

COMPANHIA DE SANEAMENTO BASICO DO ESTADO DE SAO PAULO-SABESP

Form 20-F

July 16, 2007

**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, 2006**

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 ⁽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⁾ As of June 8, 2007, American Depositary Shares, evidenced by American Depositary Receipts, each representing 2 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.

28,479,577,827 Common Shares, without par value, as of December 31, 2006

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

Yes No

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

Yes No

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

Yes No

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

Item 17

Item 18

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

Yes No

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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\$2.1380 to US\$1.00, the commercial selling rate as of December 31, 2006 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.A. Selected Financial Data Exchange Rates* for information regarding exchange rates allocable to the Brazilian currency since January 1, 2002.

Our audited financial statements as of December 31, 2005 and 2006 and for the years ended December 31, 2004, 2005 and 2006 are included in this annual report. The financial statements as of and for the years ended December 31, 2004, 2005 and 2006 have been audited by Deloitte Touche Tohmatsu Auditores Independentes, São Paulo, Brazil. The selected financial data as of December 31, 2002 and 2003 and for the two years ended December 31, 2003 is derived from our financial statements audited by PricewaterhouseCoopers Auditores Independentes for the year ended December 31, 2002 and by Deloitte Touche Tohmatsu Auditores Independentes for the year ended December 31, 2003, both included in previously filed annual reports.

Our audited financial statements are presented in *reais* and are prepared in accordance with the Brazilian Corporate Law Method, which is based on Brazilian Corporate Law (Law No. 6,404/76, as amended), the rules and regulations issued by the Brazilian Securities Commission (*Comissão de Valores Mobiliários*), or CVM, 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 Brazilian 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 Brazilian Corporate Law Method with a reconciliation to generally accepted accounting principles 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 the Brazilian Corporate Law Method.

The Brazilian Corporate Law Method differs in significant respects from U.S. GAAP. Note 23 to our financial statements provides a description of the differences between the Brazilian Corporate Law Method and U.S. GAAP as they relate to our financial statements and a reconciliation from the Brazilian 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 Brazilian 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.

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 investments in improvement programs have not been audited.

Other Information

We do not have any subsidiaries.

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

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 phrases 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.

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In this annual report, we refer to the São Paulo Metropolitan Region, the area where the Metropolitan Executive Office operates, comprising 38 municipalities, including the City of São Paulo. We refer to the Regional Systems, the area where the Regional Systems Executive Office operates, comprising 329 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 367 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 State System Foundation Data Analysis (*Fundação Sistema Estadual de Análise de Dados - 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*).

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:

- 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, the State of São Paulo;
- our ability to collect amounts owed to us by our controlling shareholder and by municipalities;
- our ability to continue to use certain reservoirs within the present 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;
- 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 concessions for the City of São Paulo and other municipalities including the cities comprising the São Paulo Metropolitan Region;
- municipalities' power to terminate our existing concessions;
- our ability to provide water and sewage services in additional municipalities and to maintain current rights to provide such services;
- the size and growth of our customers' base;
- our ability to maintain universalization of Water Coverage in the municipalities to which we provide water services and to increase Sewage Coverage Ratio;
- our ability to gain access to attractive financing in the future;
- our level of indebtedness and limitations on our ability to incur additional indebtedness;

- 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 concerning our future financial performance;
- other risk factors as set forth under *Item 3.D. Risk Factors*.

The words believe, may, will, estimate, continue, anticipate, plan, intend, expect and similar words 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 guarantees 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 as of December 31, 2002 and 2003 and for the two years ended December 31, 2003 is derived from our financial statements audited by PricewaterhouseCoopers Auditores Independentes for the year ended December 31, 2002 and by Deloitte Touche Tohmatsu Auditores Independentes for the year ended December 31, 2003, included in previously filed annual reports. The selected financial data as of December 31, 2004, 2005 and 2006 and for the three years ended December 31, 2006 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, 2006 have been translated into U.S. dollars at the selling rate as of December 31, 2006 of R\$2.1380 per US\$1.00.

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,

2002 2003 2004 2005 2006

(in millions, except per share and per ADS data)

**Brazilian Corporate Law
Method**

	R\$	R\$	R\$	R\$	R\$	US\$
Statement of operations data:						
Net revenue from sales and services	3,767.1	4,130.8	4,397.1	4,953.4	5,527.3	2,585.3
Cost of sales and services	(1,815.0)	(2,067.1)	(2,253.4)	(2,376.4)	(2,616.8)	(1,224.0)
Gross profit	1,952.2	2,063.6	2,143.7	2,577.0	2,910.5	1,361.3
Selling expenses	(385.1)	(297.5)	(502.5)	(537.8)	(719.2)	(336.4)
Administrative expenses	(226.0)	(254.1)	(313.6)	(349.6)	(387.4)	(181.2)
Financial income (expenses), net	(2,276.3)	(346.5)	(503.7)	(447.0)	(563.3)	(263.5)
Income (loss) from operations ⁽¹⁾	(935.3)	1,165.5	823.9	1,242.6	1,240.6	580.2
Non-operating income (expenses)	(3.4)	(54.5)	(33.9)	(25.4)	(50.9)	(23.8)
Income (loss) before taxes on income	(938.7)	1,111.1	790.0	1,217.2	1,189.7	556.4
Income tax and social contribution tax	323.3	(242.6)	(241.9)	(316.5)	(375.7)	(175.7)
Extraordinary item, net of income and social contribution taxes ⁽²⁾	(35.1)	(35.1)	(35.1)	(35.1)	(35.1)	(16.4)
Net income (loss)	(650.5)	833.3	513.0	865.6	778.9	364.3
Net income (loss) per 1,000 common shares	(22.84)	29.26	18.01	30.40	27.35	12.80
Net income (loss) per ADS	(5.71)	7.32	4.50	7.60	6.84	3.20
Dividends and interest on shareholders' equity per 1,000 common shares	3.80	17.70	5.37	12.23	9.51	4.45
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
Balance sheet data:						
Cash and cash equivalents	414.7	281.0	105.6	280.2	328.2	153.5
Customer accounts receivables, net	820.5	1,056.2	1,227.9	1,332.5	1,407.9	658.5
Reimbursement for pension benefits paid	403.9	491.0	576.3	672.7	774.5	362.3
Short and long-term receivables from shareholders, net ⁽³⁾	423.7	164.2	245.6	420.4	456.9	213.7

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

	2002	2003	2004	2005	2006
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(in millions, except per share and per ADS data)

	R\$	R\$	R\$	R\$	R\$	US\$
Property, plant and equipment, net	13,395.1	13,376.6	13,523.5	13,613.6	13,837.5	6,472.2
Concession assets acquired, net	275.7	686.6	517.4	502.5	495.1	231.6
Total assets	16,348.7	16,590.1	16,783.8	17,431.1	18,000.0	8,419.1
Total short-term loans and financing	1,332.5	997.0	1,496.8	759.0	852.5	398.7
Total long-term loans and financing	6,545.2	6,267.3	5,553.8	5,905.2	5,474.3	2,560.5
Total liabilities	9,102.2	9,013.2	8,832.2	8,948.5	8,981.5	4,200.9
Shareholders equity	7,246.5	7,576.9	7,951.6	8,482.5	9,018.5	4,218.2
Other financial information:						
Cash provided by operating activities ⁽⁴⁾	1,764.8	1,655.3	1,441.1	1,737.6	2,020.8	945.2
Cash used in investing activities ⁽⁴⁾	(597.2)	(650.8)	(675.5)	(643.2)	(850.0)	(397.6)
Cash used in financing activities ⁽⁴⁾	(1,165.7)	(1,138.2)	(941.1)	(919.7)	(1,122.8)	(525.2)
Adjusted EBITDA ⁽⁵⁾	1,860.1	2,076.5	1,926.5	2,285.6	2,446.1	1,144.1
Capital expenditures ⁽⁴⁾	586.0	641.3	670.3	643.1	855.1	399.9
Depreciation and amortization	519.1	564.5	598.9	596.0	642.2	300.4

As of and for the year ended December 31,

	2002	2003	2004	2005	2006
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(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	3,767.1	4,130.8	4,397.1	4,953.4	5,527.3	2,585.3
Gross profit	1,820.1	1,853.3	1,953.1	2,383.2	2,704.8	1,265.1
Selling expenses	(393.6)	(323.4)	(521.5)	(555.4)	(737.3)	(344.9)
Administrative expenses	(328.8)	(276.3)	(324.1)	(350.2)	(428.7)	(200.5)
Income from operations ⁽⁶⁾	1,086.5	1,136.5	1,073.0	1,470.2	1,451.4	678.9
Financial income (expenses), net	(2,284.5)	(329.4)	(479.2)	(401.9)	(542.3)	(253.6)
Net income (loss)	(847.6)	642.6	417.5	791.2	622.5	291.2
Net income (loss) per common shares-						
basic and diluted	(3.72)	2.82	1.83	3.47	2.73	1.28
Net income (loss) per ADS-basic and						

diluted	(7.44)	5.64	3.67	6.95	5.46	2.56
Weighted average number of common shares outstanding	227,836,623	227,836,623	227,836,623	227,836,623	227,836,623	227,836,623

