	1,750	1,753	1,748	1,726	8,627

Our capital expenditure program from 2009 through 2013 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 366 municipalities we serve. 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 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. The infrastructure of water storage tanks will be expanded by 210,000 cubic meters, and 44 water pumping stations and 240 kilometers of mains will be constructed. The investment will reach R\$2.7 billion and the construction will expand the water production capacity in 13.2 cubic meters per second until 2014. We have been working on the project since 2006 and it is expect to be completed by 2014. In 2006, 2007, 2008 and 2009, we invested R\$53.0 million, R\$176.0 million, R\$223.0 million and R\$327.0 million, respectively, in this region. The Alto Tietê Public Private Partnership was the most significant project of the Metropolitan Water Program in 2008 and 2009.

Alto Tietê Public Private Partnership (PPP)

In June 2008, we entered into a Public Private Partnership, 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 10 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 done by Cab Spat is estimated at R\$300.0 million. Cab Spat will also perform maintenance on the dams of the Alto Tietê System, at which time 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. We initiated the provision of the services on February 1, 2009, and the works of construction on February 11, 2009. Throughout 2009, we executed 39.0% of the construction work.

Tietê Project

The Tietê river crosses the São Paulo metropolitan region and receives most of the region's runoff and wastewater. The environmental status of the river reached a critical level in 1992. As a way of reversing 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 during the years of 1992 and 1998.

In connection with the first phase of the Tietê Project, 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 IDB, US\$100.0 million was financed by *Caixa Econômica Federal*, or the Caixa, and US\$550.0 million was funded by us.

The second phase of the project was carried out from 2000 through 2008, with investments of approximately US\$500.0 million, of which US\$200.0 million were financed by the IDB, R\$60.0 million were financed by the Brazilian Development Bank (*Banco Nacional de Desenvolvimento Econômico e Social*), or the BNDES, and R\$180.0 million were financed by the BNDES through another financial institution. In this phase, 290,000 sewage connections and more than 1,500 kilometers of sewage collection networks, branch collectors and interceptors were installed and/or built. 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.

The main objective of this second phase was to continue expanding and optimizing of the sewage systems of the São Paulo metropolitan region, primarily focusing on actions that allow the destination of a higher volume of raw sewage to the sewage treatment facilities that were built in the first phase of the Tietê Project.

As part of the second phase of the Tietê Project, we implemented the 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 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, 2008 and 2009, we owed US\$236.7 million and US\$164.5 million to the IDB, respectively, for the financing it provided. For further information on the agreement entered into with the IDB, see *Item 5.B. Operating and Financial Review and Prospects Liquidity and Capital Resources Capital Sources*. We now provide secondary treatment to approximately 70.0% 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 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 and treatment of sewage in the São Paulo metropolitan region, with a total estimated cost of US\$1.1 billion.

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 2009 to 2015. 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 3.0 million people.

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Corporate Water Loss Reduction Program

The objective of the corporate water loss reduction program 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 semester of 2007 and finalized it in 2008. We anticipate investments of approximately R\$3.0 billion. The program has a 11-year term, beginning in 2009 and aims at reducing 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 27.9% in December 2008 to 13.0% in 2019. This number is comparable to international standards. For instance, in Japan, the average water losses is approximately 8%. In 2009 we invested R\$261.0 million in this program.

New Life

The New Life Program 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 will directly benefit 45,000 families.

The State government, local authorities and the federal government will invest approximately R\$1.2 billion in the program. We will fund this program with R\$300.0 million. The State Secretariat for Sanitation and Energy 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.

Clean Stream Program

This program is a partnership between the State, through us, and the mayor's office of the city of São Paulo, and aims to clean and recover 100 urban streams in the city of São Paulo, with an investment of R\$197.1 million, of which R\$143.0 million will be funded by us. The program will benefit 1.8 million people who live in the hydrographic basins of the streams. As of December 31, 2009, 42 urban streams had been decontaminated, benefiting 800,000 people. The second phase of the program will clean and recover an additional 58 streams, with a total investment of R\$118.7 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\$331.2 million, R\$321.0 million and R\$707.0 million and R\$1,091 million in these projects in 2006, 2007, 2008 and 2009, respectively, and we have budgeted for additional capital expenditures of approximately R\$2.7 billion from 2009 through 2013.

Clean Wave Program

On August 6, 2004, we entered into a credit agreement with the Japan Bank for International Cooperation, or the JBIC for the financing of the Environmental Recovery Program for the Baixada Santista metropolitan region, which was guaranteed by the Federative Republic of Brazil, for a total amount of R\$382.8 million. On October 1, 2008, JICA

incorporated the loan transactions of JBIC. For further information on the agreement entered into with the JICA, see *Item 5.B. Operating and Financial Review and Prospects Liquidity and Capital Resources Capital Sources*. The total investment to be made with respect to this project for sewage systems is approximately R\$1.4 billion and the balance R\$1,080.4 million will be funded by us, for which we will seek further financial support from local and international banks and agencies. The first disbursements under this agreement began in August 2005 with the commencement of the management agreement. The construction works began in the second quarter of 2007. The main goals of this program are to improve and expand the water and sewage systems in the municipalities comprising the Baixada Santista metropolitan region, increasing the sewage collection from 54.0% to 95.0% and treat 100.0% of the collected sewage. As of December 31, 2008, the total disbursements for this program reached R\$391 million and 35.0% of all the project was already built. As of December 31, 2009, the total disbursements for this program reached approximately R\$960.0 million and 67.0% of the project was completed.

Northern Coast Clean Wave Program

The program will expand the collection and treatment of sewage in the Northern coast of the State of São Paulo, benefiting 600 thousand people. Until 2015, the program will increase the collection and treatment of sewage index of the region from 30.0% to 85.0%, improving the health and well-being of the population, in addition to stimulating the economic development by allowing for an increase in tourism in the region.

In 2008, we inaugurated the Porto Novo sewage treatment plant in the city of Caraguatatuba and began working in the sewage systems projects in the cities of Ilhabela, Ubatuba and Caraguatatuba. We expect to complete these sewage systems in the first semester of 2010. In February 2009, we began other sewage systems projects in the cities of Caraguatatuba, Ilhabela and São Sebastião, which are expected to be completed in the second semester of 2010. The total investment in the program will be R\$385.0 million. As of December 31, 2008, the total disbursements for this program reached R\$20.0 million.

Coastal Water Program

The program is the main combination of long term activities to expand water production capacity in the entire coastal region of the State of São Paulo, of which Mambu/Branco is part of. More than four million people in coastal cities in the State of São Paulo will benefit from this program. This program will enable us to increase the level of reliability of the systems, eliminating existent and potential deficiencies and irregularities in the water supply. It will also be possible to expand our services to reaching universal coverage in the Baixada Santista metropolitan region and assure the availability of treated water to the local population and tourists, and also to improve the quality of water available to the population. We expect to invest R\$1.1 billion in the program until 2013.

Research and Development

Our policy is to invest continually in the modernization of equipment and in the technology needed to identify, evaluate and improve our provision of basic sanitation services while promoting environmental protection and maintaining our competitiveness and profitability. Our research and development activity is divided into committees according to strategy and complexity. In 2006, 2007, 2008 and 2009, we invested R\$4.9 million, R\$3.4 million, R\$3.5 million and R\$3.8 million, respectively, in research and development.

We have also partnered with several research institutions. The most significant partnership is our agreement with the State of São Paulo Research Foundation (*Fundação de Amparo à Pesquisa do Estado de São Paulo*), or the FAPESP, to develop and support research projects involving researchers from graduate schools, the State of São Paulo and our employees. This agreement aims to create new technologies to be applied in our business, in addition to develop new technologies related to energy efficiency. We and the FAPESP will jointly invest up to R\$50 million in this project during a five-year term.

