

COMPANHIA DE SANEAMENTO BASICO DO ESTADO DE SAO PAULO-SABESP
Form 20-F
June 30, 2006

**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

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005**

OR

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

For the transition period from _____ to _____

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)

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 250 Common Shares	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.

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.

28,479,577,827 Common Shares, without par value, as of December 31, 2005

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

Yes No

Indicate by check mark which financial statement item the registrant has elected to follow.

Item 17 Item 18

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PRESENTATION OF FINANCIAL INFORMATION

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 United States dollars. Solely for the convenience of the reader, we have translated some of the *real* amounts contained in this annual report into U.S. dollars at a rate equal (unless otherwise indicated) to R\$2.3407 to US\$1.00, the commercial selling rate on December 31, 2005 as reported by the Central Bank of Brazil, or the Central Bank. 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. Therefore, you should not read these translations as representations that any such amounts have been, could have been or could be converted into U.S. dollars at that or at any other exchange rate. See *Item 3. Key Information Exchange Rates* for information regarding exchange rates allocable to the Brazilian currency since January 1, 2001.

Our audited financial statements as of December 31, 2004 and 2005 and for the years ended December 31, 2003, 2004 and 2005 are included in this annual report. The financial statements as of and for the years ended December 31, 2003, 2004 and 2005 have been audited by Deloitte Touche Tohmatsu Auditores Independentes, São Paulo, Brazil. The selected financial data as of December 31, 2001 and 2002 and the two years ending on December 31, 2002 is derived from our financial statements audited by PricewaterhouseCoopers Auditores Independentes included in previously filed annual reports.

Our audited financial statements are presented in *reais* and are prepared in accordance with Corporate Law Method, which are based on the Brazilian corporation law (Law No. 6,404/76, as amended), the rules and regulations issued by the Comissão de Valores Mobiliários (CVM), or the Brazilian securities commission, and the accounting standards issued by the Brazilian Institute of Independent Auditors (Instituto dos Auditores Independentes do Brasil, or IBRACON), hereinafter referred to as the Corporate Law Method .

Like other Brazilian companies, we have the option of presenting our primary financial statements on the basis of accounting principles established in accordance with the Corporate Law Method with a reconciliation to generally accepted accounting principles in the United States of America (U.S. GAAP). Unless otherwise indicated, our financial statements and all financial data included in this annual report have been prepared in accordance with the Corporate Law Method.

The Corporate Law Method differs in significant respects from U.S. GAAP. Note 22 to our audited financial statements provides a description of the differences between the Corporate Law Method and U.S. GAAP as they relate to our financial statements and a reconciliation from the Corporate Law Method to U.S. GAAP, for periods presented therein, of our net income (loss) and shareholders' equity. The reconciliation from the financial statements prepared in accordance with the Corporate Law Method to U.S. GAAP includes, among others, adjustments for differences related to the accounting for past revaluations of property, plant and equipment, historical inflation accounting and accounting for pension and other employee benefits.

We do not have any subsidiaries.

Some figures in this annual report may not total due to rounding adjustments.

FORWARD-LOOKING STATEMENTS CONTAINED IN THIS ANNUAL REPORT

This annual report includes forward-looking statements, principally 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 things:

- the interests of our controlling shareholder, the State of São Paulo (the State);
- our ability to collect amounts owed to us by our controlling shareholder and by municipalities;
- existing and future governmental regulation, including taxes on, and charges to, us;
- our lack of formal concessions for the City of São Paulo and other municipalities;
- municipalities' ability to terminate our existing concessions;
- our ability to obtain additional concessions and to renew current concessions when they become due;
- our ability to achieve plans to increase sewage coverage ratio and sewage connections;
- our ability to access attractive financing in the future;
- limitations on our ability to increase tariffs;
- our capital expenditure program and other liquidity and capital resources requirements;
- our level of indebtedness and limitations on our ability to incur additional indebtedness;
- droughts, water shortages and/or climate events;
- our costs relating to compliance with environmental laws and potential penalties for failure to comply with such laws;
- the outcome of our pending or future legal proceedings;
- general economic, political and other conditions in Brazil and in other emerging market countries;
- inflation and currency devaluation in Brazil;
- changes to tax laws in Brazil;
- power shortages, rationing or instability of electricity supply;
- our management's expectations and estimates concerning our future financial performance;
- the size and growth of our customer base; and
- other risk factors as set forth under *Item 3. Key Information Risk Factors* section.

The words believes , may , will , estimates , continues , anticipates , intends , expects and similar words are 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.

PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION**Selected Financial Data**

The selected financial data as of December 31, 2001 and 2002 and the two years ending on December 31, 2002 is derived from our financial statements audited by PricewaterhouseCoopers Auditores Independentes included in previously filed annual reports. The selected financial data as of December 31, 2003, 2004 and 2005 and for the three years in the period ended December 31, 2005 is derived from our financial statements audited by Deloitte Touche Tohmatsu Auditores Independentes, and is included in this annual report.

Our financial statements have been prepared in accordance with the Brazilian Corporate Law Method, which differs in significant respects from U.S. GAAP. You should read this selected financial data in conjunction with our financial statements and the related notes thereto included in this annual report. Solely for the convenience of the reader, *real* amounts as of and for the year ended December 31, 2005 have been translated into U.S. dollars at the selling rate as of December 31, 2005 of R\$2.3407 per U.S.\$1.00.