Balance sheet data:

Property, plant and equipment, net	15,390.3	15,268.9	15,347.2	15,393.9	15,473.5	7,237.4
Concession assets acquired, net	275.7	686.6	517.4	502.5	495.1	231.6
Total assets	17,625.6	17,630.4	17,704.5	18,209.8	18,498.7	8,652.3
Short-term loan financing	1,753.6	997.0	1,496.8	759.0	852.5	398.7
Long-term loan financing	6,124.0	6,267.3	5,553.8	5,905.2	5,459.9	2,553.7
Total liabilities	11,679.8	11,604.3	11,339.7	11,388.4	11,200.5	5,238.8
Shareholders equity	5,945.8	6,085.6	6,364.8	6,821.4	7,298.2	3,413.6

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

	2002	2003	2004	2005	2006
Operating data (at period end):					
Number of water connections (in thousands)	5,898	6,044	6,358	6,489	6,609
Number of sewage connections (in thousands)	4,304	4,462	4,747	4,878	5,002
Percentage of population with water connections (%)	100	100	100	100	99
Percentage of population with sewer connections (%)	77	78	78	78	78
Volume of water billed during period (in millions of cubic meters)	1,770	1,765	1,692	1,759	1,807
Water loss percentage during period (average)(%) ⁽⁷⁾	31.7	33.0	34.0	32.4	31.9
Water loss per connection (average) ⁽⁸⁾	546	563	547	520	511
Number of employees	18,505	18,546	17,735	17,448	16,978

- (1) Includes financial expenses, net.
- (2) 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 the Brazilian 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 financial statements.
- (4) Based upon the statements of cash flows for the years ended December 31, 2006, 2005 and 2004 included in note 25 to our financial statements and the statements of cash flows for the years ended December 31, 2003 and 2002 which are not included in this annual report.
- (5) The inclusion of Adjusted EBITDA information aims at presenting a measure for our economic operating performance. Our Adjusted EBITDA means net income before financial expenses, net, income tax and social contribution tax (federal taxes on income), depreciation and amortization, non-operating income (expenses) and extraordinary item, net of income tax and social contribution. Adjusted EBITDA is not a measure of financial performance recognized under the Brazilian Corporate Law Method, and should not be considered individually or as an alternative for net income, as a measure of operating performance, or alternative for operating cash flows, or as a measure of liquidity. Our definition of Adjusted EBITDA or EBITDA may not be comparable with the definition of Adjusted EBITDA or EBITDA used by other companies. In our operations, we relate our Adjusted EBITDA to our operating cash flows. We do not include in the calculation of Adjusted EBITDA expenses with interest, taxes, depreciation and amortization, therefore, our Adjusted EBITDA works as a general indicator of economic performance and it is not affected by debt restructurings, interest rate fluctuations, changes in tax burden or in

depreciation and amortization levels. Consequently, we believe that Adjusted EBITDA works as an adequate tool to regularly compare our operating performance. Additionally, Adjusted EBITDA is used in covenants related to some of our financial commitments. We believe that Adjusted EBITDA allows a better understanding not only of our financial performance but also of our capacity to satisfy our liabilities and to raise funds for our capital expenditures and working capital. Adjusted EBITDA, however, has limitations that prevent it from being used as a measure of our profitability because it does not take into consideration other costs resulting from our business or certain other costs, which could significantly affect our profits, such as financial expenses, taxes, depreciation, capital expenses and other related charges. Adjusted EBITDA calculation presented herein is in accordance with the rules issued by the Brazilian regulatory authorities, which set forth the Brazilian Corporate Law Method. The table below sets forth, for the periods indicated, the reconciliation between our net income with Adjusted EBITDA:

For the year ended December 31,

	2002	2003	2004	2005	2006	
	(in millions)					
	R\$	R\$	R\$	R\$	R\$	US\$
Brazilian Corporate Law Method						
Net income (loss)	(650.5)	833.3	513.0	865.6	778.9	364.3
Add:						
Financial expenses (income), net	2,276.3	346.5	503.7	447.0	563.3	263.5
Income and social contribution tax	(323.3)	242.6	241.9	316.5	375.7	175.7
Depreciation and amortization	519.1	564.5	598.9	596.0	642.2	300.4
Non-operating income (expenses), net	3.4	54.5	33.9	25.4	50.9	23.8
Extraordinary item, net of income and social contribution taxes	35.1	35.1	35.1	35.1	35.1	16.4
Adjusted EBITDA	1,860.1	2,076.5	1,926.5	2,285.6	2,446.1	1,144.1

- (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 less (ii) the total amount of water invoiced by us to customers minus (iii) the volume of water set out below that we exclude from our calculation of water losses, divided by (b) the total amount of water produced. 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, according to the new method of measuring our water losses, based on worldwide market practice for the sector. See *Item 4.B. Information on the Company Business Overview*.

Exchange Rates

Before March 14, 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*) 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. Since the beginning of 2001, the Brazilian exchange market has been increasingly volatile, and, until early 2003, the value of the *real* declined relative to the U.S. dollar. The *real* appreciated against the U.S. dollar in 2003, 2004, 2005 and 2006. As of December 31, 2006, the exchange rate for U.S. dollars was R\$2.138 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 let 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 (R\$/US\$), for the periods indicated.

	Year-end	Average for year⁽¹⁾	Low	High
	(reais per U.S. dollar)			
Year				
2002	3.5333	2.9309	2.2709	3.9552
2003	2.8892	3.0715	2.8219	3.6623
2004	2.6544	2.9257	2.6544	3.2051
2005	2.3407	2.4341	2.1633	2.7621
2006	2.1380	2.1771	2.0586	2.3711
2007 (through June 30, 2007)	1.9262	1.9319	1.9047	1.9638

	Period-end	Average for period⁽²⁾	Low	High
	(reais per U.S. dollar)			
Month				
November 2006	2.1668	2.1579	2.1353	2.1870
December 2006	2.1380	2.1499	2.1380	2.1693
January 2007	2.1247	2.1385	2.1247	2.1556
February 2007	2.1182	2.0963	2.0766	2.1182
March 2007	2.0504	2.882	2.0504	2.1388
April 2007	2.0339	2.0320	2.0231	2.0478
May 2007	1.9289	1.9816	1.9289	2.0309
June 2007	1.9262	1.9319	1.9047	1.9638

Source: Central Bank

- (1) Represents the average of the exchange rates of each trading date.
- (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 BOVESPA 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 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 contracts;
- 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 economical 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.

In October 2006, Brazil held presidential elections and President Luiz Inácio Lula da Silva was reelected. There can be no assurance that the Brazilian government will continue to follow the economic policies that were adopted under President Luiz Inácio Lula da Silva's first administration, or that any changes that may be implemented to these policies will not have an adverse effect upon us.

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 has in the past experienced extremely high rates of inflation. 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 official interest rate in Brazil, the SELIC, which is the interest rate of the Special Clearing and Settlement System (*Sistema Especial de Liquidação e Custódia*), at the end of 2002, 2003, 2004, 2005 and 2006 was 24.90%, 16.32%, 17.74%, 18.00% and 13.19%, respectively. On June 30, 2007, the official interest rate in Brazil was 12.00%.

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. However, 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 investor's confidence in Brazil, causing the 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 has 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, 18.7% in 2001 and 34.3% in 2002. Although the *real* appreciated 22.3%, 8.8%, 13.4% and 9.5% against the U.S. dollar in 2003, 2004, 2005 and 2006, respectively, no assurance can be given that the *real* will not depreciate against the U.S. dollar again. On June 30, 2007, the exchange rate was R\$1.9262 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* 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\$1,472.8 million as of December 31, 2006, 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 9.5% appreciation of the *real* against the U.S. dollar in 2006, which amounted to R\$96,1 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* may adversely affect us and the market price of our shares or ADSs.

Developments and the perception of risk in other countries, especially emerging market countries, may adversely affect our financing and the market price of our shares or ADSs.

The market value of securities of Brazilian issuers is affected to varying degrees by economic and market conditions in other countries, including other Latin American and emerging market countries. Although economic conditions in those 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. Crises in other emerging countries may diminish investors' interest in securities of Brazilian issuers, including our securities. This could adversely affect the market price of our shares or ADSs and could also make it more difficult for us to gain access to the capital markets and finance our operations in the future on acceptable terms, or at all.

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 authorize tariff adjustments, to control the election of a majority of the members of our board of directors and to appoint our senior management. As of December 31, 2006, the State owned 50.3% of our outstanding common shares.

The State has from time to time in the past, and may in the future, through its control of our board of directors, set our tariffs and direct 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 the former Energy, Water Resources and Sanitation Secretariat of the State (*Secretaria Estadual de Energia, Recursos Hídricos e Saneamento*), currently denominated Sanitation and Energy Secretariat of the State of São Paulo (*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 (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, 2006, the amounts owed to us by the State for the provision of water and sewage services totaled R\$456.9 million and, with respect to payment of pensions on behalf of the State, the State owed us R\$774.5 million. Amounts owed to us by the State for water and sewage services and reimbursements for pensions paid may increase in the future.