In 2009, we became integrated with the Technology Center of São José dos Campos, which will allow us to share and develop technologies and learn from companies with expertise in research, development and innovation, increasing the possibility of creating technology alliances and entering into new businesses.

4.B. Business Overview

Our Operations

We provide water and sewage services to 366 municipalities in the State of São Paulo either under concession agreements, under another form of legal arrangement or without a formal contract. We also supply water services on a wholesale basis to six municipalities in the São Paulo metropolitan region.

Because of the enactment of law No. 11,445 of January 5, 2007, or 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 will negotiate a new agreement that follows the terms and conditions of the new legislation, the program contracts; 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 new legislation is applicable even when the concession agreement is still valid. For further information on this topic, see *Government Regulation The Basic Sanitation Law* and *Public Consortia Law and Cooperation Agreement for Joint Management*.

The new basic sanitation legislation requires 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.

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 compensation 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.

At the end of 2008 and 2009, we were a provider of water and sewage services to 365 and 366 municipalities, respectively. Substantially all of these concessions have 30-year terms. Due to court orders, we temporarily suspended our services for two other municipalities (Araçoiaba da Serra and Cajobi), that accounted for less than 0.1% of our gross revenues. For more information, see *Item 8.A. Financial Information Consolidated Statements and other Information Legal Proceedings Concession-Related Legal Proceedings*. Since 2007, we entered into program contracts with 174 municipalities in accordance with the Basic Sanitation Law, of which 14, were entered into in 2009. 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, 2009, 82 concessions expired and we have been in negotiation with the municipalities to execute program contracts to substitute the expired concessions. From 2010 through 2030, 80 concessions will expire. The remaining concessions are for an undetermined term. Some of the expired concession agreements have been extended for a short term while we negotiate the new contract. Despite the expiration of the concession agreements, we continue to provide water and sewage services to all 366 municipalities at the end of 2009.

In February 2006, we created a new division to manage the renewal of expiring concessions. The main responsibility of this division, which reports directly to the Chief Executive Officer, is to renew and thus maintain the existing base of municipalities that we currently operate and formalize contracts under the new model of associated management. Following the increase in the demand for regulatory work, this division has begun to focus on regulatory matters, with its principal activities being centralizing communication with regulatory agencies, driving business to the new regulatory regime and proposing matters in which we have an interest to the ARSESP.

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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 legislature council of each municipality. The main provisions of the concession agreements were 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 would follow the guidelines established by the Basic Sanitation Law and the ARSESP;
- the assets comprising the existing municipal water and sewage systems are transferred from the municipality to us. 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 a 12.0% discount factor to us, from the concession being acquired. Payment was made in cash;
- 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 book value of our assets relating to the concession.

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.

Concession agreements we have entered into since 1998 provide that after a 30-year term from the commencement of the concession, the total value of the concession and assets will be 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, we are paid an amount equal to the present value of the expected cash flow from the concession over the years remaining in the concession, using the same assumptions used to determine the value of the concession at its inception (adjusted for inflation).

Following the enactment of the federal concessions law (law No. 8,987/95) and of the federal consortium law (law No. 11,107/05), the new agreements are adopting the new regime. This new regime gives municipalities a greater role and sets out more clearly the provision of services and the responsibilities of the parties. Therefore, all new agreements to be entered into by us and the new agreements to be executed after the expiration of the concessions will follow this new agreement model. See *Government Regulation Public Consortia Law and Cooperation Agreement for Joint Management*.

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

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 these assets to our possession 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.

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Another important development was that the negotiation 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 Diadema terminated our concession after asserting that we did not provide adequate water and sewage services, while the municipality of Mauá did so with our consent. However, we currently serve both municipalities through the supply of water on a wholesale basis.

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. We cannot be certain, however, 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 compensation 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 Information Legal Proceedings Concession-Related Legal Proceedings.*

Operations in the São Paulo Metropolitan Region and in Other Metropolitan Regions

We do not hold a formal concession to provide water and sewage services to the city of São Paulo, which accounts for 55.5% of our gross revenues, and to 31 other municipalities in the State of São Paulo. We believe that we have a vested and exclusive right to provide water and sewage services to the city of São Paulo and these other municipalities based, in some cases, upon a deed (*escritura pública*) and also, among other factors, based on our ownership of the water and sewage systems serving the city of São Paulo and these other municipalities and certain succession rights resulting from the merger that formed us.

The Basic Sanitation Law provides that, in case of termination of the relationship with the aforementioned municipalities with which we have not entered into a concession agreement, the municipalities should pay us an indemnity, in an amount to be appraised.

On November 14, 2007, we entered into an agreement with the city of São Paulo to establish the conditions for the provision of water and sewage services, and environmental utility services in the city of São Paulo. In December 2008, the São Paulo city council approved in an initial vote the proposed law No. 558/08, which authorizes the Executive Power to legally bind the city of São Paulo to an agreement with ARSESP and us in order to ensure stability in rendering of services. This project was approved in the first week of June 2009, authorizing the city of São Paulo to execute the agreement for a 30-year period. A draft of the agreement was submitted to a public hearing, in order to assure a broad participation of the society, as determined by the federal law No. 11,445 of 2007. We cannot anticipate the final result of the public hearing or when the agreement will be executed.

The project establishes an agreement for a 30-year period, which may be extended for an additional 30-year period. We will be required (i) to offer minimum guarantees and certain services to the city of São Paulo, as part of the provision of water and sewage services, and (ii) to offer lower tariffs to assist the city of São Paulo to guarantee the

universal access to water and sewage services to its population. For instance, we must invest up to 13.0% of our gross revenues (after the payment of social security, *Contribuição para Financiamento da Seguridade Social*, or COFINS, and Patrimony Formation Program for the Public Employee, *Programa de Formação do Patrimônio do Servidor Público*, or PASEP) from this agreement in the improvement of the water and sewage services infrastructure in the city of São Paulo. Moreover, the city of São Paulo is entitled to receive at least 7.5% of our gross revenues (after the payment of COFINS and PASEP). The model proposed for the São Paulo metropolitan region can be replicated in the other metropolitan regions of the State of São Paulo in which we operate.

Wholesale Operations

Water Services On a Wholesale Basis

We provide water services on a wholesale basis to six municipalities, including the municipalities of Diadema and Mauá. In addition, until December 2003 we provided water services on a wholesale basis to the municipality of São Bernardo do Campo. In December 2003, we acquired water and sewage service assets in this municipality through the transfer of all related assets from the municipality to us. The amount paid for the purchase of assets was estimated by an economic-financial valuation report to be approximately R\$415.5 million, which included the liquidation of the accumulated debt relating to water supply on a wholesale basis, which amounts to approximately R\$265.4 million. The difference between the value of the assets and the accumulated debt was paid by us in cash to the municipality. Accordingly, we started providing water and sewage services to the municipality of São Bernardo do Campo beginning January 2004.

These contracts 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 ARSESP.

In December 2008, we, the State, the city of Diadema and the SANED executed a memorandum of understanding, in which the parties declare their intention to conclude negotiations to liquidate the outstanding debt with us and develop a shared structure of operations between us and the city of Diadema for the operation and provision of the water and sewage services. We expect to reach a final agreement with the city of Diadema and settle all the pending judicial claims in 2010.

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 it 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 2008 and 2009 we treated about 27.9 and 31.1 million cubic meters of sewage from these municipalities, respectively. This is an example of our social-environmental responsibility actions and our commitment to these actions. In 2008, the revenues from these services were approximately R\$16.6 million. In 2009, the revenues from these services were approximately R\$21.9 million.