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

	As of and for the year ended December 31,					
	2001	2002	2003	2004	2005	
	(in millions, except per share and per ADS data)					
Corporate Law Method	R\$	R\$	R\$	R\$	R\$	US\$
Statement of Operations Data:						
Net revenue from sales and services	3,434.8	3,767.1	4,130.8	4,397.1	4,953.4	2,116.2
Cost of sales and services	(1,590.4)	(1,815.0)	(2,067.1)	(2,253.4)	(2,390.4)	(1,021.2)
Gross profit	1,844.3	1,952.2	2,063.6	2,143.7	2,563.0	1,095.0
Selling expenses	(332.6)	(385.1)	(297.5)	(502.5)	(537.9)	(229.8)
Administrative expenses	(203.1)	(226.0)	(254.1)	(313.6)	(335.5)	(143.3)
Financial income (expenses), net	(1,105.2)	(2,276.3)	(346.5)	(503.7)	(447.0)	(191.0)
Income (loss) from operations ⁽¹⁾	203.4	(935.3)	1,165.5	823.9	1,242.6	530.9
Non-operating income (expenses)	(76.9)	(3.4)	(54.5)	(33.9)	(25.4)	(10.9)
Income (loss) before taxes on income	126.5	(938.7)	1,111.1	790.0	1,217.2	520.0
Income tax and social contribution tax	89.7	323.3	(242.6)	(241.9)	(316.5)	(135.2)
Extraordinary item, net of income and social contribution taxes ⁽²⁾		(35.1)	(35.1)	(35.1)	(35.1)	(15.0)
Net income (loss)	216.2	(650.5)	833.3	513.0	865.6	369.8
Net income (loss) per 1,000 common shares	7.59	(22.84)	29.26	18.01	30.39	12.98
Net income (loss) per ADS	1.90	(5.71)	7.32	4.50	7.60	3.25

Dividends and interest on shareholders equity per 1,000 common shares	17.20	3.80	17.70	5.37	12.23	5.22
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Number of common shares outstanding at year end (in thousands of shares)	28,479,578	28,479,578	28,479,578	28,479,578	28,479,578	28,479,578
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Balance Sheet Data:

Cash and cash equivalents	460.2	414.7	281.0	105.6	280.1	119.7
Customer accounts receivables, net	878.0	820.5	1,056.2	1,227.9	1,458.6	623.1
Reimbursement for pension benefits paid	326.3	403.9	491.0	576.3	672.7	287.4
Short and long-term receivables from shareholders, net ⁽³⁾	378.3	423.7	164.2	245.6	294.2	125.7

Table of Contents**As of and for the year ended December 31,****2001 2002 2003 2004 2005****(in millions, except per share and per ADS data)**

	R\$	R\$	R\$	R\$	R\$	US\$
Property, plant and equipment, net	13,231.4	13,395.1	13,376.6	13,523.5	13,613.6	5,816.0
Concession assets acquired, net	278.6	275.7	686.6	517.4	502.5	214.7
Total assets	15,917.9	16,348.7	16,590.1	16,783.8	17,435.2	7,448.7
Total short-term loans and financing	549.3	1,332.5	997.0	1,496.8	759.0	324.3
Total long-term loans and financing	5,920.6	6,545.2	6,267.3	5,553.8	5,905.2	2,522.8
Total liabilities	7,921.2	9,102.2	9,013.2	8,832.2	8,952.6	3,824.8
Shareholders equity	7,996.7	7,246.5	7,576.9	7,951.6	8,482.5	3,623.9

Other Financial Information:

Cash provided by operating activities ⁽⁴⁾	1,657.0	1,764.8	1,655.3	1,436.1	1,754.8	749.7
Cash used in investing activities ⁽⁴⁾	(709.5)	(597.2)	(650.8)	(670.5)	(660.5)	(282.2)
Cash used in financing activities ⁽⁴⁾	(763.6)	(1,165.7)	(1,138.2)	(941.1)	(919.7)	(392.9)
Adjusted EBITDA ⁽⁵⁾	1,785.9	1,860.1	2,076.5	1,926.5	2,285.6	976.5
Capital expenditures ⁽⁴⁾	694.6	586.0	641.3	670.3	660.4	282.1
Depreciation and amortization	477.3	519.1	564.5	598.9	596.0	254.6

As of and for the year ended December 31,**2001 2002 2003 2004 2005****(in millions, except per share and per ADS data)****U.S. GAAP**

	R\$	R\$	R\$	R\$	R\$	US\$
Statement of Operations Data:						
Net revenue from sales and services	3,434.8	3,767.1	4,130.8	4,397.1	4,953.4	2,116.2
Gross profit	1,613.8	1,820.1	1,853.3	1,953.1	2,369.1	1,012.1
Selling expenses	(349.9)	(393.6)	(323.4)	(521.5)	(555.5)	(237.3)
Administrative expenses	(214.8)	(328.8)	(276.3)	(324.1)	(336.1)	(143.6)
Income from operations ⁽⁶⁾	951.1	1,086.5	1,136.5	1,073.0	1,470.2	628.1
Financial income (expenses), net	(1,107.1)	(2,284.5)	(329.4)	(479.2)	(401.9)	(171.7)
Net income (loss)	16.7	(847.6)	642.6	417.5	791.2	338.0
Net income (loss) per 1,000 common shares-						
basic and diluted	0.59	(29.76)	22.56	14.66	27.78	11.87
Net income (loss) per ADS-basic and diluted	0.15	(7.44)	5.64	3.67	6.95	2.97
Weighted average number of common shares outstanding (in thousands of shares)	28,479,578	28,479,578	28,479,578	28,479,578	28,479,578	28,479,578

Balance Sheet Data:

Property, plant and equipment, net	15,377.4	15,390.3	15,268.9	15,347.2	15,393.9	6,576.6
Concession assets acquired, net	278.6	275.7	686.6	517.4	502.5	214.7
Total assets	17,581.8	17,625.6	17,630.4	17,704.5	18,213.9	7,781.4
Short-term loan financing	549.3	1,753.6	997.0	1,496.8	759.0	324.3
Long-term loan financing	5,873.2	6,124.0	6,267.3	5,553.8	5,905.2	2,522.8
Total liabilities	10,688.5	11,679.8	11,604.3	11,339.7	11,392.5	4,867.1
Shareholders equity	6,893.3	5,945.8	6,085.6	6,364.8	6,821.4	2,914.3