We have entered into agreements with the State to settle these overdue amounts payable to us. For a detailed discussion of these agreements, see *Item 7.B. Major Shareholders and Related Party Transactions Related Party Transactions*. Pursuant to these agreements, the amounts due with respect to water and sewage services may be settled through the application of dividends payable to the State by us to the repayment of amounts owed to us. Since the State entered into these agreements in 1997, we have applied the dividends payable to the State to the repayment of amounts owed to us. However, the agreements do not require application of all dividends payable to the State to the repayment of amounts owed to us. Furthermore, there can be no assurance as to whether and to what extent we will continue to record sufficient profits to pay dividends.

Pursuant to the agreements, part of the amounts due to us with respect to payments of pensions on behalf of the State may be settled through the transfer to us of certain reservoirs in the Alto Tietê system that we use and are owned by the State. We are unable to predict whether and when these reservoirs will be transferred to us because a final judicial determination as to the fair value of these reservoirs is still pending and the Public Prosecution Office of the State of São Paulo (*Ministério Público do Estado de São Paulo*) brought 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*.

We cannot assure you as to when or if the State will pay 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. In addition, we have not established any provisions for any amounts due to us by the State, as we do not expect to incur any significant losses relating to these amounts. If the State does not pay the amount it owes to us, we will 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 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. Our right to use these reservoirs is provided for through a grant issued by the State Department of Water and Energy (*Departamento de Águas e Energia Elétrica do Estado de São Paulo 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 properties, we could be adversely affected.

Risks Relating to Our Business

We cannot anticipate the effects that the new legislation enacted in January 2007 will have on the basic sanitation sector in Brazil.

On January 8, 2007, Law No. 11,445 was enacted to regulate the basic sanitation industry in Brazil. This law is in its initial stage of implementation and we cannot anticipate the effects that it will have on our operations and business. There are several uncertainties related to the new legislation, mainly with respect to the imposition of the regulatory authority for the basic sanitation industry and the tariff adjustment formula and structure that will be used for new contracts that we will enter into under the new law, which could have a material adverse effect on us. See *Item 4.B. Business Overview The Basic Sanitation Law*.

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

We engage in the provision of water and sewage services, which are essential public services. In addition to being subject to the discretionary power of the State and the Federal Government and several governmental regulations, our industry is specifically affected by the following risks:

- 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* ;
- 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 as to when or whether these municipalities will pay us;
- we may be unable to increase our tariffs in line with increases in inflation and operating expenses, including taxes, or to increase them in a timely manner, due to political and legal constraints that may hinder us from passing on to our customers increases in our cost structure. Also, we are highly dependent upon our ability to timely set and collect adequate tariffs for our water and sewage services to fund our capital expenditure program and financing activities and to meet our debt service requirements. For a detailed discussion of the effect of tariff increases, see *Item 5.A. Operating and Financial Review and Prospects Factors Affecting Our Results of Operations Effects of Tariff Increases* ;

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- we are exposed to 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 from water supply; and
- we are dependent upon energy to conduct our operations and shortages or rationing of energy may prevent us from providing water and sewage services and may also cause material damages to our water and sewage systems when we resume operations. Also, we may not be able to pass on to customers significant increases in energy tariffs.

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

We do not hold formal concessions to provide water and sewage services to 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.

Our operations are concentrated in the City of São Paulo with which we have not entered into a concession contract. As of December 31, 2006, the City of São Paulo accounted for 56.8% of our sales and services rendered. In addition, we do not hold formal concessions in 40 other municipalities in the State of São Paulo, particularly in the municipality of Santos, in the coastal region, where we operate under a deed of authorization (*escritura pública de autorização*) and that has a significant population of approximately 426,000 as of December 31, 2006.

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, 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 contract 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*.

The new basic sanitation legislation, Law No. 11,445, enacted in January 2007, provides December 31, 2010 as the deadline for water and sewage services companies, such as us, to regularize the provision of water and sewage services to municipalities, in case there is no formal concessions to provide services to municipalities. We cannot anticipate the terms and conditions of these contracts and their effects on the provision of our services in these municipalities, particularly with respect to the City of São Paulo.

Furthermore, we cannot assure you when and if there will be changes to the conditions under which we currently provide water and sewage services to these municipalities without holding formal concessions and we cannot anticipate their effects on the provision of our services in the City of São Paulo and in these other municipalities.

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We may face difficulties to continue 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.

We provide water and sewage services to 367 municipalities in the State of São Paulo, of which 324 we operate pursuant to concessions granted by the municipalities. Substantially all of these concessions have 30-year terms. Until December 31, 2006, 120 of our concessions had expired, all of which are under negotiation. In 2007, 53 concessions will expire. From 2008 through 2034, 150 concessions will expire. The remainder of the concessions is for an undetermined period of time. As of December 31, 2006, the book value of our assets in the municipalities where the concessions are under negotiation or will expire in 2007 totaled R\$1.9 billion. For the year ended December 31, 2006, the net revenue from sales and services was R\$796.0 million with respect to these concessions.

In case certain municipalities continue to require our provision of water and sewage services, we cannot assure you that we will obtain in the new contracts the same terms under which we currently provide services to them because the new basic sanitation law prevents us from planning, regulating and monitoring our services and it requires a more stringent control by the municipalities or by the regulatory entity to be created for the Brazilian basic sanitation industry. In case certain municipalities no longer require our provision of water and sewage services, we may adversely affected. See *Item 4.B. Business Overview Our Operations* and *Item 4.B. Business Overview Government Regulation Public Consortia Law*.

We may also face difficulties in continuing to provide water and sewage services to certain municipalities by means of new contracts because of an increase in competition and in case we are outbid from a public bidding process.

Municipalities may terminate our concessions before their expiration and the compensation may be inadequate to recover the full value of our investments.

The concessions we hold are subject to early termination by the municipalities under certain circumstances. Municipalities may terminate our concessions if we fail to comply with our obligations under the relevant concession contract and applicable law, or if the municipality determines, based on authorization by municipal law, through an expropriation proceeding, that terminating our concession prior to the contractual expiration date is in the public interest. If any municipality terminates our concession, we are entitled to be indemnified for the unamortized portion of our investments, but the compensation 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, we may receive the compensation over a term of 25 years. The early termination by municipalities of any of our concession contracts, or our inability to receive adequate compensation for the investments we made, or if compensation is paid over a term of 25 years, would have a material adverse effect on us.

In 1997, the municipality of Santos enacted a law expropriating our water and sewage systems in Santos. In 1995, the municipality of Diadema terminated the concession agreement that had been entered into with us prior to the expiration of the agreement. There are pending legal proceedings discussing both the expropriation carried out by the municipality of Santos and early termination by the municipality of Diadema. We continue to provide water and sewage services to Santos and sell water on a wholesale basis to Diadema. For further information on these lawsuits, see *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 concessions before the contractual expiration date. Exercise of concession termination rights by substantial numbers of municipalities could have a material adverse effect on us.

Law No. 11,445, the new basic sanitation law, provides that the parties to new contracts have to establish the amount of the compensation in the agreement for the unamortized portion of the investment in case of termination of the

agreement prior to the contractual expiration date. In the event there is no agreement between the parties for the unamortized portion of the investment to be repaid to the service provider in case of termination of the agreement prior to the contractual expiration date, the new law determines a default provision, i.e., the valuation of the investment by an independent expert based on the economic value or revaluation of the book value of the investment. This default provision of Law No. 11,445 may also be applicable to current concessions but in the absence of mutual agreements, the calculation of the indemnity is based on the terms and conditions of the previous agreement. In addition, we cannot anticipate the effects of this law on the amount of, and enforceability of the right to, compensation and how Brazilian courts will enforce the provisions of Law No. 11,445.

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

Our capital expenditure program requires substantial liquidity and capital resources of approximately R\$5.87 billion in the period from 2007 through 2010, of which we expect to spend R\$960.0 million in 2007.

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. 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 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 and 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 entities' 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 principally of borrowing from international financial institutions or development agencies and issuing debt securities in both the domestic and international capital markets. These legal limitations could adversely affect our ability to continue our capital expenditure program.

We are also subject to financial covenants limiting our ability to incur additional indebtedness, whether denominated in *reais* or foreign currency. Under these covenants, we would have been able to borrow up to an additional R\$2,291.6 million as of December 31, 2006. These contractual limitations may prevent us from completing our capital expenditure program, which could have a material adverse effect on us.

Potential costs of environmental compliance and potential environmental liability could have a material adverse effect on us.

Our facilities are subject to extensive Brazilian federal, state and local laws and regulations 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, especially fines, and have not provisioned any amounts. 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.

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, 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 lawyers, we have provisioned a total aggregate amount of R\$657.6 million as of December 31, 2006 to cover probable losses related to legal proceedings. However, 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 an adverse effect on us. For more information, see *Item 8.A. Consolidated Statements and other Financial Information Legal Proceedings*.