In December 2008, we entered into an agreement for the collection and treatment of 20.0% of the sewage generated by the city of Guarulhos. Our total revenue over the five years of the agreement is expected to increase approximately R\$58.0 million. In 2010, we expect to finalize the negotiation with the city of Guarulhos for the collection and treatment of the sewage of the central region of the city.

Description of Our Activities

As set forth in Article 2 of our by laws, our corporate purpose is to render basic sanitation services, aiming its universalization in the State of São Paulo 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 its assets, operations and activities. We are allowed to act, in a subsidiary form, in other Brazilian locations and abroad. See *Government Regulation Public Consortia Law and Cooperation Agreement for Joint Management*.

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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 customers' premises. In 2008 and 2009, we produced approximately 2,852.6 and 2,844.9 million cubic meters of water, respectively. 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 72.0% and 71.5% of water invoiced by volume in 2008 and 2009, respectively.

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

	2006	Year ended December 31,		2009
		2007	2008	
		(in millions of cubic meters)		
<i>Produced</i>				
São Paulo metropolitan region	2,134.8	2,115.0	2,107.9	2,091.7
Regional systems	752.0	758.7	744.7	753.2
Total	2,886.8	2,873.7	2,852.6	2,844.9
<i>Invoiced</i>				
São Paulo metropolitan region	1,030.8	1,046.8	1,065.9	1,083.9
Wholesale	263.4	274.3	284.5	288.0
Regional systems	513.0	525.9	529.6	546.1
Reused water	0	0	0.2	0.8
Total	1,807.2	1,847.0	1,880.2	1,918.8

The difference between the volume of water produced and the volume of water invoiced generally represents both real and commercial water loss. See *Water Resources* *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).

Generally, the São Paulo metropolitan region experiences higher water demand during the summer and lower water demand during the winter. In the São Paulo metropolitan region, the summer coincides with the rainy season, while the winter corresponds to the dry season. Demand within the Regional systems will vary depending on the area; while the countryside region experiences seasonality in demand similar to the São Paulo metropolitan region, the demand in the coastal region is driven 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 the DAEE, and pursuant to authorization contracts entered into with 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 the ANA, is also 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 flow from nearby rivers, or by a combination of these sources.

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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 71.7 cubic meters per second. Total current capacity is 67.7 cubic meters per second, which can be treated from the interconnected water system of the São Paulo metropolitan region. Average verified production during 2008 and 2009 on the interconnected water system of the São Paulo metropolitan region was 65.6 and 65.0 cubic meters per second, respectively. The Cantareira, Guarapiranga and Alto Tietê systems, as a whole, supplied approximately 84.0% of the water we produced for the São Paulo metropolitan region in 2008 and 2009.

The Cantareira system accounted for approximately 46.3% and 48.2% of the water that we supplied to the São Paulo metropolitan region (including the municipalities to which we supplied water on a wholesale basis) in 2008 and 2009, respectively, which represented 76.1% and 75.6% of our gross revenues for 2008 and 2009, respectively. 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.

With respect to water usage, federal and state agencies are authorized to collect charges from entities, such as us, for the abstraction of water from, or dumping of sewage into, water resources. 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 Jundiaí river basins. In 2011, we will start to incur expenses in connection with the use of water from the Sorobaca and Médio Tietê river basins. We also expect to start being charged for the use of water from the Baixo Tietê river basin. The ARSESP, has so far regulated our tariff structure and adjustments according to the same structure and adjustment formula that we ordinarily follow, which takes into consideration the variation of expenses considered as non administrable, which these expenses fall under. We expect to continue to be able to pass on these expenses to our customers. However, we are uncertain as to the likely charges that may be assessed against us in connection with the abstraction of water from or the dumping of sewage into other water resources that we use, or whether we will be able to continue to pass on the cost of all of these charges 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:

System	Production Rate ⁽¹⁾ (in cubic meters per second)	
	2008	2009
Cantareira	30.4	31.3
Guarapiranga	13.5	13.1
Alto Tietê	11.2	10.3
Rio Claro	3.6	3.7
Rio Grande (Billings reservoir)	4.9	4.7
Alto Cotia	1.0	1.0
Baixo Cotia	0.9	0.8
Ribeirão da Estiva	0.1	0.1
Total	65.6	65.0

(1) Average of the twelve months ended December 31, 2008 and 2009.

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 on 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.

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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 Taiacupeba reservoirs. See *Item 8.A. Financial Information Consolidated Statements and Other 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 156, 174, 189 and 201 thousands new water connections in 2006, 2007, 2008 and 2009, respectively.

The interconnected water system of the São Paulo metropolitan region services 30 municipalities, of which 24 are operated directly by us. 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 comprising 32,014 kilometers of water mains and 192 reservoirs. This water system requires permanent operational supervision, engineering inspection, maintenance, 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\$2.1 billion from 2009 to 2013 to increase our water production and distribution capacities as well as to improve the water supply systems. In 2008 and 2009, our total investment in water supply systems, amounted to R\$433.0 million and R\$506.2 million, respectively.

Water Treatment

We treat all water at our water treatment facilities prior to placing it into our water distribution network. We operate 208 treatment facilities, of which the eight largest, located in the São Paulo metropolitan region, account for approximately 74.0% of all water we produce. 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. As of December 31, 2008 and 2009, our water network contained 62,582 and 63,732 kilometers of water pipes and mains 6.9 and 7.1 million water connections, respectively. The following table sets forth the total number of kilometers of water pipes and mains and the number of connections in our network for the periods indicated.

	2006	As of December 31,		
		2007	2008	2009
Water distribution pipes and mains (in kilometers)	61,469	62,318	62,582	63,732
Number of connections (in thousands)	6,609	6,767	6,945	7,118

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, 2008 and 2009, our water distribution pipes and mains included: (i) 31,270 and 32,014 kilometers in the São Paulo metropolitan region, respectively; and (ii) 31,312 and 31,718 kilometers in the Regional systems, respectively.

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We have 384 storage tanks in the São Paulo metropolitan region with a total capacity of 1.9 million cubic meters, and 1,672 storage tanks in the Regional systems. We have 122 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. 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.

We expect that new customers will be responsible for covering part of the costs of connecting to our water distribution network. Our water connection policy pays for the cost of installation of up to 15 meters of pipe between our distribution network and the point of connection. The customer pays for any further pipe that is necessary for connection. 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. Industrial customers are responsible for the entire cost of connection. 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.

	2008	2009	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2009-2018
	Actual		Forecast										
	(in thousands)												
São Paulo metropolitan region	119.2	130.1	93.8	92.6	82.8	89.2	88.4	87.9	88.2	85.3	85.5	84.7	878.4
Regional systems	70.2	70.8	64.9	65.1	65.9	69.4	70.5	71.4	71.1	69.7	70.2	73.1	691.3
Total	189.4	200.9	158.8	157.7	148.8	158.6	158.8	159.3	159.3	155.0	155.7	157.8	1,569.8

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 established a new method of measuring our water losses, based on worldwide market practice for the industry. According to this new 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, 2008 and 2009, we experienced 516 and 477 liters/connections per day of water losses in the São Paulo metropolitan region and 315 and 290 liters/connections per day in the regional systems, averaging 436 and 402 liters/connections per day. We plan to reduce water losses in both regions to 348 liters/connections per day for the São Paulo metropolitan region and 247 liters/connections per day for the Regional systems, which we expect will result in a total reduction to an average of 307 liters/connections per day by 2013. Based on water loss percentage, we intend to reduce water losses from 28.0% to 21.0% in the São Paulo metropolitan region, and from 27.1% to 21.0% in the Regional systems. In 2008 and 2009, we experienced an overall 27.9% and 26.0% in water losses and we expect the water losses to decrease to 20.0% in 2013.

