

COMPANHIA DE SANEAMENTO BASICO DO ESTADO DE SAO PAULO-SABESP

Form 20-F

June 28, 2004

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

FORM 20-F

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

OR

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

For the fiscal year ended December 31, 2003

OR

o 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
American Depositary Shares, evidenced by American
Depositary Receipts, each representing 250 Common Shares

New York Stock Exchange*
New York Stock Exchange

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

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

None

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act:

None

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

28,479,577,827 Common Shares, without par value, as of December 31, 2003

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

Yes No

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

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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\$2.8892 to US\$1.00, the commercial selling rate on December 31, 2003 as reported by the Central Bank of Brazil, or the Central Bank. As a result of the recent fluctuations in the *real*/U.S. dollar exchange rate, the commercial selling rate may not be indicative of current or future exchange rates. Therefore, you should not read these translations as representations that any such amounts have been, could have been or could be converted into U.S. dollars at that or at any other exchange rate. See *Item 3. Key Information-Exchange Rates* for information regarding exchange rates allocable to the Brazilian currency since January 1, 1999.

Our audited financial statements on December 31, 2002 and 2003 and for the years ended December 31, 2001, 2002 and 2003 are included in this annual report. The financial statements for the years ended December 31, 2001 and 2002 have been audited by PricewaterhouseCoopers Auditores Independentes, São Paulo, Brazil, and the financial statements for the year ended December 31, 2003 have been audited by Deloitte Touche Tohmatsu Auditores Independentes, São Paulo, Brazil.

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

Like other Brazilian companies, we have the option of presenting our primary financial statements on the basis of accounting principles established in accordance with the Corporate Law Method with a reconciliation to generally accepted accounting principles in the United States of America, 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 Corporate Law Method.

The Corporate Law Method differs in significant respects from U.S. GAAP. Note 25 to our audited financial statements provides a description of the differences between the Corporate Law Method and U.S. GAAP as they relate to our financial statements and a reconciliation from the Corporate Law Method to U.S. GAAP, for periods presented therein, of our net income (loss) and shareholders' equity. The reconciliation from the financial statements prepared in accordance with the Corporate Law Method to U.S. GAAP includes, among others, adjustments for differences related to the accounting for past revaluations of property, plant and equipment, historical inflation accounting and accounting for pension and other employee benefits.

We do not have any subsidiaries.

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

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FORWARD-LOOKING STATEMENTS CONTAINED IN THIS ANNUAL REPORT

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

the interests of our controlling shareholder, the State of São Paulo;

amounts owed to us by our controlling shareholder;

existing and future governmental regulation, including taxes on, and charges to, us;

our lack of a contractual concessions for the City of São Paulo and other municipalities;

municipalities' ability to terminate our existing concessions;

our ability to collect amounts owed to us by municipalities;

limitations on our ability to increase tariffs;

our capital expenditure program and other liquidity and capital resources requirements;

our level of indebtedness and limitations on our ability to incur additional indebtedness;

water and/or electrical energy crises;

our costs relating to compliance with environmental laws and potential penalties for failure to comply with such laws;

our ability to obtain additional concessions and to renew current concessions;

general economic, political and other conditions in Brazil;

inflation and devaluation;

our management's expectations and estimates concerning our future financial performance;

the size and growth of our customer base; and

other risk factors as set forth under *Item 3. Key Information-Risk Factors* section.

The words *believes*, *may*, *will*, *estimates*, *continues*, *anticipates*, *intends*, *expects* and similar words are used to identify forward-looking statements. In light of these risks and uncertainties, the forward-looking events and circumstances discussed in this annual report might not occur. Our actual results could differ substantially from those anticipated in our forward-looking statements.

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PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

Table of Contents**ITEM 3. KEY INFORMATION****Selected Financial Data**

The following table presents our selected financial information at and for each of the periods indicated. The selected financial information on December 31, 2002 and for the two years in the period ended December 31, 2002 are derived from our financial statements audited by PricewaterhouseCoopers Auditores Independentes included in this annual report. The selected financial information on December 31, 2003 and for the year ended December 31, 2003 is derived from our financial statements audited by Deloitte Touche Tohmatsu Auditores Independentes, also included in this annual report.

Our financial statements have been prepared in accordance with the Corporate Law Method, which differs in significant respects from U.S. GAAP. You should read the selected financial information in conjunction with our audited financial statements and notes thereto included elsewhere in this annual report, as well as *Presentation of Financial Information* and Item 5. Solely for the convenience of the reader, *real* amounts as at and for the year ended December 31, 2003 have been translated into U.S. dollars at the commercial selling rate on December 31, 2003 of R\$2.8892 to US\$1.00.

	As at and for the year ended December 31,					
	1999	2000	2001	2002	2003	
	(in millions, except per share and per ADS data)					
Corporate Law Method	R\$	R\$	R\$	R\$	R\$	US\$
Statement of Operations Data:						
Net operating revenue	3,235.7	3,355.8	3,434.8	3,767.1	4,109.9	1,422.5
Cost of services rendered	(1,364.2)	(1,474.1)	(1,590.4)	(1,815.0)	(2,046.8)	(708.4)
Gross profit	1,871.5	1,881.7	1,844.3	1,952.2	2,063.1	714.1
Selling expenses	(278.7)	(332.7)	(332.6)	(385.1)	(297.3)	(102.9)
General and administrative expenses	(153.8)	(137.3)	(203.1)	(226.0)	(253.7)	(87.8)
Financial expenses, net	(1,529.9)	(737.7)	(1,105.2)	(2,276.3)	(346.5)	(119.9)
Operating profit (loss)	(90.9)	673.9	203.4	(935.3)	1,165.5	403.4
Non-operating income (expenses), net	(124.5)	(82.3)	(76.9)	(3.4)	(54.5)	(18.9)
Income (loss) before taxes on income	(215.4)	591.6	126.5	(938.7)	1,111.1	384.6
Income tax and social contribution	(20.2)	(70.2)	89.7	323.3	(242.6)	(84.0)
Extraordinary item, net of income tax and social contribution ⁽¹⁾				(35.1)	(35.1)	(12.1)
Net income (loss)	(235.6)	521.4	216.2	(650.5)	833.3	288.4
Net income (loss) per 1,000 common shares	(8.28)	18.31	7.59	(22.84)	29.26	10.1
Net income (loss) per ADS	(2.07)	4.58	1.90	(5.71)	7.32	2.5

Dividends and interest on shareholders' equity per 1,000 common shares		18.97	17.20	3.80	17.70	6.1
Number of common shares outstanding at year end (in thousands of shares)	28,437,155	28,479,578	28,479,578	28,479,578	28,479,578	28,479,578
Balance Sheet Data:						
Customer accounts receivable, net	890.5	887.4	878.0	820.5	996.8	345.0
Reimbursement due from State Government for pensions paid	184.2	253.5	326.3	403.9	491.0	169.9
Long-term receivables from State Government agreements ⁽²⁾			378.3	423.7	164.2	56.8

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	1999	2000	2001	2002	2003	
(in millions, except per share and per ADS data)						
Corporate Law Method	R\$	R\$	R\$	R\$	R\$	US\$
Property, plant and equipment	13,298.3	13,346.4	13,510.0	13,670.8	14,063.2	4,867.5
Total assets	15,116.9	15,192.1	15,917.9	16,348.7	16,530.7	5,721.5
Total short-term loans and financings	841.6	381.7	549.3	1,332.5	997.0	345.1
Total long-term loans and financings	5,023.6	5,616.1	5,920.6	6,545.2	6,267.3	2,169.2
Total liabilities	6,845.3	6,923.7	7,921.2	9,102.2	8,953.7	3,099.0
Shareholders equity	8,271.5	8,268.5	7,996.7	7,246.5	7,576.9	2,622.5
Other Financial Information:						
Cash provided by operating activities	1,874.2	1,744.1	1,657.0	1,764.8	1,655.3	572.9
Cash used in investing activities	(801.8)	(598.4)	(709.5)	(597.2)	(650.8)	(225.3)
Cash used in financing activities	(943.4)	(1,098.3)	(763.6)	(1,165.7)	(1,138.2)	(393.9)
Adjusted EBITDA ⁽³⁾	1,873.1	1,868.6	1,785.9	1,860.1	2,076.5	718.7
Capital expenditures ⁽⁴⁾	790.7	596.3	694.6	586.0	641.3	222.0
Depreciation and amortization	434.1	457.0	477.3	519.1	564.5	195.4