Because we are not insured for all business-related and environmental-related contingencies, the occurrence of any of these events may have a material adverse effect on us.

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 us.

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 the United States, and these investments are generally 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 in the United States. Accordingly, although you are entitled to withdraw the common shares underlying the ADSs from the depository 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 in the United States. The ten largest companies in terms of market capitalization represented approximately 50.4% of the aggregate market capitalization of the BOVESPA as of December 31, 2006. The top ten stocks in terms of trading volume accounted for approximately 45%, 51% and 46.4% of all shares traded on the BOVESPA in 2004, 2005 and 2006, respectively.

Restrictions on the movement of capital out of Brazil may impair the ability of holders to receive dividends and distributions on, and the proceeds of any sale of, the common shares underlying our ADSs.

The Brazilian government may impose temporary restrictions on the conversion of Brazilian currency into foreign currencies and on the remittance to foreign investors of the proceeds of their investments in Brazil. Brazilian law permits the government to impose these restrictions whenever there is a serious imbalance in Brazil's balance of payments or there are reasons to foresee a serious imbalance.

The Brazilian government imposed remittance restrictions in 1990. Similar restrictions, if imposed, would impair or prevent the conversion of dividends, distributions, or the proceeds from any sale of common shares, as the case may be, from *reais* into U.S. dollars and the remittance of the U.S. dollars abroad. We cannot assure you that the Brazilian government will not take similar measures in the future. In such a case, the depository for our ADSs will hold the *reais* it cannot convert for the account of the ADR holders who have not been paid. The depository will not invest the *reais* and it will not be liable for the interest.

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 for five business days from the date of exchange on the custodian's certificate of registration. 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, of January 26, 2000, of the Brazilian National Monetary Council, 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.

The protections afforded to minority shareholders in Brazil are different from those in the United States and other jurisdictions and may be more difficult to enforce.

Under Brazilian law, the protections afforded to minority shareholders are different from those in the United States and other jurisdictions. In particular, the case law with respect to shareholder disputes is less developed under Brazilian law than under US law and the laws of other jurisdictions and there are different procedural requirements for bringing shareholder lawsuits, such as shareholder derivative suits. As a result, in practice it may be more difficult for our minority shareholders to enforce their rights against us or our directors or controlling shareholder than it would be for shareholders of a non-Brazilian company.

Actual or anticipated sales of a substantial number of our common shares could decrease the market prices of our common shares and ADSs.

Sales of a substantial number of our common shares or the anticipation of such sales could decrease the trading price of our common shares and ADSs. As of December 31, 2006, we had 28,479,577,827 common shares outstanding, including 14,313,511,867 shares held by the State. As a consequence of the issuance of common shares or sales by the State or other existing shareholders, the market price of our common shares and, by extension, our ADSs may decrease significantly. As a result, a holder may not be able to sell his or her securities at or above the price he or she paid for them.

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 São Paulo Stock Exchange Arbitration Rules in the São Paulo Stock Exchange 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. The State is currently not permitted by law to sell its control shares. 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 is effective with respect to those rights or an exemption from the registration requirements of the Securities Act is available. We are not obligated to file a registration statement with respect to our common shares relating to these rights, and we cannot assure you that we will file any such registration statement. Unless we file a registration statement or an exemption from registration is available, an ADR holder may receive only the net proceeds from the sale of his or her preemptive rights and tag-along rights or, if these rights cannot be sold, they will lapse and the ADR holder will receive no value for them.

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

Holders may exercise voting rights with respect to the common shares represented by our ADSs only in accordance with the deposit agreement relating to our ADSs. There are no provisions under Brazilian law or under our 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

Companhia de Saneamento Básico do Estado de São Paulo-SABESP is a *sociedade de economia mista*, a mixed capital company with limited liability of unlimited duration, duly organized and operating under Brazilian Corporate Law on September 6, 1973. 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 111 Eighth Avenue, New York, New York 10011. As set forth in Article 2 of our by-laws, our corporate purpose is to plan, provide and operate basic sanitation services throughout the territory of the State of São Paulo, and sell these services and the related benefits that directly or indirectly arise in connection with these services. Since March 2006, we are also authorized to provide these services in all Brazilian territory and abroad.

We believe we are one of the largest water and sewage service providers in the world based on customers in 2005. 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 net revenue from sales and services of R\$5,527.3 million (US\$2,585.3 million) and net income of R\$778.9 million (US\$364.3 million) for 2006. We had total assets of R\$18,000.0 million (US\$8,419.1 million) and shareholders' equity of R\$9,018.5 million (US\$4,218.2 million) as of December 31, 2006.

We provide water and sewage services to a broad range of residential, commercial, industrial and governmental customers in 367 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, 2006, the São Paulo Metropolitan Region (including the municipalities to which we provide water on a wholesale basis) and the Regional Systems accounted for 75.8% and 24.2% of our gross revenue from sales and services, respectively.

As of December 31, 2006, we provided water services to approximately 22.7 million people, approximately 59% of the urban population of the State of São Paulo, with a universalization of Water Coverage through 61,469 kilometers of water pipes and mains to approximately 6.6 million water connections. As of December 31, 2006, we provided sewage services to approximately 18.5 million people through 39,126 kilometers of sewer lines to approximately 5.0 million sewage connections. In addition, we currently sell water on a wholesale basis to six municipalities with a total estimated population of approximately 3.2 million.

The State, our controlling shareholder, is required by our by-laws and State law to own at least one-half plus one of our common (voting) shares. The State currently owns 50.3% of our outstanding common shares. As a mixed capital company, we are an integral part of the governmental structure of the State. Our strategy and major policy decisions are formulated in conjunction with the Sanitation and Energy Secretariat of the State of São Paulo (*Secretaria de Saneamento e Energia do Estado de São Paulo*) 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 and reporting directly to the Governor.

In addition, our capital expenditure budget is subject to approval by the legislature of the State and is approved in conjunction with the budget of the Sanitation and Energy Secretariat of the State of São Paulo (*Secretaria de Saneamento e Energia do Estado de São Paulo*) 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:

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Well-established business with significant size and scale. We believe we are one of the largest water and sewage service providers in the world based on population served in 2005. We provide water services directly and through other public companies to approximately 25.9 million people (including the municipalities to which we provide water services on a wholesale basis), having a universalization of Water Coverage as of December 31, 2006, and sewage services to approximately 18.5 million people, having a Sewage Coverage Ratio of 78% as of December 31, 2006. From 2003 to 2006, our net revenue from sales and services has increased by an average of 10.2% per year.

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 40.8 million as of December 31, 2006. The City of São Paulo had an estimated population of 10.8 million as of December 31, 2006, with 19.5 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\$546.6 billion in 2004, representing approximately 31% of Brazil's total GDP. The State of São Paulo generates more revenues 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. All of our water quality laboratories in the São Paulo Metropolitan Region and all of our ten laboratories in the Regional Systems have received ISO 9001/2000 certification and three in the Regional Systems have received ISO 17025 certification with respect to the quality of our management systems to respond to clients' needs and the technical ability of our laboratories to produce results. We believe our technology enhances the efficiency and quality of our operations.

Access to low-cost and diverse sources of financing. Strong cash flow generation from our operations and compliance with financial covenants place us in a privileged position in our industry to obtain low cost, long-term financing from Brazilian public banks and international multilateral agencies and development banks. In addition, we are not dependent upon one or few sources of financing. We benefit from various alternatives of funding 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*, the highest corporate governance listing segment of the São Paulo Stock Exchange (*Bolsa de Valores de São Paulo - BOVESPA*). We are committed to maintaining certain corporate governance practices and disclosure requirements in addition to those already required under Brazilian law. These corporate governance practices have require us to increase shareholders' rights and to enhance the quality of information provided to our shareholders.

Expansion opportunities. We had a Sewage Coverage Ratio of 78% as of December 31, 2006, and plan to increase this level to 84% by 2010 by adding over 791,700 sewage connections. Since January 1, 1997, we have obtained concessions for 32 additional municipalities (representing a total population of 2.2 million). In addition, there are municipalities in the State of São Paulo in which we currently do not operate water or sewage concessions or to which we currently supply water solely on a wholesale basis, which represent a total population of approximately 15.7 million. Our strong presence in the State and experience in providing water and sewage services place us in a privileged position to expand our Sewage Coverage Ratio in municipalities where we only provide water services and to expand our water and sewage services to municipalities where we are not yet operating, not only in the State of São Paulo but also in other states of Brazil and abroad.

Our Strategy

Our mission is to make public sanitation services universally available in the State of São Paulo and to provide quality services in both the national and international markets. To this end, our strategic objectives are based upon the guiding principles of growth, quality, universalization of water services, social, economic and environmental sustainability, as

well as our political and institutional relationships. We seek to implement these guiding principles through the following strategies:

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Continue to reduce operating costs and increase productivity and profitability. We intend to continue our efforts to reduce operating costs and increase productivity and profitability. To this end, we plan to improve the management of our assets, as well as continue reducing 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 are also continuing our efforts to improve our collection of overdue accounts receivable from municipalities to which we provide water on a wholesale basis, from the State and from other governmental entities. We are actively pursuing the overdue amounts and in some cases exploring opportunities to swap these amounts for rights and infrastructure to operate water and sewage systems.