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, 2009, we had installed 1,714 valves at strategic points in the network (1,635 as of December 31, 2008), with 1,032 valves being installed in the São Paulo metropolitan region (994 as of December 31, 2008) and 682 in the Regional systems (641 as of December 31, 2008);
- 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 requirements are similar to the standards set in the United States of America and Europe. Pursuant to the Brazilian Ministry of Health (*Ministério da Saúde*) regulation, 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 quality water from underground or superficial water sources. However, urbanization and disorganized occupation of some areas of the São Paulo metropolitan region ended up reducing the quantity of water in mains 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.

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Water quality is monitored in 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. These laboratories employ approximately 300 technicians, biologists, engineers and chemists. Our laboratories perform an average of 60,000 analyses 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 ISO 9001/2000 certification and 13 of our 16 water control and quality laboratories have obtained a the NBR ISO/IEC 17,025 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 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 because of the higher volumes of chemicals used to treat the water. In 2008 and 2009, we did not detect significant algae growth.

We participate in the New Life Program, that 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. See *Capital Expenditure Program New Life 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.

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, 2008 and 2009, we collected approximately 84.0% and 85.0% of all the sewage produced in the municipalities in which we operate in the São Paulo metropolitan region, respectively. In addition, during December 31, 2008 and 2009, we collected approximately 72.0% of all the sewage produced in the municipalities in which we operate in the Regional systems. During 2008 and 2009 we accounted for approximately 79.0% and 80.0% of all the sewage produced in the municipalities in which we operated in the State of São Paulo, respectively.

Sewage System

The purpose of our sewage system is to collect, isolate, treat and adequately dispose of sewage. As of December 31, 2008 and 2009, we were responsible for the operation and maintenance of 41,241 and 42,895 kilometers of sewage lines, respectively, of which approximately 21,267 and 22,118 kilometers are located in the São Paulo metropolitan region and 19,974 and 20,777 kilometers are located in the Regional systems, respectively.

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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.

	2006	As of December 31,		2009
		2007	2008	
Sewage lines (in kilometers)	39,126	40,608	41,241	42,895
Sewage connections (in thousands)	5,002	5,167	5,336	5,520

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 19 of State Decree 8,468 dated September 8, 1976, as amended and supplemented. 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 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 sewage treatment facilities (*Estações de Tratamento de Esgotos*), or the ETEs, must comply with discharge standards established by federal and state regulations and also must comply with emission standards and observe the water quality of the bodies of water established by federal and state legislation. Emission standards consist of a set of parameters that must be verified before the effluents are discharged into a body of water. Quality standards are based on the classification of bodies of water, taking into account the expected use of the water, with these standards becoming more stringent for bodies of water with more important use profiles.

We consider the condition of the sewage lines in the São Paulo metropolitan region to be adequate. 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 a continuing 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 51% of all residences in the coastal region currently connected to our sewage network.

New sewage connections are made on substantially the same basis as connections to water lines: we assume the cost of installation for the first 15 meters of sewage lines from the sewage network to residential and commercial customers sewage connections and the customer is responsible for the remaining costs. Industrial customers are responsible for the entire cost of extension and connection to the sewage network.

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

	2008	2009	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2009-2018
	Actual		Forecast										
	(in thousands)												
São Paulo metropolitan region	85.9	112.9	84.5	69.5	65.1	65.9	72.6	89.6	97.6	116.7	117.4	120.4	899.3
Regional systems	68.8	71.2	75.5	155.4	113.8	101.2	81.4	74.3	76.7	71.2	73.8	77.5	900.8
Total	154.7	184.1	160.0	224.9	178.9	167.2	154.1	163.9	174.3	187.9	191.2	197.9	1,800.1

Sewage Treatment and Disposal

In 2008, approximately 70.0% and 78.0% of the sewage we collected in the São Paulo metropolitan region and the Regional systems, respectively, or 72.0% 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. In 2009, we treated approximately 74.0% of the sewage we collected in the State of São Paulo (72.0% of the sewage collected in the São Paulo metropolitan region and 80.0% of the sewage collected in the Regional systems). 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. In 2008 we operate 456 sewage treatment facilities and eight ocean outfalls. Currently, we operate 467 sewage treatment facilities and eight ocean outfalls.

The treatment consists of the removal of pollutants from the sewage. The method to be used depends upon the physical, chemical and biological characteristics of the wastewater. In the São Paulo metropolitan region, the treatment used in the large treatment facilities is activated sludge, where there is a liquid phase and a solid phase which involves the 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 intimately 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.

We operate 49 activated sewage treatment facilities, each of which also contains a primary treatment facility. The five largest activated sewage treatment facilities 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 379 secondary treatment facilities in the countryside region that have treatment capacity of approximately 11.3 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. We have 66 sewage treatment facilities in the coastal region.

Our trunk lines are 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 released untreated into receiving waters, resulting in high levels of pollution in these bodies of water. We are a party to a number of legal proceedings related to

environmental matters. See *Item 8.A. Financial Information Consolidated Statements and other Information Legal Proceedings*. In addition, our capital expenditure program includes projects to increase the amount of sewage that we treat. See *Capital Expenditure Program and Government Regulation Sewage Requirements*.

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Sludge Disposal

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 2008, we produced 64,137 tons of sludge-dry base, of which 54,909 tons were discharged into landfills and the remaining was used for agricultural purposes. In 2009, we produced 42,338 tons of sludge-dry base, of which 41,184 tons were discharged into landfills and the remaining was used for agricultural purposes. In addition, we are testing new technologies for sludge disposal as fertilizer in forest projects, fuel development and concrete manufacturing.

Customers

We currently operate water and sewage systems in 366 of the 645 municipalities in the State of São Paulo. In addition, we currently supply water on a wholesale basis to six municipalities with a urban population of approximately 3.3 million. The following table provides a breakdown of total revenues by geographic market for the periods indicated.

	2006	Year ended December 31,		2009
		2007	2008	
		(in millions of <i>reais</i>)		
São Paulo metropolitan region	4,534.1	4,888.1	5,207.7	5,471.6
Regional systems	1,449.9	1,560.1	1,631.1	1,764.6
Total	5,984.0	6,448.2	6,838.8	7,236.2

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 274 municipalities that operate their own water and sewage systems and that collectively have a population of approximately 13.0 million, or approximately 31.0% 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 to be in a good position to compete in some strategic 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 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. The competition in the State of São Paulo from private water service providers is limited. Only a small number of municipalities have private companies operating water and sewage services.

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 the customers. We have established new tariff schedules for commercial and industrial customers in order to assist us in retaining these customers.

Billing Procedures

The procedure for billing and payment of our water and sewage services is basically the same for each customer category. 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.

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We deliver all water and sewage bills by hand to our customers, mainly through independent contractors who are also responsible for reading water meters.

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 2006, 2007, 2008 and 2009, we received, respectively, payment of 91.5%, 92.8%, 97.3% and 94.7% of the amount billed to our retail customers, and 92.5%, 92.5%, 94.4% and 93.9% of the amount billed to those customers other than State entities, within 30 days after the due date. In 2006, 2007, 2008 and 2009, we have received 73.1%, 97.9%, 153.1% and 110.1%, respectively, of the amount billed to the State entities. With respect to wholesale supply, in 2006, 2007, 2008 and 2009, we received payment of 61.4%, 65.2%, 64.4% and 68.7%, respectively, of the amount billed within 30 days.