Table of Contents**As of and for the year ended December 31,**

	2001	2002	2003	2004	2005
Operating Data (at period end):					
Number of water connections (in thousands)	5,717	5,898	6,044	6,358	6,489
Number of sewage connections (in thousands)	4,128	4,304	4,462	4,747	4,878
Percentage of population with water connections (%)	100	100	100	100	100
Percentage of population with sewer connections (%)	76	77	78	78	78
Volume of water billed during period (in millions of cubic meters)	1,698	1,770	1,765	1,692	1,759
Water loss percentage during period (average)(%) ⁽⁷⁾	32.6	31.7	33.0	34.0	32.4
Water loss per connection (average) ⁽⁸⁾	538	546	563	547	520
Number of employees	18,159	18,505	18,546	17,735	17,448

- (1) Includes financial expenses, net.
- (2) The extraordinary item charged to income in the years ended December 31, 2003, 2004 and 2005 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 the Corporate Law Method. For purposes of U.S. GAAP, the pension expense has been treated as a payroll expense from the first year presented.
- (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 audited financial statements.
- (4) Based upon the audited statements of cash flows for the years ended December 31, 2004, 2003 and 2002 included in note 24 to our audited financial statements and the audited statement of cash flows for the years ended December 31, 2000 and 2001 which are not included in this annual report.
- (5) Adjusted EBITDA means net income (loss) before financial expenses, net, income tax and social contribution tax (a federal tax on income), depreciation and amortization, non-operating income (expenses), net and extraordinary item, net of income tax and social contribution tax. Adjusted EBITDA is a non-accounting measurement which is parallel to the conventional measurements contained in the Financial Statements prepared according to the Corporate Law Method, does not represent cash flow for the periods presented and should not be considered as an alternative to net income (loss), as an indicator of our operating performance or as an alternative to cash flows as an indicator of liquidity. Our definition of Adjusted EBITDA may not be comparable with EBITDA as defined by other companies. Although Adjusted EBITDA, as defined above, does not provide a measurement of operating performance as accepted under the Corporate Law Method, our management uses it to measure our operating performance and it is commonly used by financial analysts in evaluating our business. Adjusted EBITDA is calculated as follows:

For the year ended December 31,

2001	2002	2003	2004	2005
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(in millions)

	R\$	R\$	R\$	R\$	R\$	US\$
Corporate Law Method						
Net income (loss)	216.2	(650.5)	833.3	513.0	865.6	369.8
Add:						
Financial expenses (income), net	1,105.2	2,276.3	346.5	503.7	447.0	191.0
Income and social contribution tax	(89.7)	(323.3)	242.6	241.9	316.5	135.2
Depreciation and amortization	477.3	519.1	564.5	598.9	596.0	254.6
Non-operating income (expenses), net	76.9	3.4	54.5	33.9	25.4	10.9
Extraordinary item, net of income and social contribution taxes		35.1	35.1	35.1	35.1	15.0
Adjusted EBITDA	1,785.9	1,860.1	2,076.5	1,926.5	2,285.6	976.5

- (6) Under U.S. GAAP, income from operations is determined before financial expenses, net.
- (7) Includes both physical and non-physical losses. Water loss percentage represents the quotient of (a) the difference between (i) the total amount of water produced by us (after excluding certain non-physical water losses set out below) less (ii) the total amount of water invoiced by us to customers divided by (b) the total amount of water produced (after excluding certain non-physical water losses set out below) by us. We exclude from our calculation of water losses the following: (1) water discharged for periodic maintenance of water mains and water storage tanks; (2) water supplied for municipal uses such as firefighting; (3) water we consume in our facilities; and (4) estimated water losses associated with water we supply to *favelas* (shantytowns).
- (8) Measured in liters/connections per day.

Exchange Rates

Before March 14, 2005, there were two principal legal foreign exchange markets in Brazil, in which rates were freely negotiated but could be strongly influenced by Central Bank intervention:

- the commercial rate exchange market, dedicated principally to trade and financial foreign exchange transactions such as the buying and selling of registered investments by foreign entities, the purchase or sale of shares or the payment of dividends or interest with respect to shares; and
- the floating exchange market that was generally used for transactions not conducted through the commercial foreign exchange market.

On March 4, 2005, the National Monetary Council enacted Resolution No. 3,265, pursuant to which the commercial rate exchange market and the floating rate exchange market were unified in a sole exchange market, effective as of March 14, 2005. The new regulation allows, subject to certain procedures and specific regulatory provisions, the purchase and sale of foreign currency and the international transfer of *reais* by a person or legal entity, without limitation with respect to the amount involved, provided, however, the transaction is legal. However, the underlying transaction must have been valid. Foreign currencies may only be purchased through financial institutions domiciled in Brazil authorized to operate in the exchange market.

Following the introduction of the *real* in 1994 and through 1998, the Central Bank maintained a band system exchange rate, under which the exchange rate between the *real* and the U.S. dollar would fluctuate within a pre-established moving band. In January 1999, due to market pressures, the Central Bank abolished the band system and allowed the *real*/U.S. dollar exchange rate to float freely. Since then, the exchange rate has been established by the market and has fluctuated considerably, reporting a maximum quotation of R\$3.955 per U.S.\$1.00 on October 22, 2002. Since the liberalization of the exchange rate, the Central Bank has intervened occasionally to control unstable movements in the foreign exchange rate. It is not possible to predict whether the Central Bank will continue to let the *real* float freely or whether the *real* will remain at its present level. Accordingly, it is not possible to predict what impact the Brazilian government's exchange rate policies may have on us.