Ensure the quality and availability of our services in our existing service area. Our goal is to maintain universal coverage of water services with a high standard of quality and availability. We intend to continue providing universal water services and meet population growth by adding 652,100 water connections by 2010 and to increase our Sewage Coverage Ratio to 84% by 2010. 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 customers base.

Maintain our operating geographic base. We intend to maintain our operating base through the execution of new agreements. To this end, we are also seeking to develop closer relationships with the municipal governments that we serve to increase customer loyalty and thereby increase our revenues.

Continue to expand our existing service areas and provide our services in other municipalities. Our goal is to expand sewage collection and treatment services. A significant portion of our capital expenditure program, which will require total expenditures of approximately R\$5.87 billion between 2007 and 2010, 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 solely on a wholesale basis, representing a total population of approximately 15.7 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.

Set our tariffs to cover our costs of operations and to provide a return on investment. Until the definition of the entity responsible for establishing tariffs regulations, we intend to continue adjusting our tariffs for water and sewage services according to the formula we currently use, which covers our operating costs and other expenses, accounts for inflation, and provides for return on investment. We generally adjust our tariffs once a year, usually in the month of August, for a period of at least 12 months. We increased our tariffs by 9.0% on August 31, 2005 and by 6.71% on August 31, 2006. To ensure proper adjustment of our tariffs and higher return on investment, we intend to restructure our tariffs with values based on costs of services for all segments or clients, except for the low-income population, which should be subsidized.

Continue to diversify sources of financing and reduce levels of indebtedness. Our total financial indebtedness decreased by 5%, from R\$6,664.2 million in 2005 to R\$6,326.7 million in 2006. In 2006, we raised funds in the Brazilian capital market through a new funding instrument called *Fundo de Investimentos em Direitos Creditórios*, or FIDC. This instrument involves the securitization of receivables, and enabled R\$250.0 million to be raised at a significantly reduced cost. As a debt management strategy, we used part of these funds for the early redemption of higher cost indebtedness in the Brazilian money market. Based on our pre-refinancing strategy, we carried out a tender offer to promote the partial redemption of our 12% notes due 2008, in the amount of US\$225.0 million, with funds raised through a new issuance of 7.5% notes due 2016, in the amount of US\$140.0 million.

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Improve operating efficiency and reduce water losses. We seek to reduce both physical water losses and non-physical water losses. We are continuing our efforts to reduce physical water losses through, among other things, the replacement and repairing of water mains and pipes and installation of probing and other equipment. We are continuing our program of strategically locating pressure-regulating valves throughout our water system, which regulate water pressure at a variable rate corresponding to consumption in the relevant sector. We are also striving to reduce physical water losses by continuing to shorten the average time to detect and repair leaks in our systems. We intend to reduce non-physical water losses by upgrading and replacing inaccurate water meters and through increased outsourcing of meter reading activities to third-party contractors outside the São Paulo Metropolitan Region. In particular, we are replacing the water meters for our industrial and commercial customers, as well as increasing the rate at which we read the meters for these customers in each case to minimize losses.

We believe that our overall strategy will enable us to meet the demand for high-quality water and sewage services in the State of São Paulo, in other Brazilian states and abroad and, at the same time, bolster our results of operations and our financial condition and enhance 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 lies between the States of Rio de Janeiro and Minas Gerais to the north, the State of Paraná to the south, Mato Grosso do Sul to the west and the Atlantic Ocean to the east.

The State of São Paulo occupies 3.0% of Brazil's land mass and encompasses an area totaling approximately 96,000 square miles. According to the State of São Paulo Data System (*Fundação Sistema Estadual de Análises de Dados - SEADE*), the State of São Paulo had an estimated population as of December 31, 2006 of 40.8 million.

As of December 31, 2006, the City of São Paulo, the State of São Paulo's capital, had an estimated population of 10.8 million, with 19.5 million inhabitants in the greater São Paulo Metropolitan Region. The São Paulo Metropolitan Region encompasses 39 cities and is the second largest metropolitan area in the Americas and among the four largest metropolitan areas in the world, according to the United Nations' World Urbanization Prospects, 2000 Revision. The São Paulo Metropolitan Region accounted for approximately 48% of the population of the State of São Paulo as of December 31, 2006.

According to IBGE, in 2004, the most recent year for which this data is available, the GDP of the State of São Paulo was approximately R\$ 546.6 billion, representing approximately 31% of Brazil's total GDP, making it the largest economy of any state in Brazil, based on 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 production, steel making and plastics, among others, as well as the 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 19th 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 provision 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 provision 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 government of the State. 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.

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In 1954, in response to dramatic population growth in the São Paulo Metropolitan Region, the government of the State 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 *Companhia Metropolitana de Água de São Paulo*, or COMASP, which purpose was to provide potable water on a wholesale basis for public consumption in the municipalities making up 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 *Superintendência de Água e Esgoto da Capital*, or SAEC, was created by the government of the State 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 these activities were transferred to SAEC. Also in 1970, the State created the *Companhia Metropolitana de Saneamento de São Paulo*, or 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 those activities were transferred to SANESP. The Department of Water and Sewers was subsequently closed.

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

During 2004, 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 the board of directors, in accordance with the by-laws and following receipt of an initial proposal from the Chief Executive Officer. 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, performing the coordination, evaluation and control of all functions related to senior management, strategic planning, corporate organization, corporate communication, audit, ombudsman, new businesses and concession negotiation. The executive officers that are below the Chief Executive Officer are:

- 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 debt transactions and managing debt levels, accounting, corporate governance and investor relations. This division also monitors and acts as controller for our other divisions.
- the Planning and Technology Officer, who is responsible for the integrated technical planning, environmental planning and management, technological development, management and control of water quality, strategic maintenance, integrated project management and coordination and execution of special projects.

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- the Chief Operating Officer of the São Paulo Metropolitan Region Division, who is responsible for managing the distribution of water and collection of sewage for the São Paulo Metropolitan Region. The main function of the Chief Operating Officer of the São Paulo Metropolitan Region Division is planning, operating and maintaining the water and sewage systems and customer relation services in the metropolitan regions, the provision of wholesale water supply and sewage treatment, and the control of the financial and operational performance of its business units. The Chief Operating Officer of the São Paulo Metropolitan Region Division is also responsible for providing technical support to the autonomous municipalities, and intermediating and directly negotiating with local communities and municipalities in order to accommodate both the interests of the communities and our commercial interests.
- the Chief Operating Officer of the Regional Systems Division, who is responsible for managing the production of water and operation and maintenance of water and sewage systems in municipalities in the Regional Systems. The Chief Operating Officer of the Regional Systems Division is also responsible for performing the same tasks as the Chief Operating Officer of the São Paulo Metropolitan Region for the Regional Systems Division.

Recovery Program

We experienced significant operational and financial problems beginning in the mid-1980 s, which culminated in 1994. These problems were due, in part, to adverse economic conditions in Brazil prior to implementation of the *Real* Plan in mid-1994, but also to our position as a State-controlled company which financial performance was then only a secondary consideration of the State.

We also had significant and increasing levels of unpaid account receivables from our customers, including the State and municipal governments.

In 1995, we, in conjunction with the administration of the State, initiated a recovery program designed to restore our business operations and financial condition, including the organizational restructuring, the implementation of the initial stages of our strategy and the development of a new for-profit orientation.

We believe that our continuing recovery program and the continuing implementation of our overall strategy have, to date, permitted a recovery in terms of our business operations and financial performance, which we expect to provide the basis for our long-term operational and financial development.

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: (1) to continue to meet the maximum demand for treated water; (2) to expand the percentage of households connected to our sewage system; (3) to increase the treatment of sewage collected; and (4) to increase operating efficiency and reduce water losses.

From 1998 through 2006, our capital expenditure program included capital expenditures totaling R\$6.4 billion in the aggregate, primarily to build up our infrastructure and for our program to reduce water losses. We have budgeted investments in the amount of approximately R\$5.87 billion from 2007 through 2010. We invested R\$678.2 million and R\$904.9 million in 2005 and 2006, respectively.

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

	Planned Capital Expenditures				
	2007	2008	2009	2010	2007-2010
	<i>(in millions of reais)</i>				
Water	336	563	622	755	2,276
Sewage	487	907	824	814	3,032
Others	137	104	145	176	562
Total	960	1,574	1,591	1,745	5,870

Our capital expenditure program from 2007 through 2010 will continue to focus on achieving our targets by making regular investments in and expanding our infrastructure as well as making investments in our program for the reduction of water losses throughout the 367 municipalities that we serve. The following is a description of four of the principal projects in our capital expenditure 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 capacities of our water systems there. As a result, prior to September 1998, certain of our customers in this region received water only on certain days of the week. We refer to this as rotation. In order to remedy this situation, we implemented the Metropolitan Water Project to improve regular water supply to the entire São Paulo Metropolitan Region. This program was terminated in 2000, but we have maintained our investment projections for the São Paulo Metropolitan Region. In 2005 and 2006, we invested R\$75.0 million and R\$53.0 million, respectively, in this region.