In the São Paulo metropolitan region, 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. We outsourced this billing system to third-party contractors that employ and train their own personnel whose training we supervise. We have water meter reading and printing by hand-held computers in some municipalities that we serve in the Regional systems and intend to expand this system to other municipalities we serve.

Tariffs

Tariff adjustments follow the guidelines established by the Basic Sanitation Law and ARSESP. The guidelines also establish procedural steps and the terms for the annual adjustments. The adjustments has 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%.

With the enactment of the Basic Sanitation Law, an independent regulatory entity is responsible for tariff regulation. ARSESP has been the independent regulatory entity, regulating our tariffs, pursuant to a cooperation agreement between each municipality and the State. With respect to other municipalities where ARSESP has not been explicitly selected to perform this task, we will depend on legal interpretation to conclude whether the independent entity will be in charge of regulating tariffs. For instance, the municipality of Lins decided to create its own regulatory agency. See *Government Regulation Tariff Regulation in the State of São Paulo* for additional information regarding our tariffs.

Since 2008, the ARSESP 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 to 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 2011.

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As of the date of this annual report, ARSESP applies 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; and where 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 price 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 ARSESP replaced the variable gross operating revenue for the variable cost of reference (CR).

In September 2008, we adjusted our tariffs by 5.10% pursuant to ARSESP regulation. In August 2009, the ARSESP approved a 4.43% adjustment for our water and sewage tariffs, starting on September 11, 2009. This adjustment was valid for all municipalities served by our services, except for the municipalities of São Bernardo do Campo and Lins, which have different rules. 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 the 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.

We 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; (iv) government entities that have entered into a water loss reduction agreement with us and pay 75.0% of the prevailing non residential tariff; and (v) 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 that entered into program agreements with us, 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 the ones 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 (v) 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 demand agreements with us for at least one-year terms. In October 2007, the minimum volume for the formalization of the agreement declined from 5,000 m³/month to 3,000 m³/month. We believe this tariff schedule will help prevent our commercial and industrial customers from switching to the use of private wells. In the 2008 adjustment authorized by ARSESP, we contested that the tariffs for the provision of water supply and sewage collection for non residential consumption of more than 3,000 cubic meters per month would have as a maximum limit values referred to in the tables for non residential consumption of more than 50 cubic meters per month. We may charge lower prices depending on the market conditions of category of customer.

We establish separate tariff schedules for our services in each of the São Paulo metropolitan region 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.

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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	2006	As of December 31,		
		2007	2008	2009 ⁽²⁾
		(in cubic meters per month)		
Residential:				
Standard Residential:				
0-10 ⁽¹⁾	1.19	1.24	1.31	1.36
11-20	1.86	1.94	2.04	2.13
21-50	4.65	4.84	5.09	5.32
Above 50	5.13	5.34	5.61	5.86
Social:				
0-10 ⁽¹⁾	0.40	0.42	0.44	0.46
11-20	0.70	0.73	0.77	0.80
21-30	2.47	2.57	2.70	2.82
31-50	3.52	3.67	3.86	4.03
Above 50	3.89	4.05	4.26	4.45
Favela (shantytown):				
0-10 ⁽¹⁾	0.30	0.32	0.34	0.35
11-20	0.35	0.36	0.38	0.40
21-30	1.16	1.21	1.27	1.33
31-50	3.52	3.67	3.86	4.03
Above 50	3.89	4.05	4.26	4.45
Non Residential:				
Commercial/Industrial/Governmental:				
0-10 ⁽¹⁾	2.39	2.49	2.62	2.74
11-20	4.65	4.84	5.09	5.32
21-50	8.97	9.31	9.78	10.21
Above 50	9.34	9.69	10.18	10.63
Social Welfare Entities:				
0-10 ⁽¹⁾	1.19	1.24	1.31	1.37
11-20	2.34	2.44	2.56	2.67
21-50	4.50	4.67	4.91	5.13
Above 50	4.66	4.83	5.08	5.31
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⁾	1.79	1.87	1.97	2.05
11-20	3.49	3.63	3.82	3.99

21-50	6.73	6.98	7.34	7.67
Above 50	7.00	7.26	7.63	7.97

- (1) The minimum volume charged is for ten cubic meters per month.
- (2) Since September 11, 2009.

In 2008 and 2009, the average tariff calculated for the Regional systems was approximately 30.0% below the average tariff of the São Paulo metropolitan region.

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. We use 1.8% of the total energy consumption in the State of São Paulo. In 2008 and 2009, 46.6% and 44.6%, respectively, of the energy that we used was provided by *Companhia Energética São Paulo*, or CESP, pursuant to a long term contract expiring in 2012. 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.*

Energy prices have a significant impact on our results of operations. An average increase of 17.5% in 2004 negatively affected our results of operations. In 2005, we migrated 43.0% of our energy requirements to the free market where we can more efficiently negotiate the supply of energy. In 2008 and 2009, 46.6% and 44.6%, respectively, of our total energy consumption occurred under free market rates.

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. As of December 31, 2008 and 2009, we had paid a total aggregate amount of R\$3.39 million and R\$4.58 million in premiums, covering approximately R\$780.7 million and R\$1,270.3 million on assets, third-party liabilities and D&O insurance, respectively. 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. 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 new environmental policy, adopted in January 2008 establishes environmental management directives to allow us to become a contributing force to environmental sustainability and excellence. We based the new directives on a systematic approach to the environment, which allowed 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 the NGAs.

We have the following environmental management programs:

- the structuring of the progressive program for ISO 14001 certification for the 65 water and/or sewage treatment stations by 2010;
- creation of the Corporate Management of Greenhouse Effects Program (*Programa Corporativo de Gestão de Emissões de Gases de Efeito Estufa*);

- the elaboration of an Environment Balance Sheet model, as of 2009 and 2010, in order to improve our balance sheet illustrating our environmental investments;
- the structuring and implementation of the program for review of our environmental liabilities, fulfillment/execution of the conduct adjustment terms and judicial agreements and for maintaining environmental licenses and granting permits for the use of water resources operational facilities;

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- structuring of the SABESP Corporate Environmental Education Program (*PEA SABESP*), including environmental education projects involving the community;
- specific training programs to train technical assistants and experts to participate in legal proceedings regarding environmental matters; and
- implementation of the SABESP 3-Rs Program (*Programa SABESP 3Rs*) for the reduction, re-use and recycling of waste or by-products, a program involving the three largest administrative bodies of SABESP with plans to include all other administrative bodies.

In addition to corporate environmental management initiatives, we launched several projects in 2008 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;
- Sustainable Planet (*Planeta Sustentável*);
- One million Trees in Cantareira (*Programa Um Milhão de Árvores no Cantareira*);
- Eyes in the Atlantic Rainforest (*De Olho na Mata Atlântica*); and
- Supporters of Sustainability (*Audiências de Sustentabilidade*).

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 implementation 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 contract 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 common responsibility shared by 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.

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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.

The Consortium 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 60.0% of the State's population and providing sanitation services through concession agreements, we notice the impacts of the Consortium Law on the expiration of our concession agreements in the 1970's when the Brazilian Sanitation Plan (*Plano Nacional de Saneamento*), or the PLANASA, was created. The Consortium Law has caused important changes in the relationship among municipalities, states and public sanitation service providers, most notably 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 of 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 due expiration date and the reversibility conditions of 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, it was enacted the Federal Law No. 11,445, known as the Basic Sanitation Law, 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.

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.

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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 indemnization must be paid in no more than four equal and successive annual installments upon presentation of security interest, with the first installment payable until the last business day of the fiscal year in which the assets are reversed.