The following table shows the commercial selling rate for U.S. dollars for the periods and dates indicated. The information in the Average column represents the average of the exchange rates for the period indicated.

	Low	High	Average	Period-end
	<i>(Reais per U.S.\$1.00)</i>			
Year ended December 31,				
2001	1.9353	2.8007	2.3522	2.3204
2002	2.2709	3.9552	2.9309	3.5333
2003	2.8219	3.6623	3.0715	2.8892
2004	2.6544	3.2051	2.9257	2.6544
2005	2.1633	2.7621	2.4341	2.3407
Month ended				
December 31, 2005	2.1800	2.3735	2.2855	2.3407
January 31, 2006	2.2116	2.3460	2.2739	2.2160
February 28, 2006	2.1177	2.2217	2.1619	2.1355
March 31, 2006	2.1067	2.2238	2.1520	2.1724
April 30, 2006	2.0892	2.1542	2.1293	2.0892
May 31, 2006	2.0586	2.3711	2.1781	2.3005

Source: Central Bank of Brazil.

Risk Factors**Risks Relating to our Control by the State of São Paulo**

We are controlled by the State, whose interests may be contrary to the interests of holders of our shares or ADSs.

The State of São Paulo, which we refer to as the State, through its ownership of our common shares, has the ability to control the election of a majority of the members of our *Conselho de Administração* (Board of Directors), to appoint our senior management and to determine our operations and strategy. The State owned 50.3% of our outstanding common shares as of March 31, 2006 and 50.3% of our outstanding common shares as of December 31, 2005.

The State has from time to time in the past used, and may in the future use, its controlling interest in our company to direct that we engage in certain business activities and make certain expenditures which are designed primarily to promote the political, economic or social goals of the State and not necessarily to enhance our business and results of operations. As a result, actions taken by the State in relation to Sabesp could be contrary to the interests of the holders of our shares or ADSs.

Most of our Board of Directors and senior management are political appointees of the Governor of the State, who are subject to periodic change unrelated to our business needs.

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 the Energy, Water Resources and Sanitation Secretariat of the State. In 2002, new senior officials were appointed for the state government administration, including Mr. Mauro Guilherme Jardim Arce as the new Secretary of the Energy, Water Resources and Sanitation Secretariat of the State. Mr. Arce was also elected as Chairman of our Board of Directors. On October 2006, there will be elections for the State government. Changes in government or government policy could lead to changes in our senior management which in turn could have a material adverse effect on our business strategy, cash flows, results of operations, financial condition or prospects.

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

Historically, the State and some State entities have had substantial overdue accounts payable to us relating to (1) the provision of water and sewage services and (2) 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, 2005, the amounts owed to us by the State for the provision of water and sewage services included R\$182.7 million, which was considered overdue as of February 29, 2004. As of December 31, 2005, the State owed us an additional R\$111.5 million in accounts receivable related to the provision of water and sewage services rendered from February 2004. With respect to reimbursement for pensions paid on behalf of the State, the State owed us

R\$672.7 million as of December 31, 2005 (R\$320.6 million of which was acknowledged by the State in an agreement with us subject to a further audit which has not yet occurred, as discussed below). We expect amounts owed to us by the State for water and sewage services and reimbursements for pensions paid to increase in the future. We have not established any provisions for any amounts due to us by the State.

In September 1997, December 2001 and March 2004, we entered into agreements with the State to settle overdue amounts payable to us. Under the terms of these agreements, the amounts may be settled through the application of dividends payable by us to the State and by the transfer to us of certain reservoirs in the Alto Tietê System which we

use, but which are owned by the State. However, the agreements do not require the State to apply all dividends payable by us to them to the repayment of amounts owed to us. Since the State entered into these agreements it has applied the dividend received from us to the repayment of amounts it owes to us.

Under the December 2001 agreement, we converted a substantial amount of overdue accounts receivable due from the State and some State entities into long-term accounts receivable. According to the March 2004 agreement,

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which amended the December 2001 agreement, the State recognized a debt with us in the amount of R\$581.8 million regarding unpaid receivables up to February 29, 2004 and we recognized an amount owed to the State as dividends declared in the form of interest on shareholders' equity totaling R\$518.7 million.

We cannot assure you as to when or if the State will pay overdue amounts due to us by it and by some State-controlled entities. Furthermore, due to the State's history of not making timely payments to us in respect of services provided by us and of not reimbursing us in a timely manner for the State-mandated special retirement and pension payments, 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. If the State does not pay the amounts it owes us, our cash flows, results of operations and financial condition will be adversely affected.

We expect that a portion of long-term accounts payable by the State to us will be settled by the transfer to us of State-owned reservoirs in the Alto Tietê System, but we cannot assure you of the value to be given to these reservoirs or of the timing or legality of these transfers.

Under the terms of the December 2001 agreement referred to above, the State agreed to transfer the reservoirs in the Alto Tietê System to us in exchange for the cancellation of a portion of the accounts receivable due from the State and of reimbursements due from the State for State-mandated special pension payments we have made. Under the terms of the agreement, the value of these reservoirs should be determined by an appraisal process prior to their transfer and amounts owed to us from the State are subject to an audit by a State-appointed auditor.

In July and August 2002, a State-owned construction company, on behalf of the State, and an independent appraisal firm, on our behalf, presented their valuation reports relating to the reservoirs. The appraisals contained in these reports were in the amounts of R\$335.8 million and R\$341.2 million, respectively. Under the terms of the

December 2001 agreement, the arithmetic average of these appraisals will be deemed to be the fair value of the reservoirs. Because we had already made investments in these reservoirs by then, the arithmetic average of the appraisals submitted to our Board of Directors by August 2002, R\$300.9 million, was net of a percentage corresponding to these investments. However, a final determination as to the fair value of these reservoirs is still pending and we cannot assure you as to when the reimbursement of the pension payments will take place.