As at and for the year ended December 31,

	1999	2000	2001	2002	2003	
(in millions, except per share and per ADS data)						
U.S. GAAP	R\$	R\$	R\$	R\$	R\$	US\$
Statement of Operations Data:						
Net operating revenue	3,235.7	3,355.8	3,434.8	3,767.1	4,109.9	1,422.5
Gross profit	1,691.3	1,668.6	1,613.8	1,820.1	1,852.8	641.3
Selling expenses	(295.9)	(349.6)	(349.9)	(393.6)	(323.2)	(111.9)
General and administrative expenses	(198.5)	(184.1)	(214.8)	(328.8)	(276.3)	(95.6)
Operating profit ⁽⁵⁾	963.2	983.0	951.1	1,086.5	1,136.5	393.4
Financial expenses, net	(1,563.2)	(740.6)	(1,107.1)	(2,284.5)	(329.4)	(114.0)
Net income (loss)	(449.3)	284.4	16.7	(847.6)	642.6	222.4
Net income (loss) per 1,000 common shares-basic and diluted	(15.95)	10.00	0.59	(29.76)	22.56	7.80
Net income (loss) per ADS-basic and diluted	(3.99)	2.50	0.15	(7.44)	5.64	1.95
Weighted average number of common shares outstanding (in thousands of shares)	28,159,721	28,448,607	28,479,578	28,479,578	28,479,578	28,478,578

Balance Sheet Data:

Property, plant and equipment	15,643.0	15,583.8	15,656.0	15,666.0	15,955.5	5,522.5
Total assets	17,493.2	17,381.0	17,581.8	17,625.6	17,630.4	6,102.2
Total short-term debt (including short-portion of long-term debt)	816.5	381.7	549.3	1,753.6	997.0	345.1
Total long-term debt	5,023.6	5,612.2	5,873.2	6,124.0	6,267.3	2,169.2
Total liabilities	9,883.2	10,046.5	10,688.5	11,679.8	11,544.8	3,995.8
Shareholders' equity	7,610.0	7,334.4	6,893.3	5,945.8	6,085.6	2,106.3

On December, 31

	2000	2001	2002	2003
Operating Data (at period end):				
Number of water connections (in thousands)	5,535	5,717	5,898	6,044
Number of sewage connections (in thousands)	3,976	4,128	4,304	4,462
Volume of water billed during period (in millions of cubic meters)	1,731	1,698	1,770	1,765
Water loss percentage (average)(6)	31.4%	32.6%	31.7%	33.0%
Number of employees	18,048	18,159	18,505	18,546

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- (1) The extraordinary item charged to income in the years ended December 31, 2002 and 2003 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 Brazilian securities commission. For purposes of U.S. GAAP, the pension expense has been treated as a payroll expense from the first year presented.
- (2) Long-term receivables from State Government agreements represent amounts due from the state government for water and sewage services. Amounts for 2003 are reflected net of R\$401.7 million of amounts due to the State Government related to interest on shareholders' equity which has been designated for reciprocal offset under the terms of the agreement executed among the parties, as amended. See note 6 to our audited financial statements.
- (3) Adjusted EBITDA means net income (loss) before financial expenses, net, income tax and social contribution (a federal tax on income), depreciation and amortization, non-operating income (expenses), net and extraordinary item, net of income tax and social contribution. Adjusted EBITDA is not a measurement accepted under the Corporate Law Method, does not represent cash flow for the periods presented and should not be considered as an alternative to net income (loss), as an indicator of our operating performance or as an alternative to cash flows as an indicator of liquidity. Our definition of EBITDA may not be comparable with EBITDA as defined by other companies. Although Adjusted EBITDA, as defined above, does not provide a measurement of operating performance as accepted under the Corporate Law Method, our management uses it to measure our operating performance and it is commonly used by financial analysts in evaluating our business. Adjusted EBITDA is calculated as follows:

For the year ended December 31,

	1999	2000	2001	2002	2003	
	R\$	R\$	(in millions)		R\$	US\$
			R\$	R\$		
Corporate Law Method						
Net income (loss)	(235.6)	521.4	216.2	(650.5)	833.3	288.4
Add:						
Financial expenses, net	1,529.9	737.7	1,105.2	2,276.3	346.5	119.9
Income tax and social contribution	20.2	70.2	(89.7)	(323.3)	242.6	84.0
Depreciation and amortization	434.1	457.0	477.3	519.1	564.5	195.4
Non-operating income (expenses), net	124.5	82.3	76.9	3.4	54.5	18.9
Extraordinary item, net of income tax and social contribution				35.1	35.1	12.1
Adjusted EBITDA	1,873.1	1,868.6	1,785.9	1,860.1	2,076.5	718.7

- (4) Based upon the audited statements of cash flows for the years ended December 31, 2003, 2002 and 2001 included in note 27 to our audited financial statements and the audited statements of cash flows for the years ended December 31, 1999 and 2000 which are not included in this annual report.
- (5) Under U.S. GAAP, operating profit is determined before financial expenses, net.
- (6) Includes both physical and non-physical loss. Water loss percentage represents the quotient of (a) the difference between (i) the total amount of water produced by Sabesp (after excluding certain non-physical water losses set out below) less (ii) the total amount of water invoiced by Sabesp to customers *divided by* (b) the total amount of

water produced (after excluding certain non-physical water losses set out below) by Sabesp. We exclude from our calculation of water losses the following:

water discharged for periodic maintenance of water mains and water storage tanks;

water supplied for municipal uses such as firefighting;

water we consume in our facilities; and

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estimated water losses associated with water we supply to *favelas* (shantytowns).

Exchange Rates

There are two principal legal foreign exchange markets in Brazil:

the commercial rate exchange market; and

the floating rate exchange market.

On January 25, 1999, the Brazilian government announced the unification of the operational limits applicable to both markets. However, each market continues to have a specific regulation. Most trade and financial foreign-exchange transactions are carried out on the commercial rate exchange market. These transactions include the purchase or sale of common shares or the payment of dividends or interest with respect to common shares. The Floating market rate generally applies to transactions to which the commercial market rate does not apply. Prior to February 1999, the exchange rate in each market was established independently, resulting in different rates during some periods. Since February 1, 1999, financial institutions operating in the commercial market have been authorized to unify their positions in the two different markets, which caused a reduction in the difference between their respective rates. These markets are now differentiated solely for regulatory purposes and offer similar pricing and liquidity, despite the potential for distinct treatment for regulatory purposes in the future. Foreign currencies may only be purchased through a Brazilian bank authorized to operate in these markets. In both markets, rates are freely negotiated but may be strongly influenced by intervention from the Brazilian Central Bank.

From March 1995 through January 1999, the Brazilian Central Bank allowed the gradual devaluation of the *real* against the U.S. dollar. In January 1999, the Brazilian Central Bank abolished the band system and allowed the *real*/U.S. dollar exchange rate to float freely. Since then, the *real*/U.S. dollar exchange rate has been established mainly by the interbank market, and has fluctuated considerably. The *real* devalued to a low of R\$2.165 per U.S.\$1.00 on March 3, 1999, but subsequently appreciated to R\$1.789 per U.S.\$1.00 on December 31, 1999, representing a net devaluation against the U.S. dollar of 32.4% during 1999. In 2000, the *real* devalued by a further 8.5% against the U.S. dollar.

Further deterioration in the political and economic environment in 2001, in addition to the Brazilian energy crisis, resulted in the *real* devaluing by 15.7% against the U.S. dollar in the year. In the final quarter of 2001, however, the *real* appreciated by 15.1% from R\$2.671 per U.S.\$1.00 at September 30, 2001 to R\$2.3204 per U.S.\$1.00 at December 31, 2001.

In 2002, as a reaction to political and economic uncertainties, the global economic downturn, the crisis in Argentina and the Brazilian presidential elections, the U.S. dollar appreciated by 34.3% against the *real* to R\$3.5333 per U.S.\$1.00 at December 31, 2002. The *real* recovered in 2003, appreciating by 22.3% to R\$2.8892 per U.S.\$1.00, at December 31, 2003. During the first four months of 2004, the *real* has devalued approximately 1.9% against the U.S. dollar. Recently the Brazilian Central Bank has only intervened occasionally to control unstable movements in the foreign exchange rate. At the present time, we cannot predict whether the Brazilian Central Bank will continue to let the *real* float freely or if the *real* will remain at its present level. The *real* may devalue substantially in the near future.

As of April 30, 2004, the commercial selling rate published by the Brazilian Central Bank was R\$2.9447 per U.S.\$1.00.

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The following table shows the commercial selling rate for U.S. dollars for the periods and dates indicated. The information in the *Average* column represents the average of the exchange rates on the last day of each month during the years presented.