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, although some of these concessions have an indefinite term of effectiveness. 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 correlated 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 compensation may be inadequate to recover the full value of our investments.*

The Federal Concessions Law and the State Concessions Law require that the granting of a concession by the government be preceded by a public bidding process. However, the Federal Public Bidding Law 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 Constitution determines waiver of the public bidding requirement in similar situations. Based on this provision, the municipalities granted concessions with waiver of public bidding processes to us after the enactment of the Federal Constitution. Currently, the Basic Sanitation Law provides that the program contracted can be executed with waiver of a public bidding process.

On November 25, 2003, the Municipal Law No. 13,670 was enacted creating the Municipal System for Regulation of Water Supply and Sanitary Sewage Services (*Sistema Municipal de Regulação dos Serviços de Abastecimento de Água e Esgotamento Sanitário*), providing for their constitution and operation and also establishing the Municipal Sanitation Plan (*Plano Municipal de Saneamento*). According to this law, the Mayor of the city of São Paulo has powers to grant and monitor formal concessions for water and sewage services in the city of São Paulo. Subsequent to law No. 13,670/03, the Governor of the State filed a legal action claiming that this law was unconstitutional and, as a consequence, the applicability of law No. 13,670/03 was suspended. On April 20, 2005 the court ruled, by majority of votes, in favor of the Governor of the State. The city of São Paulo appealed the decision and a final decision is still pending to this date.

On June 18, 2009, the Municipal Law No. 14,934 was enacted, authorizing the City of São Paulo to enter into an agreement with SABESP. This law revoked the Municipal Law No. 13,760/2003, pursuant to which the state was the owner of the basic sanitation services in metropolitan region, that is object of a Direct Unconstitutionality Action,

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pending before the São Paulo State Court of Appeals.

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Public Consortia Law and Cooperation Agreement for Joint Management

On April 6, 2005, the federal government enacted the Federal Consortium 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. 6,017/07 details the conditions of establishment of joint management and the execution of the program contract regulating the Public Consortia and Program Contracts 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 as regards tariffs, of the services and creating the program contract 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 31, 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 contract without public bidding process. In addition, the Decrees establish that we will continue to render services in the areas covered by the concession granted by the State.

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

On June 8, 2006, the State of São Paulo enacted the Decree No. 50,868 creating the Commission for the Regulation of Sanitation Service of the State of São Paulo to regulate sanitation services. The Commission for the Regulation of Sanitation Service of the State of São Paulo was directly subordinated to the State Secretariat for Sanitation and Energy.

The main duty of the Commission for the Regulation of Sanitation Service of the State of São Paulo was the conduction of studies for the creation of a regulatory agency for the basic sanitation industry and the presentation of legal and regulatory measures, which resulted in the publication of supplementary law No. 1,025 of December 7, 2007, creating the ARSESP.

ARSESP regulates the basic sanitation services that belong to the State, relating to the federal and municipal jurisdictions and prerogatives, and exercising the following functions:

- complying with and enforcing state and federal basic sanitation legislation;
- publishing the organizational platform for the services, indicating the types of services provided by the state, as well as the equipment and facilities composing the system;
- assuming, where applicable, the legal attributions of the jurisdictional authority;
- establishing, in accordance with the tariff guidelines defined by Decree No. 41,446/96, tariffs and other manners for the compensation of services, adjusting and reviewing them to ensure the financial-economic balance of services

and low-cost tariffs through mechanisms that increase service efficiency and lead to the appropriation of productivity gains by society; and

- approving, overseeing and regulating (including tariff issues) 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.

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Regarding municipal basic sanitation, ARSESP oversees, controls and regulates (including tariff issues) services that have been delegated by municipalities to the state through shared management resulting from cooperation agreements to formalize the program agreements between municipalities and us for the execution of these services. If possible and convenient for the municipality, it can act on agreements executed prior to the enactment of the current regulation.

For its services, ARSESP charges 0.50% of the annual total invoiced of the municipality. This fee is charged either from municipalities that have signed program contract with us and municipalities in São Paulo metropolitan region.

Supplementary law No. 1,025/07 also amended paragraphs 5, 7 and 8 and added paragraphs 9 and 10 to Article 1 of State law 119/73, which created us, expanding 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 own or third-party use.

In addition, the new 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.

Finally, the supplementary law No. 1,025/07 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), connected to the State Secretariat for Sanitation and Energy, for the collection and management of resources in support of State-approved programs, as well as support of development of technology, management and human resources and of a system of information on sanitation, in addition to other support programs.

On November 13, 2009, the Sanitation and Energy Regulatory Agency of the State of São Paulo - ARSESP published Resolution No. 106 establishing technical conditions for the provision of water supply and sanitary sewage services under state and municipal ownership that had their attributes of oversight, control and regulation of services including tariffs delegated by the agency to the state for the fiscal year. Technical, economic and financial viability studies have not yet been carried out for the implementation of the new rules and therefore it is not possible to estimate the impacts thereof.

Public-Private Partnerships and Growth Acceleration Plan

The PPP is a form of agreement with the public administration used for the concession of services only to private enterprises, as well as for construction works coupled with the provision of services. PPPs are regulated in the State of São Paulo by law No. 11,688 enacted on May 19, 2004. PPPs may be used for: (i) implantation, expansion, improvement, reform, maintenance, or management of public infra-structure; (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) assignment of credits belonging to the Public Administration, except taxes; and (iii) transfer of rights related to the commercial exploitation of public assets.

Law No. 11,688 also authorized the creation of *Companhia Paulista de Parcerias*, or the CPP. CPP may grant guarantees, enter into insurance contracts, and participate in PPP contracts. CPP is fully owned by the São Paulo State government.

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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 service provision of water and sewage, housing, as well as highways, airports, ports, energy, that would benefit the poor population of Brazil. The Plan calls for a total investment of R\$504.0 billion through 2010 and most part of this amount would be provided by State-owned companies and the private sector, while the rest would come from the federal government. Of this total, a R\$40 billion investment is for the sanitation sector.

Public Bidding Procedures

Pursuant to the Federal Public Bidding Law, the public bid process commences with publication by the granting authority in the federal, state or municipal official newspaper, as the case may be, and another leading Brazilian newspaper, of an announcement that it 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 bids; (v) the criteria used for selection of the winning bidder; and (vi) a list of the documents required to establish the bidder's technical, financial and legal capabilities.

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 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, among other things, 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 development and use of water resources in the State of São Paulo in accordance with the State Constitution. These principles include:

- rational utilization of water resources, with service to the population identified as having priority;
- 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 hydrographic 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 sources against pollution and excessive exploitation; and
- prevention of erosion of land in urban and rural areas, with a view to protecting against physical pollution and silting of water resources.

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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 other 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), the 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, the DAEE is the public authority responsible for granting such authorizations. The 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 integral use of water resources, directly or by means of agreements with third parties. The DAEE has established the standards which regulate abstraction of water from water resources in the State of São Paulo.

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 of Grants.

In July 2000, the ANA, a federal agency under the Ministry of the Environment, was established to develop the National System for Water Resources Management. According to existing law, the Hydrographic Basin Committees are authorized to collect charges related to water usage from entities, such as us, for the abstraction of water from, or dumping of sewage into, water resources controlled by these agencies. The charges collected by these agencies will be used to sponsor studies, programs, projects and constructions provided for in the Water Resources Plan (*Plano de Recursos Hídricos*) and for the payment of expenses concerning the creation of the Federal System for Water Resources Managing (*Sistema Nacional de Gerenciamento de Recursos Hídricos*), as well as may be loaned or provided as grants to governmental agencies and corporations, including us, for use in the development of conservation and recovery of water resources.