In addition, on October 29, 2003, the Public Attorney of the State (*Ministério Público do Estado de São Paulo*), on behalf of the people of the State, brought a civil public action in a Trial Court of the state of São Paulo (*12a Vara da Fazenda Pública do Estado de São Paulo*) alleging that a transfer to us of ownership of the Alto Tietê System reservoirs from the State Department of Water and Energy of the State would be illegal. In October 2004, the court ruled in favor of the Public Attorney of the State. In response, we filed an appeal, which is pending final decision and the State successfully filed an action suspending the lower court's decisions until final judgment is reached by the Court of Appeals of the state of São Paulo (*Tribunal de Justiça do Estado de São Paulo*). We are unable to predict whether we will succeed in appealing such decision and cannot assure you as to whether the transfer of these reservoirs will occur.

The State has agreed to reimburse us for pension benefits owed to us; however, if agreement is not reached with respect to the amounts of these reimbursements or if the State delays in making these payments, our cash flows, results of operations and financial condition could be adversely affected.

The December 2001 agreement also provided that the State's legal advisors would carry out specific analyses, which have commenced, to ensure agreement among the parties as to the methodology employed in determining the amount of reimbursement for pension benefits owed to us by the State. The commencement of reimbursement payments with respect to pension amounts owed to us by the State has been postponed until these analyses are completed, the

appraisal report is approved and the credit assignments relating to the transfer of the reservoirs in the Alto Tietê System are formalized. In addition, the transfer of these reservoirs is currently being disputed and we are not certain whether such transfer will be legally allowed, as discussed above. Under the December 2001 agreement, the original first payment was to be made in July 2002. Negotiations are still ongoing between the Company and the State with a view to restatement of the debt for supplemental retirement and pension benefits, under the terms defined in the December 2001 agreement, including amounts due after November 2001. These negotiations are expected to be consolidated in a second amendment to the December 2001 agreement. We have retained *Fundação*

Instituto de Pesquisas Contábeis, Atuárias e Financeiras (FIPECAFI) to validate the actual values to be reimbursed by the State, in accordance with the opinions provided by the Office of the State Attorney General. We cannot assure you as to when agreement among the parties will be reached or when the State will commence making payments in respect of these amounts. If an agreement among the parties is not reached or if the State delays or fails to make such payments, our cash flows, results of operations and financial condition could be adversely affected.

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 fees to the owner in the form of rent and additional operational and maintenance expenses with respect to our use of such 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 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 in the future we will continue to be able to use the reservoirs without paying a fee, 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 fees to the owner or additional maintenance or operational costs for these properties, our cash flows, results of operations and financial condition could be adversely affected.

Risks Relating to Our Business

The basic sanitation sector is not specifically regulated in Brazil and the approval of any proposed regulations for the water and sewage industry may negatively affect our operations.

There is not, at the present time, any specific regulation in connection with sanitation services in Brazil. Accordingly, the Brazilian Federal Congress has, from time to time, discussed proposals for regulation, which would establish directives for basic sanitation services.

Currently, several bills are under debate at the Brazilian Federal Congress and at the Brazilian Senate. Both Houses of Representatives have agreed upon the creation of a joint committee (*comissão mista*) that will be responsible for the organization and systemization of the proposed regulation for water and sewage services in Brazil. Any proposed regulation, when and if approved, could establish a new municipal regulatory authority for our industry that may, in part, preempt the existing State regulatory authorities under which we operate in the Metropolitan Region. In this respect, there are currently two legal proceedings being reviewed by the Brazilian Supreme Court (*Supremo Tribunal Federal*) challenging the constitutionality of two state laws that provide for the creation of metropolitan regions and seeking the declaration of the state as the regulatory authority for water and sewage services within such regions. Although the results of these proceedings may not directly impact the bills currently in debate at the House of Representatives, they will set relevant precedents in connection with the establishment of the regulatory authority for metropolitan regions. In addition, a new regulation could modify the way we charge for our water and sewage services businesses, as well as our capital expenditure program. Any of these changes could have an adverse effect on our revenue, by causing us to lose concessions we currently hold, or on our operating margins, by limiting our ability to pass our cost on to our customers.

As of the date of this annual report, no proposed federal regulation for the water and sewage industry has been voted on by the Brazilian Federal Congress. We cannot anticipate if, when or in which terms any proposed federal regulation will become effective. Any of the proposed new regulations, if approved by the Brazilian Federal Congress, could have a negative effect on our operations in the São Paulo Metropolitan Region, as well as in other areas that we serve.

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.

Governmental water agencies of the State and the Federal Government are authorized to collect fees from entities, including us, that either abstract water from, or dump sewage into, water resources controlled by these agencies.

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The fees collected by these agencies are to 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 administrative costs regarding the bodies and entities pertaining thereto and they may be loaned or provided as grants or subsidies to governmental agencies and corporations, including us, for use in the development and maintenance of water resources. The legislature of the State and the Federal Government enacted legislation under which we must pay fees to the Federal Government, the State or an agency in respect of the use of water from specified sources. Since February 2004 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 Basin. Given that the tariff readjustment formula currently approved by our Board of Directors 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 fees that may be assessed in connection with the abstraction of water or the dumping of sewage to other water resources that we use, or whether we will be able to continue to pass on the cost of all of these fees to our customers.

We have accounts receivable due from municipalities and we cannot assure you as to when or whether these municipalities will pay us.