	<u>Low</u>	<u>High</u>	<u>Average</u>	<u>Period-end</u>
	(Reais per US\$1.00)			
Year ended				
December 31,				
1999	1.2078	2.1647	1.8514	1.7890
2000	1.7234	1.9847	1.8348	1.9554
2001	1.9353	2.8007	2.3519	2.3204
2002	2.2709	3.9552	2.9983	3.5333
2003	2.8219	3.6623	3.0600	2.8892
2004 (through April 30)	2.8022	2.9878	2.9270	2.9447
Month ended				
November 30, 2003	2.8559	2.9546	2.9138	2.9494
December 31, 2003	2.8883	2.9434	2.9270	2.8892
January 31, 2004	2.8022	2.9409	2.8518	2.9409
February 28, 2004	2.9042	2.9878	2.9303	2.9138
March 31, 2004	2.8752	2.9410	2.9055	2.9086
April 30, 2004	2.8743	2.9522	2.9060	2.9447

Source: Brazilian Central Bank

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Risk Factors

Risks Relating to our Control by the State of São Paulo

We are controlled by the State of São Paulo, whose interests may be contrary to the interests of other holders of our common shares and holders of our ADSs.

The State of São Paulo (the **State**), through its ownership of our common shares, has the ability to control the election of a majority of the members of our *Conselho de Administração* (**Board of Directors**), the appointment of our senior management and our operations and strategy. The State owned 71.5% of our common shares on April 30, 2004.

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

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

Each newly-elected Governor of the State typically makes significant changes in our Board of Directors and senior management and, historically, the Chairman of our Board of Directors has been the Secretary of the Energy, Water Resources and Sanitation Secretariat of the State. In 2002, the current Governor, Mr. Geraldo Alckmin, appointed new senior officials for his administration, including Mr. Mauro Guilherme Jardim Arce as the new Secretary of the Energy, Water Resources and Sanitation Secretariat. Mr. Arce was also elected as Chairman of our Board of Directors. In addition, during the last twelve months our Board of Directors has appointed new executive officers, including our new chief executive officer and our new chief financial officer.

Changes in government or government policy could lead to changes in our senior management which in turn could have a material adverse effect on our business strategy, results of operations, financial condition or prospects.

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

Historically, the State and some State entities have had substantial overdue accounts payable to Sabesp 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.

On December 31, 2003, we had accounts receivables due from the State and some State entities relating to the provision of water and sewage services totaling approximately R\$164.2 million, net of R\$401.7 million of amounts applied in respect of dividends due to the State Government. In addition, on December 31, 2003, we had R\$491.0 million in accounts receivable due from the State in respect of State-mandated special retirement and pension payments to some of our

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former employees. Under a federal law enacted in December 1996, we are not permitted to write-off any amounts owing to Sabesp from the State, our controlling shareholder, or entities controlled by the State. We have not established any provisions for any amounts owed to us by the State.

In September 1997, December 2001 and March 2004 we entered into agreements with the State under which the State agreed to settle amounts the State owes us in respect of water and sewage services provided to the State and State-controlled entities and for State-mandated special retirement and pension payments which we made to some of our former employees for which the State is required to reimburse us. Under the terms of these agreements, the amounts may be settled through the application of dividends payable by us to the State and by the transfer to us of certain reservoirs which we use but which are owned by the State. However, some of the agreements do not require the State to apply all dividends payable by us to the State to the repayment of amounts owed to us by the State. In addition, the agreements provide for an extended period of time before any transfer of the reservoirs to us is effected. Since the State entered into these agreements, it has applied some, but not all, of the dividend received by it from Sabesp to the repayment of amounts it owes to Sabesp.

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

We cannot assure you as to when or whether the State will pay overdue amounts owing to us, or as to whether the State will continue to apply dividends payable to the State to settle amounts owing to us by the State and some State-controlled entities. Furthermore, due to the State's history of not making timely payments to us in respect of services provided by us and of not reimbursing us in a timely manner for the State-mandated special retirement and pension payments we make, we cannot assure you that the amount of accounts receivables owed to us by the State and some State entities will not significantly increase in the future. If the State does not pay the amounts it owes us, our cash flows, results of operations and financial condition will be adversely affected.

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

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

Under the December 2001 agreement, in July and August 2002 a State-owned construction company, on behalf of the State, and an independent appraisal firm, on behalf of Sabesp, presented their valuation reports relating to the reservoirs. The appraisals contained in these reports were in the amounts of R\$335.8 million and R\$341.2 million, respectively. Under the December 2001 agreement, the arithmetic average of these appraisals will be deemed to be the fair value of the reservoirs. Since we have made investments in these reservoirs, the arithmetic average of the appraisals submitted to our Board of Directors, R\$300.9 million, was net of a

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percentage corresponding to these investments. Our Board of Directors approved the valuation reports which will now have to be submitted for approval by an extraordinary general meeting of shareholders. However, we cannot assure you as to when such meeting will take place and a final determination as to the fair value of these reservoirs will be made, when the transfer of the reservoirs will occur, or when the reimbursement of the values paid by us in relation to the State-mandated special pension and benefits will take place.

The December 2001 agreement also provided that the State's legal advisors would carry out specific analyses, which have commenced, to ensure agreement among the parties as to the methodology employed in determining the amount of reimbursement for pension benefits owed to Sabesp by the State. The commencement of reimbursement payments with respect to pension amounts owed to Sabesp by the State has been postponed until these analyses are completed, the appraisal report is approved and the credit assignments relating to the transfer of the reservoirs described above are formalized. Under the December 2001 agreement, the original first payment was to be made in July 2002, but no payment in this respect has been made as of the date of this document. We cannot assure you as to when agreement among the parties will be reached or when the State will commence making payments in respect of these pension amounts.

We may be required to acquire reservoirs that we use that are owned by a State-controlled company, and we may be required to pay substantial fees, rent and additional operational and maintenance expenses with respect to our use of such reservoirs.

In connection with the provision of water services, we use the Billings and Guarapiranga reservoirs that are owned by a State-controlled company. The State, through its control of our Board of Directors, could require us to acquire the Billings and Guarapiranga reservoirs. As a result of such acquisition, our cash position and overall financial condition could be adversely affected. In addition, since we are not currently charged for the use of these reservoirs, we are uncertain as to whether in the future we will continue to be able to use the reservoirs without paying a fee, or what the likely fee scale would be if so imposed. We may also be required to pay additional maintenance and operational costs for our use of the Billings and Guarapiranga reservoirs. If we were required to pay substantial fees or additional maintenance or operational costs for these properties, our results of operations could be adversely affected.

Risks Relating to Our Business

The basic sanitation sector is not regulated in Brazil and the approval of any proposed regulations for the water and sewage industry may negatively affect our operations in the São Paulo Metropolitan Region as well as other areas that we serve.

The Brazilian Federal Congress has, from time to time, discussed proposals for regulation, which would establish directives for basic sanitation services. Any proposed regulation, when and if approved, could establish a new municipal regulatory authority for our industry that may, in part, preempt the existing state regulatory authorities under which we operate.

Law Project No. 4,147, for example, has been under the analysis of the Brazilian Federal Congress since February 21, 2001. This proposed new legislation and regulatory regime may grant to the new regulatory authorities the power to deny renewals of our concessions after they expire or to cancel existing ones. In addition, the proposed new legislation could modify the

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way we charge for our water and sewage services businesses, as well as our capital expenditure program. Any of these changes, if they were to occur, could have an adverse effect on our revenues, by causing us to lose concessions we currently hold, or on our operating margins, by limiting our ability to pass our costs on to our customers. In addition, some changes have been introduced to the proposed legislation by which the State would share the authority with municipalities comprising the São Paulo metropolitan region. These changes, if adopted, could negatively affect our operations in the São Paulo Metropolitan Region as well as other metropolitan areas which we serve.

As of the date of this annual report, neither Law Project No. 4,147 or any other proposed federal regulation for the water and sewage industry has been voted by the Brazilian Federal Congress or been sent to the Brazilian Senate for debate. However, representatives of the federal government have repeatedly informed the press that new regulation is expected to be proposed to the Brazilian Congress in the near future. Our Board of Directors has recently become aware that such new regulation, if proposed to the Brazilian Congress in the form presented to us, will have a negative effect on our operations in the São Paulo Metropolitan Region, as well as in other areas that we serve. Accordingly, we cannot anticipate when, in what terms, or if, Law Project No. 4,147 or any other proposed federal regulation will become effective.

We may become subject to substantial water and sewage related charges imposed by governmental water agencies of the State of São Paulo and of the Federal Government.