State law No. 12,183 of December 29, 2005 established the basis for the fees charged for the use of the water resources owned by the State of São Paulo. To implement this fee, the law provides for, among other provisions, the participation of the Basin Committees, the creation of Basin Agencies and the organization of a registered list of water resource users. The Committee's proposals regarding the amounts to be charged at the basins must be approved by the State Water Resource Council, with the approval and setting of the amounts to be applied at each water basin formalized by a decree issued by the State Governor. Article 4 of the law also established that, until December 2009, the fees charged for the use of water resources by public or private basic sanitation (water and sewage) companies will correspond to 50.0% of the established amount, provided these companies demonstrate they are making investments with their own funds in studies, projects and works aimed at the removal and treatment of sewage. The law also provides for penalties for the failure to pay fees that range from a fine of 2.0% and interest on arrears on the value of the outstanding payment to the suspension or loss of water resource use rights, which are imposed at the discretion of the water resource authority and in accordance with the applicable regulations.

Water Quality

Administrative Rule No. 518/04, issued by the Ministry of Health of the federal government provides the standards for drinking 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, establishing rules for sampling and limits related to substances that are potentially hazardous to 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. 5,440/05 provides for the obligation to disclose the quality of water to consumers. We have been complying with these regulations by publishing the significant information in monthly bills and annual reports delivered to all consumers that we serve.

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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 licensing 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 March 31, 1976, which regulates the control of environmental pollutants, and with the state Law No. 13,542 enacted on May 8, 2009.

The control and environmental planning instruments are defined by several legal instruments, such as the State Law No. 997/1976 which regulates the environmental pollution control; the Conama Resolution 05/1988 that oversees sanitation projects which causes environmental alterations; the Conama Resolution No. 237/1997 which regulates environmental licenses; Federal, State and Local jurisdiction; listed activities subject to licensing; environment and impact researches and reports; State Decree No. 47,400/02 which regulates articles from State Law No. 9,509/1997 regarding environmental licensing, establishes validity terms to each environmental licensing branch and conditions to its renewal, as well as terms to requirement analysis and environmental licensing; establishes suspension notifications and termination requirements, and payment analysis; State Decree No. 8,468/76 which regulates both State Law No. 977/1976 and Conama Resolution No. 357/05 which classifies water resources and environmental guidelines, as well as establishes effluent patterns, among other provisions.

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, which include the following licenses:

- prior 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 the compliance with the approved plans, programs and projects, including environmental control measures and other necessary technical requirements.
- operation license - authorizing the operation of a unit or activity subject to compliance with the technical requirements contained in the installation license.

Sewage Requirements

State law sets forth regulations regarding pollution control and environmental preservation in the State of São Paulo establishing limits for the discharge of waste that impact the water, air and soil. State law provides that, in areas in which there exists 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 certain criteria established by the applicable environmental law, which allow such effluents to be treated by our treatment facilities and discharged in an environmentally safe manner. Effluents which exceed such characteristics 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. Federal Law No. 11,455/2007 also regulates the subject, establishing the national sanitation guidelines in article 45.

The CETESB is authorized under State law to monitor discharges of pollutants into the environment and to enforce the requirements of State law. CETESB is responsible for issuing previous installation and operation licenses granted to sewage treatment facilities and other pollution sources. We have a program aimed at cleaning up the Tietê river, called the Tietê Project, which was launched in 1992 and is considered the largest basic sanitation program ever implemented in Brazil. The Tietê Project is included in our capital expenditure program, and involves work for the collection, removal and treatment of sewage to expand and optimize the basic sanitary sewage system in the São Paulo metropolitan region. See *Capital Expenditure Programs São Paulo Metropolitan Region Investment Programs Tietê Project*.

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The disposal of sludge must also meet State and Federal Law requirements such as the Conama Resolution No. 375 enacted on August 29, 2006. CETESB also regulates the discharge of effluents into bodies of water and must approve all of our treatment facilities in accordance with federal and state regulations. Water resource legislation in the State of São Paulo establishes the charging of fees for the discharge of treated effluents into bodies of water, however, this provision is currently in the final stages of implementation.

Some municipalities of the State of São Paulo have enacted municipal laws requiring us to charge a fixed fee for these services, and not use the tariff system, for sewage services being provided. To date, we have not been the subject of enforcement of these laws.

Tariff Regulation in the State of São Paulo

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

On December 16, 1996, the governor of the State 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 equity 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; and
- social and economic conditions of residential customers.

We may be subject to a federal law which, in the case of water and sewage services, provided pursuant to certain concessions, effectively prohibits tariffs that would produce a return on assets in excess of 12% per annum. Return on assets is calculated using operating income (before financial and certain other expenses) measured against operational assets (property, plant and equipment and certain other assets), based on our financial statements prepared in accordance with Brazilian GAAP. We could be subject to the above return on assets limitation in adjusting tariffs because substantially all of our current concessions were granted during the period in which these rate regulations were in effect. We are not, however, subject to such limitations in setting tariffs under our newer concessions. The above return on assets limitation does not apply to renewals of existing concessions.

In addition to the specific regulation mentioned above, we are also subject to general rules such as periodic readjustments established by law No. 9,069/95 which established, among other things, the *Real Plan*.

With the enactment of the Basic Sanitation Law and federal consortium law, we were prohibited from planning, inspecting and regulating services, which included determining the tariff policy to be adopted. These activities are to be exercised by the entity of the State that controls the services, which, with the exception of the responsibility for

planning, may delegate the exercise of the other applicable responsibilities. Pursuant to the Basic Sanitation Law, tariff regulation is to be performed by an independent regulatory entity. Municipalities can choose to delegate tariff regulation to the ARSESP instead of creating their own regulatory agency. Considering that, with the sole exception of the municipality of Lins, no other municipality has decided to create its own regulatory entity so far and that many municipalities have already delegated regulation to ARSESP, we believe that at least in the near future ARSESP will be in charge of regulating tariffs for most of the concession and program agreements entered into by us. However, we cannot be certain that other municipalities will not take the same decision as Lins.

The current tariff structure maintain three different tariff schedules, depending upon whether a customer is located in the São Paulo metropolitan region or the interior or coastal regions comprising our Regional Systems. There are four levels of volume consumed for each category of customer, except for the residential social and *favelas* (shantytowns) that present five levels of volume consumed. Customers are billed on a monthly basis. 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.

Governmental Restrictions on Incurrence of Debt

On June 30, 1998, the Central Bank issued a resolution 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 Central Bank resolution further provides that the requirements described above do not apply to financing transactions involving multilateral or official organizations such as the World Bank, the IDB 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 external credit transactions are also subject to the approval of the National Secretariat of Treasury and the Central Bank, which, after reviewing the financial terms and conditions of the transaction, 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.

The Company is also subject to the provisions of National Monetary Council Resolution No. 2,827 of March 30, 2001, as amended, that limits the value of credit operations of financial institutions and other institutions authorized by the Brazilian Central Bank with bodies and entities in the public sector.

Lending Limits of Brazilian Financial Institutions

The National Monetary Council resolutions limit the amount that Brazilian public 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.

4.C. Organizational structure

Not applicable.

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4.D. Property, Plant and Equipment

Our principal properties consist of 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. As of December 31, 2008, we owned 206 water treatment facilities and 62,582 kilometers of water pipes and mains, 464 sewage treatment facilities and 42,241 kilometers of sewer lines, as well as 16 water quality control laboratories. As of December 31, 2009, we owned 208 water treatment facilities and 63,732 kilometers of water pipes and mains, 475 sewage treatment facilities and 42,895 kilometers of sewer lines, 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 World Bank 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 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, 2008 and 2009, the total net book value of our property, plant and equipment and intangible assets (including concession assets) was R\$15.7 billion and R\$17.0 billion, respectively, including concession assets acquired (intangible assets).