As of December 31, 2005, we had accounts receivable totaling R\$727.9 million from municipalities to which we provide water on a wholesale basis. Of this amount, R\$78.9 million was 91 to 360 days overdue and R\$588.7 million was more than 360 days overdue. In some cases, the Brazilian courts have required that we continue to provide water on a wholesale basis to municipalities, even if they fail to pay our invoices. Additionally, as of December 31, 2005, we had accounts receivable in the amount of R\$377.4 million, owed to us by municipalities to which we render water and sewage services, including R\$300.6 million owed by the Municipality of the City of São Paulo.

Although we have entered into negotiations with municipalities to reschedule such accounts receivable and have also filed legal proceedings against municipalities to collect the overdue amounts, some municipalities are currently not paying our invoices in full or on a timely basis. In addition, some governmental entities located in municipalities we serve are also not paying us on a regular basis. We cannot assure you as to whether or when these municipalities will resume making regular payments or pay overdue amounts owing to us. If these municipalities and government agencies do not pay amounts they owe us, our cash flows, results of operations and financial condition will be adversely affected.

We do not hold formal concessions for the City of São Paulo and several other municipalities that we serve, and therefore we may not be able to enforce our rights to continue to provide services in these municipalities.

We do not hold formal concessions in the City of São Paulo, which on December 31, 2005 accounted for 56.8% of our sales and services rendered, or in 40 other municipalities in the state of São Paulo. Because we do not hold concessions or formal contract rights to provide services in these municipalities, we may not be able to effectively enforce our right to continue to provide services or to be 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 local governmental actions 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 contract with us to provide water and sewage services in the City of São Paulo. The City of São Paulo legislature approved Law 13,670 of November 25, 2003 through which it intended to establish the authority to regulate its public water supply and sewage services. Following the enactment of Law No. 13,670, the

Governor of the State filed a legal action alleging that the law is unconstitutional, as a result of which the enforcement of Law No. 13,670 has been suspended. On April 20, 2005, the court ruled in favour of the Governor of the State, by a majority of votes. The City of São Paulo appealed the decision and a trial judgement was still pending as of the date of this annual report. We cannot assure you when or if the suspension of Law 13,670 will end, and we cannot anticipate the effect of its renewed application which could result in the creation of different conditions as compared to those under which our services are currently provided in the City of São Paulo.

Municipalities for which we hold concessions may choose not to renew their concessions to us.

We provide water and sewage services in 325 municipalities pursuant to concessions granted by the municipalities. Substantially all of these concessions have 30-year terms. As of December 2005, 17 of our concessions had expired; 256 are due to expire between 2006 and 2010, of which 127 are scheduled to expire during 2006 and 30 in 2007. All other concessions will expire between 2011 and 2034.

Some of the expired concession agreements have been extended for a short term while we negotiate the terms and conditions of a final agreement with each relevant municipality. The new agreements may be executed under a new regime provided for by a newly enacted law which establishes principles to be observed when public consortiums contract with the municipalities, with the objective of allowing the provision of public services to be jointly managed. Despite the expiration of the agreements, we continue to provide water and sewage services to all 17 municipalities. If certain municipalities choose not to renew their concessions, it could adversely affect our results of operations and financial condition. Even if they choose to renew these concessions, we cannot assure you that we will obtain the same terms that we currently have.

Municipalities may terminate our concessions for any good public reason or if we fail to meet our contractual obligations.

Municipalities may terminate our concessions under some circumstances, including if we fail to comply with our obligations under the relevant concession contracts and applicable law. In addition to contractual termination provisions in concession contracts, municipalities have the inherent power under Brazilian law to terminate concessions prior to their contractual expiration dates for any good public reason. The meaning of good public reason has not been defined by Brazilian law or conclusively determined by Brazilian courts. In the event of the termination of a concession, we may receive inadequate compensation from the concessionaire municipality. We may also incur material litigation costs related to termination of concessions and compensation. The Constitution of the State establishes that the municipalities in which we operate as water and sewage service providers may, in the course of granting authority over these services, create their own autonomous entities to render such services in their territories instead of continuing to use our services, with the obligation to indemnify us for the termination of the concession with us over a term of up to 25 years rather than at the time the concession is terminated. The State obtained an injunction in a legal action alleging the 25-year term to be unconstitutional. As a result, the maximum term for payment of the indemnification has been suspended. In the event that this injunction is stayed and/or the outcome of the legal action is not favorable to us, the indemnification over a term of 25 years may adversely affect our operational results and financial condition. In 1997, the Municipality of Santos enacted a law expropriating our water and sewage systems in Santos. In response, we filed an action seeking an injunction against this expropriation which was denied by the lower court. This decision was later reversed by the Court of Appeals of the State, which ordered the action to be carried forward and issued a preliminary order suspending that law. On August 2, 2002, a decision on this matter was rendered in our favor by a lower court. The municipality and the house of representatives of Santos have filed an appeal, and we cannot assure you that the ultimate determination will be favorable to us. Despite the pending lawsuit, we continue to provide water and sewage services to Santos.

We cannot assure you that other municipalities will not seek to terminate their concessions. Exercise of concession termination rights by substantial numbers of municipalities could have a material adverse effect on our cash flows, results of operations and financial condition.

We may be required to compete through a public bidding process in order to obtain new or renew existing concessions.

Substantially all of our concessions were granted without a public bidding process. Under current Brazilian Federal and State law, however, for any new concession we may be required to participate in a bidding process. In addition, if a public entity from which we hold a concession granted prior to the enactment of the concession laws determines that in order to comply with such laws it must engage in a public bidding process, we could be required to compete in order to renew our existing concession. While we may be able to obtain concessions without participating in a bidding process, we cannot assure you that the Brazilian courts will continue to interpret the concessions laws to permit municipalities to grant concessions without a public bidding process or that we will be able to secure all new water and sewage concessions that we may wish to obtain.