Governmental water agencies of the State of São Paulo may be, and the Federal Government is, authorized to collect fees from persons, including Sabesp, that either abstract water from, or dump sewage into, water resources controlled by these agencies. The fees collected by these agencies are to be used to develop new water resources and to maintain existing water resources and may be loaned or provided as grants or subsidies to governmental agencies and corporations, including Sabesp, for use in the development and maintenance of water resources. The State legislature of the State of São Paulo is currently debating new legislation that would establish procedures for the collection of these fees. The Federal Government recently enacted legislation under which we must pay fees to the Federal Government or an agency in respect of the use of water from specified sources. We are uncertain as to the likely fees that may be assessed, or whether we will be able to pass on the cost of any of these fees to our customers.

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

We do not hold formal concessions in the City of São Paulo, which accounts for a substantial majority of our sales and services rendered, and in 41 other municipalities in the State of São Paulo. We believe, however, that we have a vested or implied right to provide water and sewage services in these municipalities based upon, among other things, our ownership through our predecessor entities of the water and sewage systems serving the City of São Paulo and these other municipalities and certain rights of succession resulting from the merger of state governmental agencies and the state-controlled companies which formed Sabesp in 1973 that were involved in providing water and sewage services in the City of São Paulo and these other municipalities. Because we do not hold concessions or formal contract rights to provide services in these municipalities, we may not be able to effectively enforce our right to continue to provide services or to be paid for the services we provide. In the future, our rights in respect of the City of São Paulo and these other municipalities could be modified or adversely affected by Brazilian federal, state or local governmental actions or other factors.

From time to time mayors of the City of São Paulo, including the present mayor, have initiated or proposed discussions with the State of São Paulo regarding entering into a formal concession

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contract with Sabesp to provide water and sewage services in the City of São Paulo. The City of São Paulo legislature approved Law 13,670 of November 25, 2003 that regulates articles 148 and 149 of the Organic Law of the City of São Paulo (*Lei Orgânica do Município de São Paulo*) in relation to public water supply and sewage services. The law establishes the Municipal System for the Regulation of Public Water Supply and Sewage Services (*Sistema Municipal de Regulação dos Serviços de Abastecimento de Água e Esgotamento Sanitário* or **SIRE**), creates and provides for the organization and operation of the São Paulo Regulatory Authority for Public Water Supply and Sewage Services (*Autoridade Reguladora dos Serviços de Abastecimento de Água e Esgotamento Sanitário de São Paulo* or **ARSAE**), and establishes the Municipal Sanitation Plan (*Plano Municipal de Saneamento* or **PMS**). Following the enactment of Law No. 13,670, the Governor of the State of São Paulo has filed a legal action alleging that the Law is unconstitutional, a result of which the enforcement of Law No. 13,670 has been suspended. The merits of such lawsuit have not yet been judged. We cannot assure when or if the suspension of Law 13,670 of November 25, 2003 will end, or if its renewed application would result in the City of São Paulo granting us a formal concession contract, or the terms of any concession contract.

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

We provide water and sewage services in 325 municipalities pursuant to concessions granted by the municipalities. Substantially all of these concessions have 30-year terms: 273 of these concessions expire between 2004 and 2010; and the rest expire between 2011 and 2030. Each of these concessions is automatically renewable for a period equal to its initial term, unless we or the municipality exercise the right to terminate the concession prior to the six-month period ending on the expiration date of the concession. If a substantial number of these municipalities choose not to renew their concessions, it could adversely affect our revenues and cash flows.

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

Municipalities may terminate our concessions under some circumstances, including if we fail to comply with our obligations under the relevant concession contracts. In addition to contractual termination provisions in concession contracts, municipalities have the inherent power under Brazilian law to terminate concessions prior to their contractual expiration dates for any good public reason. The meaning of good public reason has not been defined by Brazilian law or conclusively determined by Brazilian courts. In the event of the termination of a concession, we may receive inadequate compensation from the concessionaire municipality. We may also incur material litigation costs related to termination of concessions and compensation.

In 1997, the municipality of Santos enacted a law expropriating the water and sewage systems of Sabesp in Santos. In response, we filed an action seeking an injunction against this expropriation which was denied by the lower court. This decision was later reversed by the Court of Appeals of the State of São Paulo, which issued a preliminary order suspending that law. On August 2, 2002, a decision on this matter was rendered in favor of Sabesp by a lower court, but such decision is still subject to appeal, and we cannot assure you that the ultimate determination will be favorable to us. Despite the pending lawsuit, we continue to provide water and sewage services to Santos.

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

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

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

The conditions attached to the renewal of our authorization to abstract water from the Cantareira System may be unreasonably burdensome and could result in an increase in costs and a higher capital expenditure requirement.

We may abstract water from rivers or reservoirs only to the extent permitted by the Department of Water and Energy of the State of São Paulo (*Departamento de Águas e Energia Elétrica do Estado de São Paulo*). 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 - ANA*) is also required. The term of these authorizations will vary depending on the granting authority, and their renewal must be approved by their original grantors.

The authorization to abstract water from the Cantareira System, which supplies approximately 48% of the water produced by Sabesp for the São Paulo Metropolitan Region, will expire in August 2004. Accordingly, we have filed a request for the renewal of the authorization before the Department of Water and Energy of the State of São Paulo on February 27, 2004, and before ANA on April 7, 2004.

The conditions upon which such governmental authorities will renew our authorization to abstract water from the Cantareira system are still unknown, and will only be disclosed on August 2004. If we are unable to negotiate any burdensome condition imposed by the State government we may be exposed to increase in costs and capital expenditures, which may negatively affect our results of operation.

We may experience difficulty in collecting substantial overdue accounts receivables due from municipalities.

On December 31, 2003, we had accounts receivables totaling R\$506.3 million from municipalities to which we provide water on a bulk basis. Of this amount, we estimate that approximately R\$63.2 million was between 90 and 360 days overdue and R\$382.1 million was more than 360 days overdue. In some cases, the Brazilian courts have required that we continue to provide water on a bulk basis to municipalities, even if they fail to pay our invoices.

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

Our financial performance will be adversely affected if we are unable to increase customer tariffs in line with increases in inflation and operating expenses.

Our results of operations and financial condition are highly dependent upon our ability to set and collect adequate tariffs for our water and sewage services. Although we generally have broad power to establish tariffs, this power is, in practice, subject to political and legal constraints. Since 1995, we have generally been able to raise tariffs yearly in line with increases in inflation or operating expenses, and to support our liquidity and capital resource requirements. However, from mid-1999 until mid-2001 we did not raise our tariffs, due to a State policy of not increasing tariffs for public services. In June 2001, we increased our average tariffs by approximately 13.1% which was broadly in line with the prevailing inflation rates in Brazil since mid-1999 and, in August 2002 we raised our tariffs by approximately 8.2%. In August 2003 we were able to raise our tariffs by 18.9%, except for the social and *favela* categories, which tariffs were increased by 9.0%. Also in August 2003 a new readjustment formula was approved by our Board of Directors. See "*Information on the Company Customers Tariffs*" below. We will continue to rely upon tariff revenues, among other things, to provide funds for our capital expenditure program and to meet our debt service requirements. Any failure to establish or maintain tariffs commensurate with these and our other needs could have an adverse effect on our results of operations and financial condition.

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

Our capital expenditure program calls for expenditures of approximately R\$4.3 billion in the period from 2004 through 2008, including approximately R\$883.0 million in 2004 and R\$880.0 million in 2005. We plan to fund these expenditures and our other liquidity and capital resource needs out of funds generated by operations and domestic and foreign currency borrowings on acceptable terms. See "*Operating and Financial Review and Prospects - Liquidity and Capital Resources*" below.

Historically, a significant portion of our financing needs has been met by financing provided by lenders controlled by the federal government. To the extent the policies of the federal government regarding the financing of water and sewage services change, our ability to finance our capital expenditure program may be impaired.

We cannot assure you that we will be able to obtain sufficient funds to complete our capital expenditure program or satisfy our other liquidity and capital resources requirements. Failure to obtain the requisite funds could delay or prevent completion of our capital expenditure program

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and other projects, which may have a material adverse effect on the operation and development of our business.

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

Brazilian regulations provide that a state-owned company, such as Sabesp, may only use the proceeds of external credit operations (*i.e.*, foreign currency borrowings) to refinance outstanding financial obligations. These regulations do not apply to import financing and financing transactions involving multilateral organizations, such as the World Bank and the Inter-American Development Bank. As a result of these regulations, our ability to incur foreign currency-denominated debt is limited.

Under our existing debt instruments, we are subject to covenants limiting our ability to incur additional indebtedness, whether denominated in *reais* or foreign currency. Under these covenants, we would have been able to borrow up to an additional R\$517.4 million at December 31, 2003. If, however, these and other limitations prevent us from completing our capital expenditure program or executing our business plans generally, we may be unable to satisfy all of our liquidity and capital resources requirements, which could have a material adverse effect on our business.