Tietê Project

The Tietê River crosses the São Paulo Metropolitan Region and receives most of the region's run-off and wastewater. The environmental status of the river reached a critical level in 1992. As a way of reversing the situation, the State of São Paulo created a recovery program to save the river. The Tietê Project is 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 construction of three additional sewage treatment facilities and invested a total of US\$900.0 million, of which US\$450.0 million was financed by the Inter-American Development Bank and US\$450.0 million was funded by us. As of December 31, 2006, we owed US\$265.4 million to the Inter-American Development Bank for the financing it provided. For further information on the agreement entered into with the Inter-American Development Bank, see *Item 5.B. Operating and Financial Review and Prospects Liquidity and Capital Resources Capital Sources*. We now provide secondary treatment to approximately 58% 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 12 cubic meters of sewage per second. Currently, raw sewage is delivered to our secondary treatment facilities along the Tietê River and the Tamanduateí River before treated sewage is discharged into those rivers. We plan to build additional collection lines to direct more raw sewage to our treatment facilities.

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We are currently in the second phase of the Tietê Project, for which we budgeted for additional capital expenditures of approximately US\$400.0 million from 2000 through 2007, US\$200.0 million of which is financed by the Inter-American Development Bank. We have also entered into a loan agreement and an on-lending agreement with the Brazilian National Bank for Social and Economic Development (Banco Nacional de Desenvolvimento Econômico e Social), or BNDES, for R\$60.0 million and R\$180.0 million, respectively, to finance this second phase. Until December 31, 2006, we had invested US\$336.9 million in this phase of the Tietê Project.

The main objective of this second phase is the continuity of the expansion and optimization 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. In addition, this phase included the undertaking of a project aimed at evaluating and potentially revising our current tariff structure in order to cover the systems operation and maintenance costs and appropriately remunerate current and future investments. This project is also financed by our loan with the Inter-American Development Bank.

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 spent R\$212.0 million, R\$222.0 million and R\$331.2 million on these projects in 2004, 2005 and 2006, respectively, and we have budgeted for additional capital expenditures approximately R\$2.4 billion (unaudited) from 2007 through 2010.

Environmental Recovery Program for the Santos Metropolitan Region

On August 6, 2004, we entered into a credit agreement with Japan Bank for International Cooperation, or JBIC, for the financing of the Environmental Recovery Program for the Santos Metropolitan Region, which was guaranteed by the Federative Republic of Brazil, for a total amount of R\$382.8 million. For further information on the agreement entered into with the JBIC, 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 is approximately R\$1.1 billion and the balance will be our responsibility. The first disbursements under this agreement began in August 2005 with the commencement of the management agreement. We expect that construction works will begin 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 Santos Metropolitan Region.

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 function is divided into committees according to strategy and complexity. In 2004, 2005 and 2006, we spent R\$4.2 million, R\$4.7 million and R\$4.9 million, respectively, on research and development. We have also partnered with several research institutions.

4.B. Business Overview

Our Operations

We provide water and sewage services to 367 municipalities in the State of São Paulo either under concession contracts or under another form of legal arrangement. We also provide water services on a wholesale basis.

Because of the enactment of new legislation regarding basic sanitation in Brazil, we currently operate under two different contractual environments: (1) for the concession contracts that have already expired, we will negotiate a new contract model that follows the terms and conditions of the new legislation, and (2) for the concession contracts that will expire, we will continue to operate under the terms and conditions of the previous concession contracts, except in circumstances where the new legislation is automatically applicable. For further information on this topic, see *The Basic Sanitation Law*.

The new basic sanitation legislation, Law No. 11,445, establishes the date of December 31, 2010 as the deadline for water and sewage services companies, such as us, to regularize the provision of water and sewage services to municipalities, in case there is no formal concessions to provide services to them.

Concessions

Under 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.

Under the terms of the new basic sanitation law, Law No. 11,445, existing concessions will remain in effect until payment of compensation is made based on the valuation of investments. The new law provides that our new concession contracts be planned, overseen 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.

We provide water and sewage services to 367 municipalities in the State of São Paulo, of which 324 we operate pursuant to concessions granted by the municipalities. Substantially all of these concessions have 30-year terms. Until December 31, 2006, 120 of our concessions had expired, all of which are under negotiation. In 2007, 53 concessions will expire. From 2008 through 2034, 150 concessions will expire. The remainder of the concessions is for an undetermined period of time. Some of the expired concession contracts have been extended for a short term while we negotiate the terms and conditions of the termination of the previous contract and the terms and conditions for the new final contract with each municipality. Despite the expiration of the contracts, we continue to provide water and sewage services to all municipalities regardless of whether we have entered into contracts with them.

In February 2006, we created a new internal division to manage the renewal of expiring concessions. The main responsibility of this division, which reports directly to the Chief Executive Officer, is to maintain the existing base of municipalities that we operate and formalize contracts under the new model of associated management.

The current concessions are based on a standard form of contract between us and the relevant municipality. Each contract must receive the prior approval of the legislative council of each municipality. The principal terms of the concession contracts are as follows:

- We assume all responsibility for providing water and sewage services in the municipality.
- We may determine and collect the tariffs for our services without prior authorization of the municipality.

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- 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 is 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 sewer lines.
- On termination of the concession, or upon cancellation 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 concession contracts executed prior to 1998, we were reimbursed for these assets 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 contract.

Concession contracts we have entered into since 1998 provide that after a period of 30 years 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 period, we are paid an amount equal to the present value of the 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 Concessions Law (Law No. 8,987/95) and of the Consortium Law (Law No. 11,107/05), the new contracts will adopt 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 contracts acquired by us and the new contracts to be executed after the expiration of the concessions will follow this new contract model. See *Government Regulation Public Consortia Law*.

Our new contract model follows the provisions of the newly enacted Law No. 11,445. 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 others.

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 sale 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.

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In addition, there is currently ongoing litigation with respect to municipalities that intend to expropriate our water and sewage systems or to terminate concession contracts prior to paying us any indemnification. For example, among others, we have pending proceedings with the municipalities of Santos, Sandovalina, Presidente Prudente and Itapira. For a detailed discussion on these proceedings, see *Item 8.A. Financial Information Consolidated Statements and other Information Legal Proceedings Other Legal Proceedings*.

We are also defendants in legal proceedings initiated by municipalities seeking to require us to exhibit documents and information in connection with our concessions. These legal proceedings involve the municipalities of Guariba, Ribeirão Pires, Itupeva and Monte Mor. For a detailed discussion of these proceedings, see *Item 8.A. Financial Information Consolidated Statements and other Information Legal Proceedings Other 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 56.8% of our revenue, and to 40 other municipalities in the State of São Paulo. None of these other municipalities has a significant population, other than the municipality of Santos, which has a population of approximately 426,000. 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 things, 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 new basic sanitation law, Law No. 11,445, provides that, in case of termination of the relationship with the aforementioned municipalities with which we have not entered into a concession contract, an indemnification should be paid by the municipalities to us, in amounts to be calculated by studies and appraisals.

Wholesale Operations

We provide wholesale water services to six municipalities, including the municipalities of Diadema and Mauá. In addition, until December 2003 we provided wholesale water services 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 in approximately R\$415.5 million, which included the liquidation of the water wholesale supply accumulated debt totaling 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 in January 2004.

Execution of Sewage Services Agreements with Municipalities

We provide wholesale sewage services to the municipalities of Mogi das Cruzes, Santo André, São Caetano e Mauá. The negotiation of the agreement for the provision of wholesale sewage services with the municipality of Santo André had the intervention of the Public Prosecution Service, and in other municipalities, it was a result of our efforts concerning the environment and the awareness of the municipal public authorities related to environmental issues. Through these agreements, we started treating about 2.2 million cubic meters of sewage per month from these municipalities. This is an example of our social-environmental responsibility and commitment. In 2006, the revenues from these services were approximately R\$1.9 million.

Description of Our Activities

We plan, execute, operate and market basic sanitation services and their connected benefits throughout the territory of the State of São Paulo.

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 2006, we produced approximately 2,886.8 million cubic meters of water. The São Paulo Metropolitan Region currently is, and has historically been, our core market, accounting for approximately 72% of water invoiced by volume in 2006.

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

	Year ended December 31,		
	2004	2005	2006
Produced	(in millions of cubic meters)		
São Paulo Metropolitan Region	2,046.4	2,088.9	2,134.8
Regional Systems	724.1	741.2	752.0
Total	2,770.5	2,830.1	2,886.8
Invoiced			
São Paulo Metropolitan Region	954.5	997.8	1,030.8
Wholesale	251.4	258.7	263.4
Regional Systems	486.5	502.4	513.0
Total	1,692.4	1,758.9	1,807.2

The difference between the volume of water produced and the volume of water invoiced generally represents both physical and non-physical water loss. See *Water Resources* *Water Distribution*. 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).