In the event we are obligated to participate in public bidding processes in order to renew our existing concessions or to obtain new ones, our failure to outbid our competitors for our existing concessions may adversely impact our cash flows, results of operations and financial condition.

We may be unable to increase customer tariffs in line with increases in inflation and operating expenses, including taxes.

Our results of operations and financial condition are highly dependent upon our ability to set and collect adequate tariffs for our water and sewage services. Although we generally have broad power to establish tariffs, this power is, in practice, subject to political and legal constraints. From mid-1999 until mid-2001 we did not raise our tariffs, due to a State policy of not increasing tariffs for public services. In June 2001, we increased our average tariffs by approximately 13.1% which was broadly in line with the prevailing inflation rates in Brazil since mid-1999, and in August 2002 we raised our tariffs by approximately 8.2%. A new readjustment formula was approved by our Board of Directors and has been applied to the tariff adjustment since August 2003. Using this new formula, in August 2003 we raised our tariffs for water and sewage services by approximately 18.9%, and in August 2004 we raised our tariffs for water and sewage services by approximately 6.8%. The application of the formula in 2005 would result in a tariff increase of 11.12%. Because that increase was much higher than the accumulated inflation levels for the corresponding period, we decided to adjust the tariff by 9.0%, effective August 31, 2005. The remaining percentage (1.94%) was deferred to the 2006 tariff adjustment. Tariffs with respect to the residential social (which includes residences of low-income families that live in sub-standard conditions, residences of persons unemployed for up to 12 months and collective living residences) and *favela* (shantytown) categories, are not always increased at the same rate as other tariffs. For example, in August 2003, these tariffs were increased by only 9.0% and were not set using the new formula. However, in August 2004 and August 2005, the tariffs with respect to the residential social categories were increased by the same percentage as the other categories, 6.8% and 9.0% respectively. We will continue to rely upon tariff revenue to provide funds for our capital expenditure program in addition to our financing activities and to meet our debt service requirements. We are currently conducting studies with a view to implementation of a new tariff policy. Such studies have been delivered to our executive committee and board of directors and the recommendations resulting thereof are currently being detailed for implementation. However, we cannot assure you when and if a new tariff policy will be implemented or if such implementation will meet our expectations. Any failure to establish or maintain tariffs commensurate with these and our other needs could have an adverse effect on our cash flows, results of operations and financial condition.

Our capital expenditure program requires substantial liquidity and capital resource, and any failure to obtain new financing may have a material adverse effect on the operation and development of our business.

Our capital expenditure program calls for expenditures of approximately R\$4.8 billion in the period from 2006 through 2010, including approximately R\$960.0 million in 2006 and R\$960.0 million in 2007. We spent R\$678.2 million on our capital expenditure program in 2005.

We have funded in the past, and we plan to continue to fund, these expenditures out of funds generated by operations and domestic and foreign currency borrowings on acceptable terms. In this way, a significant portion of our financing needs has been funded by financing provided by lenders controlled by the Federal Government. For example, we are currently negotiating with the Brazilian Economic and Social Development Bank (*Banco Nacional de Desenvolvimento Econômico e Social*, or BNDES), and Caixa Econômica Federal (a bank owned by the Brazilian government) for additional loans to finance portions of our capital expenditure program. 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 finance our capital expenditure program.

We cannot assure you that we will be able to obtain sufficient funds to complete our capital expenditure program . Failure to obtain the requisite funds could delay or prevent completion of our capital expenditure program and other projects, which may have a material adverse effect on the operation and development of our business.

Brazilian regulations as well as contractual provisions may limit our ability to incur indebtedness in the future.

Because we are controlled by the State we are subject to special credit rules for the public sector published by the Brazilian monetary authorities. 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 such entities' net 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 principally of borrowing from international financial institutions or development agencies and issuing bonds in both the domestic and international capital markets and other publicly traded obligations. These limitations on obtaining credit could adversely affect the development of our business, our ability to meet our obligations or continue our capital expenditure program, and our cash flows, results of operations and financial condition.

Under our existing debt instruments, we are subject to covenants limiting our ability to incur additional indebtedness, whether denominated in *reais* or foreign currency. Under these covenants, we would have been able to borrow up to an additional R\$1,650.5 million as of December 31, 2005. If, however, these and other limitations prevent us from completing our capital expenditure program or executing our business plans generally, we may be unable to satisfy all of our liquidity and capital resources requirements, which could have a material adverse effect on our cash flows, results of operations and financial condition.

Droughts may result in a decrease in the volume of water billed and the revenue from water supplies, which may have a material adverse effect on our company.

We experience decreases in our water supply from time to time due to droughts. In the event of prolonged drought, the volume of water provided by us may be reduced, although the impact that droughts have may vary across our different water supply systems. Throughout 2003, rain levels were below average resulting in a weak replenishment of our reservoirs, particularly in the Cantareira System, the largest system in the São Paulo Metropolitan Region. The effects of this drought continued to impact our systems through 2004. In order to minimize the effects of this drought, in March 2004 we approved a water consumption reduction incentive program based on a bonus system, pursuant to which customers that achieved their consumption reduction goal would be entitled to a 20.0% discount on their water bill. This incentive program ended on September 15, 2004 and encompassed most of the customers in the São Paulo Metropolitan Region, resulting in a reduction of our revenue from water and sewage services provided to the São Paulo Metropolitan Region by R\$74.1 million. We cannot assure you that any drought in the future will not materially adversely affect our water supply and, accordingly, our cash flows, results of operations and financial condition.

Potential costs of environmental compliance as well as potential environmental liability may have a material adverse effect on our company.