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

We experience decreases in our water supply from time to time due to droughts. Brazil recently experienced a prolonged and severe drought, which commenced in 1999 and ended in 2001. As a result of this drought, our volume of water billed decreased and our costs increased as a result of additional capital expenditures required to alleviate the effects of this drought on our water production systems. Throughout 2003 rain levels were again below average resulting in a weak replenishment of our reservoirs, particularly in the Cantareira System, the largest system of the Metropolitan Region of São Paulo. In order to minimize the effects of this drought, in March 2004 Sabesp approved a water consumption reduction incentive program based on a bonus system, pursuant to which customers who achieve their consumption reduction goal will be entitled to a 20% discount on their water bill. This incentive program is scheduled to last 6 months as from March 15, 2004 and will encompass most of the customers in the São Paulo Metropolitan Region supplied by the Metropolitan Aqueduct System. Although we expect our billing amount to decrease, we are unable to estimate the impact of this program on our revenues. We cannot assure you that any continuous drought in the future will not materially adversely affect our water supply and, accordingly, our business and results of operations.

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

Our facilities are subject to many Brazilian federal, state and local laws and regulations relating to the protection of human health and the environment. We have made, and will continue to make, substantial expenditures to comply with these provisions. In addition, because environmental laws and their enforcement are becoming more stringent, our capital expenditures and expenses for environmental compliance may increase substantially in the

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future. The amount of investments that we make in any given year is subject to limitations imposed by the State Government. Expenditures required for compliance with environmental regulation may result in reductions in other strategic investments that we have planned, which could negatively affect our profitability. We could also be exposed to criminal and administrative penalties, in addition to indemnification obligations, for possible damage for non-compliance with environmental laws and regulations. Any material unforeseen environmental costs and liabilities may have a material adverse effect on our future financial performance.

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

We are a party to a number of legal proceedings involving significant monetary claims. These legal proceedings include, among others, tax, labor, condemnation and other proceedings. A substantial monetary judgment against us in one or more of these legal proceedings may have a material adverse effect on our business or financial condition. Based on advice we received from our lawyers, we have provisioned a total aggregate amount of R\$403.8 million to cover losses related to legal proceedings considered probable. This provision does not cover, however, all legal proceedings involving monetary claims filed against us. Any unfavourable judgment in relation to these proceedings may have an adverse effect on our cash-flow and results of operation.

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

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

Risks Relating to Brazil

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

The Brazilian economy has been characterized by significant involvement on the part of the Brazilian government, which often changes monetary, credit and other policies to influence Brazil's economy. The Brazilian government's actions to control inflation and affect other policies have often involved wage and price controls, currency devaluations, increases in the Central Bank's base interest rates, capital controls and limits on imports, as well as other measures, such as the freezing of bank accounts, which occurred in 1990.

Actions taken by the Brazilian government concerning the economy may have important effects on Brazilian corporations and other entities, including Sabesp, and on market conditions and prices of Brazilian securities, including our equity and debt securities. Our financial condition

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and results of operations may be adversely affected by the following factors or the Brazilian government's response to them:

devaluations and other exchange rate movements;

inflation;

exchange control policies;

social instability;

price instability;

energy shortages;

interest rates;

liquidity of domestic capital and lending markets;

tax policy; and

other political, diplomatic, social and economic developments in or affecting Brazil.

Brazil's President, Luiz Inacio Lula da Silva, was elected in October 2002 and took office on January 1, 2003. In the period leading up to and following his election, there was substantial uncertainty regarding the policies that the new government would pursue, including the potential implementation of macroeconomic policies that differed significantly from those of the prior administration. This uncertainty resulted initially in a loss of confidence in the Brazilian capital markets and the devaluation of the *real*. The new administration has, however, continued most of the former administration's economic and administrative policies and the initial adverse market sentiment towards the new administration has substantially reversed during 2003. Accompanying this positive sentiment the *real* appreciated 22.3% against the U.S. dollar in 2003. However, there remains some uncertainty over the possibility of different policies being adopted by the government which may, once again, contribute to economic uncertainty in Brazil and to heightened volatility in Brazilian securities. Any substantial negative reaction to the policies adopted by the Brazilian government from time to time could adversely affect the Company's business, condition (financial or other), revenues, results of operations and prospects and the market price of our common shares and ADSs.

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

The Brazilian currency has been devalued frequently during the last four decades. Throughout this period, the Brazilian government has implemented various economic plans and utilized various exchange rate policies, including sudden devaluations, periodic mini-devaluations (during which the frequency of adjustments has ranged from daily to monthly), exchange controls, multiple exchange rate markets and floating exchange rate system. From time to time, there have been significant fluctuations in the exchange rates between the Brazilian currency and the U.S. dollar and other currencies. For example, in 2000, 2001 and 2002, the *real*

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devalued 8.5%, 15.7%, 34.3% respectively, while appreciating 22.3% in 2003 against the U.S. dollar.

In the event of a significant devaluation of the *real* in relation to the U.S. dollar or other currencies, our ability to meet our foreign currency-denominated obligations could be adversely affected, particularly as our tariff revenues and other sources of income are based solely in *reais*. In addition, because we have substantial foreign currency-denominated indebtedness, any significant devaluation of the *real* during a financial period will increase our financial expenses as a result of foreign exchange losses that we must record. We had total foreign currency-denominated indebtedness of R\$3,012.7 million on December 31, 2003, and we anticipate that we may incur substantial amounts of foreign currency-denominated indebtedness in the future. For example, our overall results of operations for 2003 were significantly positively affected by 65% due to the appreciation of the *real* against the U.S. dollar in 2003.

A devaluation would reduce the U.S. dollar value of distributions and dividends on our ADSs and could reduce the market price of our common shares and ADSs.

The Brazilian government's actions to combat inflation and public speculation about possible future action may contribute significantly to economic uncertainty in Brazil and cause the price of our equity and debt securities to fall.

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

Inflation, as measured by the *Índice Geral de Preços de Mercado* (the General Price Index-Market, or the IGP-M), was 20.1% in 1999, 10.0% in 2000, 10.4% in 2001, 25.3% in 2002 and 8.7% in 2003. There can be no assurance that levels of inflation in Brazil will not increase in future years and have a material adverse effect on our business, financial condition, results of operations or prospects.

If Brazil experiences significant inflation in the future, our costs and expenses may rise, we may be unable to increase our tariffs to counter the effects of inflation, and our overall financial performance may be adversely affected. In addition, a substantial increase in inflation may weaken investor confidence in Brazil, so that the market price of our equity and debt securities declines.

Brazilian law might permit claims against our shareholders for harm to the environment.

Brazilian Law No. 9,605 of February 12, 1998 provides that the corporate structure of a company may be disregarded if it impedes recovery for undue harm to the environment. We cannot assure you that, in the case of claim for environmental damage under this law, liabilities would be limited to shareholders capable of exercising control over the company at the time of the environmental damage. Accordingly, if we were unable to redress claims against us for environmental damages, which might happen, for example, if we were to become insolvent, our shareholders and the members of our management might become liable for those claims. We

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are not aware of any successful assertion of claims against any shareholders of any Brazilian corporation under this law and cannot predict the circumstances in which this might happen.

Risks Relating to our Common Shares and ADSs

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 for approximately six months 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 depositary for our ADSs will hold the *reais* it cannot convert for the account of the ADR holders who have not been paid. The depositary will not invest the *reais* and it will not be liable for the interest.

If a holder exchanges ADSs for common shares, he or she risks losing the ability to remit foreign currency abroad and 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 a holder decides to exchange his or her ADSs for the underlying common shares, he or she 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 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, he or she 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, he or she 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.

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The relative volatility and illiquidity of the Brazilian securities market may substantially limit a holder's ability to sell the common shares underlying our ADSs at the prices and time he or she desires.

The Brazilian securities markets are substantially smaller, less liquid, more concentrated and more volatile than major securities markets in the United States and other jurisdictions, and are not as highly regulated or supervised as some of these other markets. The relatively small market capitalization and illiquidity of the Brazilian equity markets may substantially limit a holder's ability to sell the common shares underlying our ADSs at the price and time he or she desires.

A holder of common shares or ADSs may face difficulties in protecting his or her interests as a shareholder, because we are subject to different corporate rules and regulations as a Brazilian company and holders may have fewer and less well-defined shareholders' rights.

Our corporate affairs are governed by our by-laws and the Brazilian corporation law, which differ from the legal principles that would apply if we were incorporated in a jurisdiction in the United States, such as the State of Delaware or the State of New York, or in other jurisdictions outside Brazil. In addition, the rights of holders of our ADSs or common shares under the Brazilian corporation law to protect their interests relative to actions by our Board of Directors may be fewer and less well-defined than under the laws of those other jurisdictions.