The São Paulo Metropolitan Region experiences its highest levels of demand during the summer months when water use increases. Water use generally decreases during the winter months. The summer months, when demand is highest, coincide with the rainy season, while the winter, when demand for water is lowest, corresponds to the dry season in the São Paulo Metropolitan Region. Demand within the Regional Systems will vary depending on the area; while the interior region experiences seasonality in demand similar to the São Paulo Metropolitan Region, the demand in the coastal region is chiefly a function of tourism, with the greatest demand occurring during the Brazilian summer holiday months.

The following table provides information on our revenues by geographic region:

Year ended December 31,

	2004	2005	2006
	(in millions of reais)		
São Paulo Metropolitan Region	3,456.8	4,044.2	4,534.1
Regional Systems	1,185.7	1,312.1	1,449.9
Total revenue from sales and services	4,642.5	5,356.3	5,984.0

Water Resources

We can abstract water only to the extent permitted by the State Department of Water and Energy and pursuant to authorization contracts entered into with it. Under some circumstances, depending on the geographic location of the relevant river basin or reservoir, the approval of the National Water Agency (*Agência Nacional de Águas*), or 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.

In order to supply water to the São Paulo Metropolitan Region, we rely on 20 reservoirs of non-treated water and 182 reservoirs of treated water, which are located in the areas under the influence of the eight water producing systems which comprise the interconnected water system of the São Paulo Metropolitan Region. Resource availability, or volume of water available at the source for public distribution in these areas, is 71.7 cubic meters per second, due to the conclusion of the barriers of the Alto Tietê system. Total current capacity, or volume of water that can be treated from the interconnected water system of the São Paulo Metropolitan Region, is 67.7 cubic meters per second and has been designed to reach 75.2 cubic meters per second in 2009. Average verified production or volume treated during 2006 on the interconnected water system of the São Paulo Metropolitan Region was 66.2 cubic meters per second. The Cantareira, Guarapiranga and Alto Tietê systems, as a whole, supply approximately 84.1% of the water we produced for the São Paulo Metropolitan Region in 2006.

The Cantareira system accounts for approximately 48.7% of the water that we provided to the São Paulo Metropolitan Region (including the municipalities to which we provide water on a wholesale basis) in 2006, which represented 75.8 % of our operating revenue for 2006. The authorization (*outorga*) for the Cantareira system to use the water in the Piracicaba water basin was renewed on August 6, 2004 for a period of ten years.

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 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 Jundiá River Basin. Our tariff readjustment formula 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 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)
Cantareira	32.3
Guarapiranga	13.8
Alto Tietê	9.7
Rio Claro	4.7
Rio Grande (Billings reservoir)	3.8
Alto Cotia	1.0

Baixo Cotia	0.8
Ribeirão da Estiva	0.1
Total production rate	66.2

(1) Average of the twelve months ended December 31, 2006.

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. However, the transfer of these reservoirs is currently being disputed and we are not certain whether this transfer will be legally allowed. See *Item 8.A. Financial Information Consolidated Statements and other Information Legal Proceedings Other Legal Proceedings*.

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In the largest municipalities of the interior region, our principal source of water consists of surface water from nearby rivers. In the smaller municipalities of the interior region, we draw water primarily 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. In 2004, 2005 and 2006, 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 loss, and the installation of 907,665 new water connections from 2000 through December 2004 and 158,323 new water connections in 2005 statewide. In 2006, we installed 156,139 new water connections.

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 the relevant municipality.

In order to reach the final customer, the water is stored and transported through a complex and interconnected system comprising 30,535 kilometers of water mains and 182 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\$1.2 million (unaudited) from the years 2007 until 2010 to increase our water production and distribution capacities as well as to improve the water supply systems.

Water Treatment. We treat all water at our water treatment facilities prior to placing it into our water distribution network. We operate 197 treatment facilities, of which the eight largest, located in the São Paulo Metropolitan Region, account for approximately 72% 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 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, 2006, our water network contained 61,469 kilometers of water pipes and mains and 6.6 million water connections. The following table sets forth the total number of kilometers of water pipes in our network for the periods indicated.

	As of December 31,		
	2004	2005	2006
Water distribution pipes and mains (kilometers)	57,321	58,000	61,469
Number of connections (in thousands)	6,358	6,489	6,609

More than 90% of the water pipes in our water distribution network are made of cast iron or polyvinylchloride (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, 2006, our water distribution pipes and mains included:

- 30,535 kilometers in the São Paulo Metropolitan Region; and
- 30,934 kilometers in the Regional Systems.

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We have 373 storage tanks in the São Paulo Metropolitan Region with a total capacity of 1.8 million cubic meters, and 1,650 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 relined. 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 generally 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 counteract these effects, we have a maintenance program in place for water pipes and mains that is intended to deal with anticipated fractures and clogs due to brittleness and encrustation and to help ensure water quality.

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 is to pay for the cost of installation of up to 15 meters of pipe from our distribution network to the point of connection, with the remainder paid by the customer. Thereafter, the customer must cover the costs of connecting to the network from the customer's residence, 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.

	2007	2008	2009	2010	2007- 2010
	(in thousands)				
São Paulo Metropolitan Region	86.7	96.9	89.3	87.6	360.5
Regional Systems	62.1	70.0	75.0	84.4	291.6
Total System	148.8	166.9	164.3	172.0	652.1

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 (1) 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 (2) the total amount of water produced by us. We exclude the following from our calculation of water losses: (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).

Since 2005, we have established a new method of measuring our water losses, based on worldwide market practice for the sector. According to this new measurement method, average water losses are calculated by dividing (1) average annual water loss by (2) the average number of active water connections multiplied by 365. The result of this calculation is the liters of water lost per connection per day.

Using this calculation method, as of December 31, 2006, we experienced 615 liters/connections per day of water losses in the São Paulo Metropolitan Region and 353 liters/connections per day in the Regional Systems, averaging 511 liters/connections per day. We plan to reduce water losses in both regions to 450 liters/connections per day for the São Paulo Metropolitan Region and 278 liters/connections per day for the Regional Systems, which we expect will result in a total reduction to 405 liters/connections per day by 2010. Using another methodology, we intend to reduce water losses from 32.5% to 24% in the São Paulo Metropolitan Region, and from 30% to 23% in the Regional Systems. In 2006, we experienced 31.9% in water losses and we expect to decrease the water losses to 24% in 2010.

Our strategy to reduce water loss will be carried out by a two-step process:

- reduction in the level of physical losses, which result mainly from leakage, primarily through the replacement and repair of water mains and pipes and installation of 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, through upgrading and replacing inaccurate water meters and expanding our personnel who work on anti-fraud actions.

We are taking measures to decrease physical losses by reducing response times for fixing leakages to less than 24 hours and by better monitoring non-visible water mains fractures. Among other measures we have adopted to reduce physical water losses are:

- the introduction of technically advanced valves to regulate water pressure throughout the water mains to correspond to 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 intelligent valves are equipped with probes programmed to feed data to the valve to reduce or increase pressure to the water mains as water usage fluctuates. As of December 31, 2006, we had installed 1,481 valves at strategic points in the network, with 900 valves installed in the São Paulo Metropolitan Region and 581 in the Regional Systems. We plan to install 168 additional valves through the end of 2007;
- 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 in each case helping 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, are billed at a lower rate;
- fighting of fraud with the use of new, more sophisticated water meters that are more accurate and less prone to tampering;
- installation of water meters where none are present; and
- 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 and Europe. Under a Health Ministry (*Ministério da Saúde*) regulation in Brazil, 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 guarantee the quality and availability of water in the next 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 and purity as required by standards set by us and as required by law, which employ approximately 300 technicians, biologists, engineers and chemists. Our laboratories perform an average of 130,000 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 ISO 9001/2000 certification and three of the Regional Systems laboratories have obtained a ISO 17025 certification awarded by INMETRO with respect to the quality of our management systems and the technical ability of our laboratories to produce results. Until 2008 we expect that all of water and sewage quality control laboratories will have been granted the ISO 17025 certification.

All chemical products used for water treatment are analyzed and follow strict specifications set out in recommendations made by the National Sanitation Foundation, or NSF, and the Brazilian Association of Technical Rules (*Associação Brasileira de Normas Técnicas*), or ABNT, to eliminate toxic substances that are harmful to human health.

Water Source Program. From time to time, we face problems with the proliferation of algae, which may cause water to have an unpleasant taste and odor. In order to mitigate this problem, we work on two fronts: (1) fighting algae growth at the water resource, resulting in our detection of no significant algae growth in 2006, and (2) using advanced treatment processes at the water treatment facilities, which involves 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 raw water.

We are planning to participate in the 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 all systems of the São Paulo Metropolitan Region. In this program, we will be responsible for the expansion of sewage systems, pre-treatment of streams and development of more sophisticated treatment facilities. It is expected that the execution of this program will initiate in the first semester of 2008 financed by the International Bank for Reconstruction and Development, or World Bank. In addition, we also participate in the Clean-up Program of Streams in the City of São Paulo (*Programa de Despoluição dos Córregos do Município de São Paulo*), a joint program with the City of São Paulo to clean up 42 important streams in this region.