Our facilities are subject to many Brazilian federal, state and local laws and regulations relating to the protection of health and the environment. We have made, and will continue to make, substantial expenditures to comply with these provisions. In addition, because environmental laws and their enforcement are becoming more stringent, our capital expenditures and expenses for environmental compliance may increase substantially in the future. The amount of investments that we make in any given year is subject to limitations imposed by the State. Expenditures required for compliance with environmental regulation may result in reductions in other strategic investments that we have planned, which could negatively affect our profitability. We could also be exposed to criminal and administrative penalties, in addition to indemnification obligations, for possible damage for non-compliance with environmental laws

and regulations. Currently, we are party to a number of environmental lawsuits and administrative proceedings, including civil public actions and criminal proceedings. Any material unforeseen environmental costs and liabilities may have a material adverse effect on our future financial performance.

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

We are a party to a number of legal proceedings involving significant monetary claims. These legal proceedings include, among others, 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 our business or financial condition. Based on advice we received from our lawyers, we have provisioned a total aggregate amount of R\$612.4 million as of December 31, 2005 to cover probable losses related to legal proceedings. This provision does not cover, however, all legal proceedings involving monetary claims filed against us. Any unfavorable judgment in relation to these proceedings may have an adverse effect on our cash flows, results of operations and financial condition.

Because we are not insured for all business-related and environmental-related contingencies, the occurrence of any such event may have a material adverse effect on our future financial performance.

We do not have insurance coverage for business interruption risk or for liabilities arising from contamination or other problems involving our water supply to customers. In addition, we do not have insurance coverage for liabilities relating to non-compliance with environmental laws and regulations relating to our sewage services. As a result, any major business interruption or environmental-related liability may have a material adverse effect on our future financial performance.

Risks Relating to Brazil

Brazilian economic, political and other conditions may have a material adverse effect on our business.

The Brazilian economy has been characterized by significant involvement on the part of the Brazilian government, which often changes monetary, credit and other policies to influence Brazil's economy. The Brazilian government's actions to control inflation and affect other policies have often involved wage and price controls, currency devaluations, increases in the Central Bank's base interest rates, capital controls and limits on imports, as well as other measures, such as the freezing of bank accounts.

Actions taken by the Brazilian government concerning the economy may have important effects on Brazilian corporations and other entities, including us, and on market conditions and prices of Brazilian securities, including our equity and debt securities. Our financial condition and results of operations may be adversely affected by the following factors or the Brazilian government's response to them:

- currency devaluation and other exchange rate movements;
- inflation;
- currency exchange control policies;
- social instability;
- price instability;
- energy shortages;
- interest rates;

- liquidity of domestic capital and lending markets;
- tax policy; and
- other political, diplomatic, social and economic developments in or affecting Brazil.

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The Brazilian Congress is currently conducting investigations, among other issues, in relation to allegations related to political campaign contributions which were not accounted for or disclosed, including contributions made to several important members of the present administration. Such allegations have resulted in the replacement of important government ministers and are occupying a significant portion of the agenda of the Brazilian Congress. These investigations could adversely affect public confidence, and any resulting reduction of economic activity in Brazil and could adversely affect our results of operations and the price of our shares and ADSs.

A presidential election will be held in Brazil in October 2006. The run-up to the presidential election may result in changes in existing policies, and the post-election administration may seek to implement new policies. In the years from 2001 to 2005 the Brazilian economy grew at an average annual rate of 2.2%, and the post-election administration may face domestic pressure to revise current economic policies to achieve higher growth rates. We cannot predict what policies will be adopted by the Brazilian government and whether these policies will negatively affect the economy or our business or financial condition or results of operations.

Devaluation of the real could adversely affect our ability to service our foreign currency-denominated debt, and could lead to a decline in the market price of our shares or ADSs.

The Brazilian currency has been devalued frequently during the last four decades. Throughout this period, the Brazilian government has implemented various economic plans and utilized various exchange rate policies, including sudden devaluations, periodic mini-devaluations (during which the frequency of adjustments has ranged from daily to monthly), exchange controls, multiple exchange rate markets and a floating exchange rate system. From time to time, there have been significant fluctuations in the exchange rates between the Brazilian currency and the U.S. dollar and other currencies. For example, in 2001 and 2002, the *real* devalued 15.7% and 34.3% respectively, while appreciating 22.3% in 2003, 8.8% in 2004 and 13.4% in 2005 against the U.S. dollar.

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 substantial foreign currency-denominated indebtedness, any significant devaluation of the *real* during a financial period 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\$1,576.0 million as of December 31, 2005, and we anticipate that we may incur substantial amounts of foreign currency-denominated indebtedness in the future. Our overall results of operations were positively affected by the 13.4% appreciation of the *real* against the U.S. dollar in 2005, which amounted to R\$312.1 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* would reduce the U.S. dollar value of distributions and dividends on our ADSs and could reduce the market price of our shares or ADSs.

The Brazilian government's actions to combat inflation and public speculation about possible future action may contribute significantly to economic uncertainty in Brazil.

Historically, Brazil has experienced high rates of inflation. Inflation itself as well as governmental efforts to combat inflation have had significant negative effects on the Brazilian economy in general. Inflation, action taken to combat inflation and public speculation about possible future action has also materially contributed to economic uncertainty in Brazil and to heightened volatility in the Brazilian securities markets.

Inflation, as measured by the General Price Index-Market, or the IGP-M (*Índice Geral de Preços de Mercado*), was 8.7% in 2003, 12.4% in 2004 and 1.2% in 2005. There can be no assurance that levels of inflation in Brazil will not increase in future years and have a material adverse effect on our cash flows, results of operations or financial condition. If Brazil experiences significant inflation in the future, 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 investor confidence in Brazil, so that the market price of our equity and