Although insider trading and price manipulation are crimes under Brazilian law, the Brazilian securities markets are not as highly regulated and supervised as the U.S. securities markets or markets in some other jurisdictions. In addition, rules and policies against self-dealing and regarding the preservation of shareholder interests may be less well-defined and enforced in Brazil than in the United States, putting holders of our common shares and ADSs at a potential disadvantage. Corporate disclosures may be less complete or informative than what may be expected of a U.S. public company.

A holder of common shares or ADSs may face difficulties in protecting his or her interests as a shareholder because we are a Brazilian 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 such 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 execution or attachment, either prior to or after judgment.

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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 March 31, 2004, we had 28,479,577,827 common shares outstanding, including 20,376,674,058 shares held by the State of São Paulo. As a consequence of the issuance of common shares or sales by the State of São Paulo 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.

A holder of ADSs might be unable to exercise preemptive rights with respect to the common shares underlying our ADSs.

A holder may not be able to exercise the preemptive rights relating to the common shares underlying his or her ADSs 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 preemptive 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, a holder may receive only the net proceeds from the sale of his or her preemptive rights by the depositary or, if the preemptive rights cannot be sold, they will be allowed to lapse.

A non-Brazilian holder of our ADSs may find it more difficult than our Brazilian shareholders do 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 ADS holders of their voting rights through the depositary with respect to the underlying common shares. However, there are practical limitations upon the ability of ADS 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. ADS 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 holders of ADSs the notice of the meeting and a statement as to the manner in which instructions may be given by holders. To exercise their voting rights, ADS 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 ADS 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.

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Developments in other emerging market countries may adversely affect the Brazilian economy and, therefore, the market prices of our common shares and ADSs, as well as of our debt securities.

In the past, the Brazilian economy and the securities of Brazilian companies have been, to varying degrees, influenced by economic and market conditions in other emerging market countries as well as investors' responses to those conditions.

In addition, although economic conditions are different in each country, investors' reactions to adverse developments in one country may affect the market price of securities of issuers in other countries, including Brazil. For example, the 1997 Asian economic crisis and the 1998 Russian debt moratorium and devaluation of the Russian currency triggered market volatility in Latin America and securities markets in other emerging market countries. Accordingly, adverse developments in other emerging market countries could lead to a reduction in the demand for, and market prices of, our common shares and ADSs, as well as our debt securities.

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ITEM 4. INFORMATION ON THE COMPANY

General

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 corporation law. Our principal executive offices are located at Rua Costa Carvalho, 300, 05429-900 São Paulo, SP, Brazil. Our telephone number is (55-11) 3388-8000. Our agent for service of process in the United States is CT Corporation System, with offices at 111 Eighth Avenue, New York, New York 10011. As set forth in Article 2 of our by-laws, our corporate purpose is to plan, execute, and operate basic sanitation services throughout the territory of the State of São Paulo, including the capture, collection, processing and distribution of water, as well as the collection, removal, processing and final disposal of sewage and sludge.

We believe we are one of the largest water and sewage companies in the Americas based upon net revenues in 2003. We operate public 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, or IBGE, the State of São Paulo is Brazil's most populous and economically productive state. We had net operating revenue of R\$4,109.9 (US\$1,422.5 million) and net income of R\$833.3 million (US\$288.4 million) in 2003. We had total assets of R\$16,530.7 million (US\$5,721.5 million) and shareholders' equity of R\$7,576.9 million (US\$2,622.5 million) on December 31, 2003.

We provide water and sewage services to a broad range of residential, commercial, industrial and governmental customers in the City of São Paulo and in 367 of the 645 other municipalities in the State of São Paulo. We also supply water on a bulk basis to municipalities in the São Paulo Metropolitan Region in which we do not operate water systems. Until December 2002 we divided our service territories into three regions: the São Paulo Metropolitan Region, comprised of 31 municipalities in the metropolitan area of the City of São Paulo, the Interior Region (comprised of 306 municipalities along the São Paulo state countryside), and the Coastal Region (comprised of 29 municipalities in the São Paulo coastline). During 2003 we performed a reorganization of our internal organizational chart, according to which the Interior and Coastal Region divisions were consolidated into one single unit named Regional Systems. The São Paulo Metropolitan Region remained the same. According to this new structure, the São Paulo Metropolitan Region and the Regional Systems accounted for 76% and 24% of our sales and services rendered in 2003, respectively.

On December 31, 2003, we distributed water to approximately 21.3 million persons, which we believe includes approximately 58% of the urban population of the State of São Paulo, through approximately 56.8 thousand kilometers of water pipes and mains to more than 6.0 million water connections. We provided sewage services to approximately 17.2 million persons, or 80% of our water customers, through approximately 35.8 thousand kilometers of sewer lines, trunk lines, interceptors and outfalls to approximately 4.5 million sewage connections. At December 31, 2003, we sold water in bulk to 6 other municipalities having an estimated population of approximately 3.8 million.

The State of São Paulo, our controlling shareholder, is required by State law to own at least one-half plus one of our common (voting) shares. On April 30, 2004, approximately 71.5% of our

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outstanding common shares were owned by the State of São Paulo. As a state-controlled company, we are an integral part of the governmental structure of the State of São Paulo. Our strategy and major policy decisions are formulated in conjunction with the Energy, Water Resources and Sanitation Secretariat of the State of São Paulo as part of the overall strategic planning for the State of São Paulo. The majority of the members of the Board of Directors and the Executive Committee of Sabesp are nominated by the State Council for Protection of Capital of the State of São Paulo (*Conselho de Defesa de Capitais do Estado de São Paulo - 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 State Legislature and is approved in conjunction with the budget of the Energy, Water Resources and Sanitation Secretariat and of the State of São Paulo as a whole. However, the Governor of the State of São Paulo has the power to modify our capital expenditure budget after it has been approved. 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 of São Paulo.

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 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 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% of Brazil's land mass and encompasses an area totaling approximately 96,000 square miles. According to IBGE, the State is the most populous state in Brazil, with an estimated population on December 31, 2003 of 39.0 million.

On December 31, 2003, the City of São Paulo, the State's capital, had an estimated population of 10.6 million, with 18.7 million inhabitants in the greater metropolitan region of São Paulo. The São Paulo Metropolitan Region encompasses 39 cities, 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, 1999 Revision. The São Paulo Metropolitan Region accounted for approximately 48% of the population of the State.

According to IBGE, in 2001, the most recent year for which this data is available, the GDP of the State of São Paulo was approximately R\$401 billion, representing approximately 33.4% of Brazil's total GDP, making it the largest economy of any state in Brazil, based on GDP. The State is the leading Brazilian state in terms of manufacturing and industrial activity, 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 is the most important exporting state in Brazil, according to the Brazilian Ministry of Development, Industry and Foreign Trade.

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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 of São Paulo. Historically, water and sewage services in substantially all other municipalities of the State of São Paulo were administered by the municipalities directly either by municipal water and sewage departments or through *autarquias* of the municipal government. *Autarquias* are relatively autonomous public bodies with separate legal standing, assets and revenues, created by law to undertake administration of public services, which are considered to be better managed by a decentralized administrative and financial structure.

In 1954, in response to dramatic population growth in the São Paulo Metropolitan Region, the government of the State of São Paulo created the Department of Water and Sewers (*Departamento de Águas e Esgotos*), as an *autarquia* of the State Government. 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, whose purpose was to provide potable water in bulk 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 of São Paulo 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 such activities were transferred to SAEC. Also in 1970, the State Government 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 such 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 Sabesp 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 the formation of Sabesp, 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 Sabesp.

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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 enterprise whose financial performance was only a secondary consideration of the State of São Paulo. The tariff structure then in place did not generate sufficient revenues to enable Sabesp to provide adequate service to existing or new customers or to satisfy its liquidity and capital requirements, but instead was reflective of political considerations which viewed water and sewage services as a public entitlement.

As a result of our operational and financial problems, we experienced difficulties in providing basic water and sewage services to our then existing customer base and in maintaining our water and sewage systems. We had a net loss of R\$223.1 million for the year ended December 31, 1994 and had some difficulty meeting all of our debt and other obligations. We also had significant and increasing levels of unpaid accounts receivables from our customers, including the State of São Paulo and municipal governments. In terms of operations, we were unable to meet the demand for water from our customers and in late 1994 approximately six million persons in the municipalities that we served were subject to water rationing on a regular basis. Because we did not have the resources to make necessary capital expenditures to maintain our water and sewage systems, we experienced frequent breakdowns in our water distribution and sewage collection networks. The weakened condition of our system exacerbated water shortages and threatened, in some cases, water supplies. The general deterioration in service led, in turn, to negative relationships with the municipalities served by Sabesp and a poor overall public image for Sabesp.