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 which is 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, 2006, we collected approximately 82% and 71% of all the sewage produced in the municipalities in which we operate in the São Paulo Metropolitan Region and the Regional Systems, respectively, accounting for approximately 78% of all the sewage produced in the municipalities in which we operated in the State of São Paulo during 2006.

Sewage System. The function of our sewage system is to collect, remove and dispose of sewage. As of December 31, 2006, we were responsible for the operation and maintenance of 39,126 kilometers of sewer lines, of which approximately 19,845 kilometers are located in the São Paulo Metropolitan Region and 19,281 kilometers are located in the Regional Systems.

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

	As of December 31,		
	2004	2005	2006
Sewage lines (kilometers)	36,435	37,181	39,126
Sewage connections (thousands)	4,747	4,878	5,002

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 sewer lines made of cast iron.

Industrial sewage can vary in nature and concentration of contaminants. The standards for disposal of industrial effluents are set forth in Article 19A of State Decree No. 8,468, of September 8, 1976, as amended, and broadly correspond to the standards for such disposal set by the U.S. Environmental Protection Agency. The basic premise of these standards is that industrial effluents interfere with the natural biological process at sewage treatment facilities and, therefore, the effluents must be treated so that the final effluent meets the parameters set forth in State Decree No. 8,468. This decree requires industries that produce industrial sewage to pre-treat the sewage so that levels of certain parameters, such as pH, temperature, sediments, grease, oil and metals, are reduced to environmentally sound levels prior to release into our sewer lines. To ensure compliance with Article 19A, we periodically analyze sewage produced by each industrial customer to check whether the customer has complied with the requirements of the decree. Although we may take certain actions which include imposing penalties or cutting a customer's connection in the event that customer is continuously not in compliance, we are not responsible for and are not obligated to ensure the compliance of our customers with the requirements of this decree.

Effluents from our sewage treatment facilities (*Estações de Tratamento de Esgotos ETEs*) must comply with discharge standards established by federal and state regulations. Flow standards are related to the composition of effluents before being discharged into water bodies, while quality standards measure the condition of the water bodies after the dilution of effluents. Both flow and quality standards will vary according to the expected use of the relevant body of water: the more important the use of the body of water, the more stringent the standards applicable.

We consider the condition of the sewer lines in the São Paulo Metropolitan Region generally to be adequate. Due to greater volume of sewage collected and to higher population and commercial and industrial development, the condition of the sewer lines in the São Paulo Metropolitan Region is somewhat worse than that of the Regional Systems. To counteract the effects of deterioration, we maintain a continuing program for the maintenance of sewer lines intended to deal with anticipated fractures arising from obstructions caused by system overloads.

Unlike the São Paulo Metropolitan Region, the interior region does not generally suffer obstructions caused by sewage system overload. The coastal region, however, experiences obstructions in its sewer lines primarily due to infiltration of sand, especially during the rainy season in the summer months. In addition, the number of sewage connections 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 sewer 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.

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

Projected New Sewage Connections

	(in thousands)				2007- 2010
	2007	2008	2009	2010	
São Paulo Metropolitan Region	81.2	100.5	87.2	84.2	353.0
Regional Systems	58.9	63.9	82.4	233.4	438.6
Total	140.1	164.4	169.6	317.6	791.6

Sewage Treatment and Disposal. In 2006, approximately 58% and 73% of the sewage we collected in the São Paulo Metropolitan Region and the Regional Systems respectively, or 63% of the sewage we collected in the State of São Paulo, was treated at our treatment facilities and afterwards discharged into receiving water bodies such as inland waters and the Atlantic Ocean, in accordance with applicable legislation. Our sewage treatment facilities have a finite capacity. Flows in excess of this capacity are discharged directly, untreated, to inland waters and the Atlantic Ocean. Currently we operate 438 sewage treatment facilities and eight ocean outfalls.

The purpose of sewage treatment is to reduce the polluting impact of the incoming sewage in order to comply with State Decree No. 8,468, and the Resolution No. 357/05 of the Brazilian National Environment Committee (*Conselho Nacional do Meio Ambiente*), or CONAMA, which stipulates maximum concentrations of certain substances prior to discharge into the environment. Although the flow and composition of sewage arriving at sewage treatment facilities varies, on average more than 98% of its content is water. Our sewage treatment relies essentially on physical separation processes and on natural biological processes to break down organic matter and reduce the amount of harmful organisms and chemicals.

The primary treatment process is the principal separation process for suspended solid material present in raw sewage. The sewage is passed into sedimentation tanks. Solid matter settles to the bottom of the tanks, is removed as sludge and is then passed to the sludge treatment process. The sewage remaining after this sedimentation process is either given activated sludge treatment or may be discharged to receiving waters.

The activated sludge treatment process, the principal method for secondary treatment of sewage used by us, relies on natural bacterial action to break down the organic matter in sewage and, where required, to remove ammonia. In the activated sludge treatment process, the sewage from primary treatment is passed into aeration tanks that are continuously replenished with re-circulated activated sludge. The mixture in the tanks is agitated and aerated, enabling the micro-organisms in the activated sludge to digest organic material contained in the incoming sewage. The effluent and activated sludge mixture produced by this process flows over to the final sedimentation stage.

We operate 44 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 interior region, treatment consists largely of stabilization ponds where the organic matter is treated and discharged to receiving waters. There are 354 secondary treatment facilities in the interior region which have treatment capacity of

approximately 9.7 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 2006, we produced approximately 53,789 tons of sludge-dry base, of which 49,387 tons were discharged into landfills and the remainder 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 367 of the 645 municipalities in the State of São Paulo. In addition, we currently sell water on a wholesale bases to six municipalities with a total population of approximately 3.2 million. The following table provides a breakdown of total revenues by geographic market for the periods indicated.

	Year ended December 31,		
	2004	2005	2006
	(in millions of reais)		
São Paulo Metropolitan Region	3,456.8	4,044.2	4,534.1
Regional Systems	1,185.7	1,312.1	1,449.9
Total revenue from sales and services	4,642.5	5,356.3	5,984.0

Competition

We believe there are at least two reasons behind a possible increase in our participation in the domestic sanitation market. There are 273 municipalities in the State of São Paulo that operate their own water and sewage systems and that collectively have a population of approximately 12.4 million, or approximately 30% 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. In addition, there are private water companies which provide water and sewage services to a small number of municipalities in the State of São Paulo, which may indicate a potential opportunity for the increase of our market share.

In general, we do not face any competition in the municipalities in which we provide water and sewage services. However, governments of these municipalities may also compete with us, if they 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 *Our Operations Concessions*. In the past, municipal governments have terminated our concessions contracts before the expiration date. Also, 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 contracts and concession contracts to be expired with the municipalities in an attempt to maintain our existing areas of operations.

We face a limited level of competition with respect to the supply of water to large customers. Several large industrial customers located in municipalities served by us use their own wells to supply themselves with water. This use of

private wells has been increasing in recent years. We have established new tariff schedules for commercial and industrial customers in order to help retain these customers. Additionally, we already face competition for the disposal of non-residential, commercial and industrial sludge in the São Paulo Metropolitan Region.

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.

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 and average service fees between R\$0.32 (unaudited) and R\$1.15 (unaudited) per transaction are charged 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 2004, 2005 and 2006, we received, respectively, payment of 94.1%, 90.8% and 91.5% of the amount billed to our retail customers, and 94.4%, 91.1% and 92.5% of the amount billed to those customers other than State entities, within 30 days after the due date. With respect to wholesale sales, in 2005 and 2006, we received payment of 60.6% and 61.4%, 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 meter readers 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 in other municipalities we serve.

Tariffs

The new basic sanitation law, Law No. 11,445, does not affect the terms and conditions with respect to tariff adjustments under our existing concessions. Contracts that are currently in effect will be adjusted according to the formula that we have applied to them. Pursuant to Law No. 11,445, as a general rule, the new state regulatory authority that will be created and replace the Commission for the Regulation of Sanitation Service of the State of São Paulo (*Comissão para a Regulação dos Serviços de Saneamento Básico do Estado de São Paulo*), or CORSANPA, will be responsible for setting and adjusting tariffs. While the new state regulatory authority is not created, the Sanitation and Energy Secretariat of the State of São Paulo will be temporarily in charge of these responsibilities.

Until the definition of the entity responsible for establishing tariffs regulations, we intend to continue adjusting our tariffs for water and sewage services according to the formula we currently use, which covers our operating costs and other expenses, accounts for inflation, and provides for return on investment. To ensure proper adjustment of our tariffs and higher return on investment, we intend to restructure our tariffs with values based on costs of services for all segments or clients, except for the low-income population, which should be subsidized.

Tariffs have historically been adjusted once a year and for periods of at least 12 months. We raised tariffs in June 2001, in July 2002 and in August 2003. We increased our tariffs for water and sewage services by 6.8% on August 29, 2004 and by 9.0% on August 31, 2005. On August 31, 2006, we increased our tariffs by 6.71% .

Although we have the power to set our tariffs for water and sewage services, the State of São Paulo, our controlling shareholder, through its ownership of our common shares and control of our board of directors, may interfere i