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 financial statements included elsewhere in this annual report. 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.

The financial statements included elsewhere in this annual report have been prepared in accordance with Brazilian GAAP, which differs in certain significant respects from U.S. GAAP. We have included a discussion of the material differences between Brazilian GAAP and U.S. GAAP related to each critical accounting policy in our audited financial statements. For additional information regarding other differences between Brazilian GAAP and U.S. GAAP, please see Note 28 to our financial statements.

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.

5.A. Operating and Financial Review and Prospects

Overview

We operate water and sewage systems in the State of São Paulo, including in the City of São Paulo, Brazil's largest city, and in 366 municipalities in the State of São Paulo, which represent 55.5% of all municipalities in the State. We also provide water services on a wholesale basis to six additional municipalities in which we do not operate water systems.

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The São Paulo metropolitan region, which includes the city of São Paulo, is our most important service territory. With a population of approximately 20.2 million, the São Paulo metropolitan region accounted for approximately 75.8%, 75.8%, 76.1% and 75.6% of our gross revenue from sales and services in 2006, 2007, 2008 and 2009, respectively. Approximately 67.3% of the property, plant and equipment reflected on our balance sheet as of December 31, 2008 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 2006, our results of operations and financial condition were affected by an increase in the invoiced volume of water and sewage, as well as by a decrease in our financial expenses, as a result of our strategy to actively manage our capital market indebtedness. In addition, our results of operations and financial condition were negatively affected by an adjustment of R\$93.8 million that resulted from an analysis and reconciliation procedure related to the accounting balance of our accounts receivable. In 2007, as a result of a high number of court rulings, our management was able to analyze the contingency evaluation process. Based on this analysis and on the most recent history of favorable and unfavorable court rulings, we were able to determine the contingency amount in the lawsuits involving customers and improve our estimate of liability.

In 2008, our net income decreased significantly in comparison to our net income in 2007. We recorded a R\$409.1 million provision for losses with respect to the amount that the State acknowledges that it owes to us relating to the pension benefits paid by us on behalf of the State and a R\$535.4 million provision for actuarial liability. In the aggregate, these adjustments totaled R\$944.5 million. See Note 6 to our financial statements. The global financial and economic crisis, resulted in a depreciation of the Brazilian *real* against the US dollar, which adversely affected our foreign currency-denominated obligations. Even though the exchange rate variation negatively affected our net income, the impact was partially offset by the financial revenue recorded as a result of the commitment agreement with the State of São Paulo, the DAEE and the Company, on March 26, 2008. See *7.B. Major Shareholders and Related Party Transactions* *Related Party Transactions* *Transactions with the State of São Paulo* *Agreements with the State*.

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 Law No. 11,445/07 dated December 5, 2007, as a general rule, ARSESP 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 financial-economic balance of the agreement.

Readjustment of our tariffs would continue to be set annually, but would be dependent 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 has to be announced 30 days prior to the effective date of the new tariffs, which occur 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,			
	2006	2007	2008	2009
Increase in average tariff ⁽¹⁾	6.7%	4.1%	5.1%	4.4%
Inflation IPC - FIPE	2.5%	4.4%	6.2%	3.7%
Inflation IPCA	3.1%	4.5%	5.9%	4.3%
Inflation IGP-M	3.8%	7.8%	9.8%	(1.7)%

(1) Tariff increases for each period took effect in August of such year. Since 2007, tariff readjustments have taken effect in September, one month after the readjustment announcement.

Sources: Central Bank, *Fundação Getúlio Vargas* 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 demand for water and sewage services, and inflation affects our costs and margins. The Brazilian economic environment has been characterized by significant variations in economic growth rates.

General Economic Conditions. In 2006, the *real* appreciated by 7.5% against the U.S. dollar between December 31, 2005 and 2006. Notwithstanding the *real* 's appreciation, Brazil 's trade surplus was US\$46.5 billion. The average unemployment rate increased from 8.3% for the year ended December 31, 2005, to 8.4% for the year ended December 31, 2006, in the principal metropolitan regions of Brazil, according to IBGE estimates. In 2007, the appreciation trend continued and the *real* appreciated by 20.7% against the U.S. dollar. Notwithstanding the *real* 's appreciation, Brazil 's trade surplus was US\$40.0 billion.

By the end of 2007, Brazil had US\$180.0 billion in currency reserves. The average unemployment rate in the principal metropolitan regions of Brazil decreased from 8.4% for the year ended December 31, 2006, to 7.4% for the year ended December 31, 2007 and to 6.8% for the year ended December 31, 2008, remaining stable at 6.8% for the year ended December 31, 2009, according to IBGE estimates.

The year 2008 was characterized by the worsening of the global financial and economic crisis. As a result, in 2008 the *real* depreciated by 30.1% against the U.S. dollar. Nonetheless, Brazil had R\$206.8 billion in currency reserves. Brazil 's trade surplus was R\$24.8 billion. In addition, the worsening of the financial crisis during the last quarter of 2008 reduced the activity level of the Brazilian economy. The Brazilian economy experienced higher lending rates, currency devaluation, fall in stock prices and shrinking industrial production. In order to ease the impact of the financial crisis in the Brazilian economy, the Brazilian government implemented measures for the flexibilization of the monetary policy and tax relief. These measures strengthened the domestic market and were key to the economic recovery. In 2009, the Brazilian gross domestic product (GDP) decreased 0.2% in comparison with 2008. Nonetheless, Brazil had US\$239.0 billion in currency reserves. Brazil 's trade surplus was US\$25.3 billion.

Interest Rates. Interest rates in Brazil are closely linked to exchange rate fluctuations and inflation 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 increase our exposure to exchange rate fluctuations as discussed below.

In November 2005, the Central Bank began a process of reducing the official interest rate. On December 31, 2005, the official interest rate was 18.0%. In 2006, the Central Bank continued to reduce the official interest rate, reaching 13.19% on December 31, 2006. In 2007, the Central Bank continued to reduce the official interest rate, reaching 11.18% on December 31, 2007. However, the trend was reverted as a result of the global financial and economic crisis, and the official interest rate was 13.66% on December 31, 2008. In 2009, in order to boost the economy, the Central Bank reduced significantly the official interest rate, reaching 8.65% on December 31, 2009. 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 increases are determined by reference to the daily government interest rate (*Taxa Referencial*), or the TR, plus an agreed margin. We cannot assure that our tariffs will be increased, in future periods, to increase tariffs

to offset, in full or in part, the effects of inflation.

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The following table shows Brazilian inflation for the periods indicated:

		Year ended December 31,				
		2006	2007	2008	2009	
Inflation	IPC - FIPE		2.5%	4.4%	6.2%	3.7%
Inflation	IGP-M		3.8%	7.8%	9.8%	(1.7)%

Sources: *Fundação Getúlio Vargas* and *Fundação Instituto de Pesquisas Econômicas*.

Currency Exchange Rates. We had total foreign currency-denominated indebtedness of R\$2,281.0 million as of December 31, 2008, of which R\$106.2 million refer 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 31.9% devaluation of the *real* in 2008 increased our financial expenses and negatively affected our overall results of operations for the year. In contrast, in 2007, the *real* appreciated 17.15% against the U.S. dollar, which resulted in a foreign exchange gain of R\$188.0 million. The 8.66% appreciation of the *real* against the U.S. dollar in 2006 led to a foreign exchange gain of R\$96.1 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 nor do we have any material 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 for the years 2006, 2007, 2008 and 2009:

	Year ended December 31,			
	2006	2007	2008	2009