During 1995, we, in conjunction with the administration of the State of São Paulo, 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. Under the organizational restructuring, we reordered our organizational structure into six divisions and sixteen business units in an effort to be more responsive to the requirements of the customers and municipalities served.

Our capital expenditure program since 1994 has been designed to improve and expand our water and sewage systems and to increase and protect our water sources. The work completed to date has helped to limit rationing and to permit Sabesp to install additional water and sewage connections to respond to growing demand for services, particularly in the City of São Paulo. We believe that the above-mentioned actions and the continuing implementation of our overall strategy have, to date, permitted a recovery in terms of our business operations and financial performance and should provide the basis for our long-term operational and financial development, although there can be no assurance in this regard.

Strategy

Our primary mission is to improve the quality of life of the population of the State of São Paulo and, in particular, to meet the growing demand for water and sewage services in an environmentally responsible manner. We are seeking to improve our operations so that we can fulfill our primary mission and at the same time strengthen our financial condition.

Our overall strategy is based upon three guiding principles:

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Marketing Strategy: to improve and expand water and sewage services for our customers and to obtain water and sewage concessions in additional municipalities in the State of São Paulo;

Economic/Financial Strategy: to enhance our financial condition and for-profit orientation by, among other things, reducing water loss and operating costs, increasing productivity and diversifying sources of financing; and

Political/Institutional Strategy: to develop closer relationships with municipal governments by means of decentralized business units and increased participation of municipal mayors in decisions affecting their municipalities.

These three global strategic principles are broken down in the following seven elements:

Continue to Improve and Expand Water and Sewage Services-Our goal is to improve and expand our water services in order to meet the demand for these services in the areas we serve, and to improve and expand our sewage collection and treatment services. Our capital expenditure program, which will require total expenditures by Sabesp of approximately R\$4.3 billion in the period from 2004 through 2008, is designed to achieve this goal.

Reduce Water Losses-As one of our central goals, we seek to reduce both physical water losses (due primarily to leakage from our water system) and non-physical water losses (due to meter errors that prevent proper accounting of water use, improper classification of customers, fraud and illegal connections). We are continuing our efforts to reduce physical water losses through, among other things, replacement and repair of water mains and pipes and installation of probing and other equipment. We are continuing our program of strategically installing 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 are aiming to reduce non-physical water losses through the upgrading and replacing of inaccurate water meters and the increased outsourcing to third party contractors of meter reading activities. 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 to minimize losses.

Continue to Reduce Operating Costs and Increase Productivity-We are continuing our efforts to lower operating costs and increase productivity. In order to achieve this, we plan to reduce our total salary and payroll expenses by decreasing the number of our employees, outsourcing more of our activities and automating some of our operations. We have in the past and expect in the future to reduce our headcount through voluntary resignation and early retirement programs. We are also continuing our efforts to outsource meter reading and maintenance services in the Regional Systems as we have successfully done in the São Paulo Metropolitan Region. Finally, in an effort to further increase productivity, improve safety and reduce our head count, we are continuing our efforts to automate our operations, especially in the Interior Region, where introduction of new technology will lead to greater operating efficiencies.

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Obtain Additional Municipal Water and Sewage Concessions and Operations-We regularly explore the possibility of obtaining additional water and sewage concessions in municipalities in the State of São Paulo in which we currently have no operations or to which we currently supply water solely on a bulk basis. We evaluate possible expansion opportunities in terms of proximity to our existing service areas and projected positive contributions to our financial performance. Since January 1, 1997, we have obtained 33 additional concessions to provide water and sewage services in municipalities in the State of São Paulo, including the municipalities of Osasco, which was one of our bulk sales customers, and Itapira (acquired in March 2004). We have also (in December 2003) acquired the right to operate water and sewage services in the municipality of São Bernardo do Campo through the transfer of all related assets from the municipality to us. Until December 2003, we provided water to São Bernardo do Campo on a bulk basis.

Improve Collection of Overdue Accounts Receivables-We are continuing efforts to improve our collection of overdue accounts receivables from municipalities to which we provide water on a bulk basis, the State of São Paulo and some governmental entities. Some of the municipalities to which we provide water on a bulk basis do not pay for our services in full or on a timely basis. We are actively pursuing these municipalities for the amounts overdue and exploring opportunities to take over the concessions of these municipalities.

Diversify Sources of Financing-Our goal is to continue to identify and secure diverse sources of financing, both public and private, with an emphasis on borrowing in local currency to reduce our exposure to foreign currency risk. Currently, we are negotiating with the Japan Bank for International Cooperation, the Brazilian National Social and Economic Development Bank (BNDES) and *Caixa Econômica Federal* (a bank owned by the Brazilian government) with a view to obtaining loans to finance our capital expenditure program. We are also exploring and pursuing various structured finance alternatives.

Develop Closer Relationships with Municipal Governments and Customers-We are seeking to develop closer relationships with the municipal governments and customers that we serve. We meet regularly with the mayors of municipalities and organize regional management commissions comprised of mayoral representatives and our officers to discuss water and sewage service, capital expenditure, tariff and other issues. We are also working to improve customer relations by shortening response times for customer installations as well as through a focused public relations program to enhance our image.

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 and, at the same time, to bolster our results of operations and financial condition.

Corporate Organization

During 2003 we have reorganized our corporate management structure. As a result we presently have six 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 President.

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President's Office - is responsible for coordinating all six divisions in accordance with the policies and directives established by our Board of Directors and Executive Committee, performing the coordination, evaluation and control of all functions related to the President's Office, strategic planning, corporate organization, corporate communication, audit and ombudsman.

Corporate Management Division - is responsible for marketing, human resources and quality control programs, legal affairs, information technology, asset management, contracts and procurement.

Economic and Financial and Investor Relations Division - is responsible for financial and economic resources and planning, capital markets and debt control, accounting and investor relations. This division also monitors and acts as controller for our other divisions.

Technology and Planning Division - is responsible for integrated technical planning, environmental planning and management, technological development, management and control of water quality, strategic maintenance and coordination and execution of special projects.

Metropolitan Division - is responsible for the distribution of water and collection of sewage for the São Paulo Metropolitan Region. The main function of this division is planning, operating and maintaining the water and sewage distribution system and customer relations services in the São Paulo Metropolitan Region, as well as providing technical support for autonomous municipalities.

Regional Systems Division - is responsible for the production of water and the operation and maintenance of water and sewage systems in municipalities in the Interior and Coastal Regions. It is also responsible for performing the same tasks as the Metropolitan Division within the Regional Systems.

Each business unit providing water and sewage services to customers participates in a regional assembly consisting of the mayors of the municipalities covered by such unit and our officers. In addition, for each unit, a regional management commission comprised of five to eight mayors and five to eight of our officers has been established to facilitate discussions and decision-making over such issues as the unit's budget, capital expenditure program, tariffs, and water and sewage services generally.

As a result of the establishment of the regional management commissions, we believe that we have improved our relationships with the municipalities and with our customers generally and that we have been able to balance better the service requirements of our customers with our own operational and financial objectives. The increased interaction between Sabesp and the municipalities has been responsible for renewed indications of interest in our water and sewage services on the part of those municipalities not currently being served by Sabesp.

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 State Constitution provides that the

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State of São Paulo 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 applicable law, we are responsible for planning basic water and sewage services and operating the related systems in the State of São Paulo, whilst respecting the autonomy of its municipalities. The municipalities are empowered to, and commonly do, grant long-term concessions to water and sewage companies to provide such services.

We do not hold a formal concession to provide water and sewage services in the City of São Paulo, which accounts for a substantial majority of our sales and services rendered, and in 41 other municipalities in the State of São Paulo. None of these other municipalities has a significant population, other than Santos, which has a population exceeding 400,000. We believe that we have a vested right to provide water and sewage services based upon, among other things, 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 which formed Sabesp.

We also provide water and sewage services in 325 additional municipalities in the State of São Paulo pursuant to concessions granted by the municipalities. Substantially all of these concessions have 30-year terms, 273 of which expire between 2004 and 2010 and the rest of which expire between 2011 and 2030. Each of these concessions is automatically renewable for a period equal to its initial term, unless the municipality or we exercise the right to terminate the concession prior to the six-month period ending on the expiration date of the concession.

The concessions are based on a standard form of contract between Sabesp and the relevant municipality. Each contract must receive the prior approval of the legislative council of the relevant 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;

The assets comprising the existing municipal water and sewage systems are transferred from the municipality to Sabesp. 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% discount factor to Sabesp, from the concession being acquired. Payment is made with a mix of cash and common shares issued at market value;

We are exempt from municipal taxes and no royalty is payable to the municipality in respect of the concession;

We are granted rights of way on municipal property for the installation of water pipes and mains and sewage lines;
and

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.

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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 as were used to determine the value of the concession at its inception (adjusted for inflation).

Municipalities have the inherent power under Brazilian law to terminate concessions prior to their contractual expiration dates for reasons of public interest. Diadema and Mauá, two municipalities previously served by Sabesp, terminated their concessions to Sabesp in February 1995 and December 1995, respectively. Diadema terminated its concession to Sabesp after asserting that we did not provide adequate water and sewage services, while Mauá did so with the consent of Sabesp. In December 1996, we have commenced legal action to collect payment due from Diadema. The lower courts have issued a decision against Sabesp and in November 2000 we appealed such decision. As of April 2004 the appeal has not yet been judged. This legal action was followed by several other related legal proceedings, which are currently pending. We entered into a settlement agreement with Mauá at the time the concession was terminated in which Mauá agreed to make the payments owed to Sabesp in connection with the return of water and sewage systems. However, to date Mauá has not yet made any payments to Sabesp under the settlement agreement. We commenced legal action in December 1996 against Mauá and, as of the date of this document, no decision has been issued by the lower court.

Diadema and Mauá are currently operating their own water and sewage systems, and we are supplying them with water on a bulk basis. On December 31, 2003, both Diadema and Mauá were in arrears with respect to amounts owed to Sabesp for water sold on a bulk basis prior to 1997, as well as for a portion of water sold since 1997.

In addition, in 1997, the municipality of Santos enacted a law expropriating the water and sewage systems of Sabesp in Santos. In response, Sabesp filed an action seeking an injunction against this expropriation which was denied by the lower court. This decision was later reversed by the Court of Appeals of the State of São Paulo, which issued a preliminary order suspending that law. On August 2, 2002, a decision on this matter was rendered in favor of Sabesp by a lower court, but such decision is still subject to appeal and we can give no assurance that the ultimate determination will be favorable to us. Despite the pending lawsuit, we continue to provide water and sewage services to Santos.

We currently do not anticipate that other municipalities will seek to terminate concessions due to, among other factors, our development of closer relationships with municipal governments, recent improvements in the water and sewage services we provide and the obligation of the municipality to repay Sabesp for the return of the concession as described above. We cannot be

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certain, however, that other municipalities will not seek to terminate their concessions in the future.

We have recently acquired the right to operate water and sewage services in the municipality of São Bernardo do Campo through the transfer of all related assets from the municipality to us. Previously, we provided water to São Bernardo do Campo on a bulk basis. The amount paid for the purchase of assets was estimated by an economic-financial valuation report, which included the liquidation of the water wholesale supply accumulated debt. See *Operating and Financial Review and Prospects Recent Developments* for information with respect to the São Bernardo do Campo transaction.

Water Operations

The supply of water by Sabesp to our customers generally involves abstraction of water from various sources, subsequent treatment and distribution to customers' premises. In 2003, we produced approximately 2,819.6 million cubic meters of water.

The following table sets forth the amount of water produced and invoiced by Sabesp for the periods stated.

	Year ended December 31,		
	2001	2002	2003
	(in millions of cubic meters)		
<i>Produced</i>			
São Paulo Metropolitan Region	1,989.4	2,046.1	2,085.9
Regional Systems	706.6	732.2	733.8
Total	2,696.0	2,778.3	2,819.6
<i>Invoiced</i>			
São Paulo Metropolitan Region ⁽¹⁾	1,225.8	1,275.9	1,278.2
Regional Systems	472.8	494.3	486.8
Total	1,698.6	1,770.2	1,765.0

(1) Includes water invoiced to bulk sales customers of 322.4 million in 2001, 339.6 in 2002 and 346.2 million in 2003, each in millions of cubic meters.

The difference between the amount of water produced and the amount of water invoiced generally represents both physical and non-physical water loss. See "*Water Distribution*" below. 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 significantly 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

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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,		
	2001	2002	2003
	(in millions of Reais)		
São Paulo Metropolitan Region	2,682.0	3,003.9	3,268.8
Regional Systems	861.5	958.5	1,038.7
Total sales	3,543.5	3,962.4	4,307.5

Water Resources

We can abstract water only to the extent permitted by the Department of Water and Energy of the State of São Paulo (*Departamento de Águas e Energia Elétrica do Estado de São Paulo*) and pursuant to authorization contracts executed 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 - 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 the São Paulo Metropolitan Region with water, we operate 19 reservoirs located in 8 water production systems. The availability of resources in such region is 66.1 cubic meters per second and should increase to 72.8 cubic meters per second in 2006 with the completion of planned improvements to the water system. The total production capacity currently reaches 67.7 cubic meters per second during peak demand periods. We estimate that demand for water currently averages 64.8 cubic meters per second and will reach an average up to 69.7 cubic meters per second by 2006. The main water production systems for the São Paulo Metropolitan Region are Cantareira and Guarapiranga, which collectively supply approximately 70% of the water produced by Sabesp for the São Paulo Metropolitan Region.

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

System	Production⁽¹⁾
	(in cubic meters per second)
Cantareira	31.3
Guarapiranga	13.4
Alto Tietê	9.6
Rio Claro	3.8
Rio Grande (Billings Reservoir)	4.7

Alto Cotia	1.0
Baixo Cotia	0.9
Ribeirão da Estiva	0.1
Total production	64.8

(1) Average of the twelve months ended December 31, 2003.

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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 of São Paulo. We currently do not pay any fees with respect to the use of these reservoirs. In December 2001, we entered into an agreement with the State whereby the State, among other things, agreed to transfer the remaining reservoirs in the Alto Tietê System to us. We cannot assure you as to when this transfer of reservoirs will take place. See *Item 7. Major Shareholders and Related Party Transactions-Related Party Transactions* .

Because of limited rainfall from 2000 to 2003, the São Paulo Metropolitan Region faced its worst drought in 65 years. From mid-June to mid-September in 2000, we rationed water in the south of the São Paulo Metropolitan Region, affecting approximately 3.5 million people, or 20% of the total population of this region. Under this rationing, water was made available to our customers for only two out of every three days. During this period of rationing, we also reduced our total water production by 8%.

From April 2001 through January 2002, we rationed water in the west of the São Paulo Metropolitan Region, affecting approximately 300,000 people, or less than 2% of the São Paulo Metropolitan Region. Under this rationing, water was made available to these 300,000 customers for only 40 out of every 72 hours. See "*Item 3. Key Information-Risk Factors-Risks Related to Sabesp-Droughts may result in major shortages in our water supply, which may have a material adverse effect on our company* .

The year of 2003 was also marked by low levels of rainfall and drought. From October to December 2003 we rationed water on the western part of the São Paulo Metropolitan Region, served by the Alto Cotia System, affecting approximately 450.000 people, or 2% of the Region's population. Under this rationing water was available to those customers for three days, followed by two days of rationing. During this period our total water production volume was reduced in 0.8%.

In the largest municipalities of the Interior Region, the principal source of water for Sabesp 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 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 the areas where we operate. In 2001, 2002 and 2003, 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, the installation of 751.5 thousand new water connections from 2000 through 2003 statewide, as well as the introduction of a new tariff structure which helped reduce average consumption and demand.

Water in the São Paulo Metropolitan Region is distributed through the Metropolitan Aqueduct System. The Metropolitan Aqueduct System is a network of aqueducts that covers most of the São Paulo Metropolitan Region, which allows for diversion of water from or to a particular region as demand varies, as required to properly supply a particular area of the network.

We are implementing as part of our capital expenditure program the Metropolitan Water Program, which involves substantial investments in reservoirs, water treatment facilities, water

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mains and the distribution network in the São Paulo Metropolitan Region to increase water production and to improve capacity of the Metropolitan Aqueduct System. The Metropolitan Water Program consists of a series of projects which will require approximately R\$620 million in investments from 2004 through 2008 in the São Paulo Metropolitan Region.

Water Treatment

We treat all water at our water treatment facilities prior to placing it into our water distribution network. We operate over 193 treatment facilities, of which the 8 largest, located in the São Paulo Metropolitan Region, typically account for approximately 76% of all water supplied by Sabesp. 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.

We use conventional treatment processes in our water treatment facilities. For surface water, the treatment process involves several phases, including filtration and disinfection. Groundwater typically is of higher purity and usually requires only disinfection by chlorine treatment. All water treated by Sabesp also receives fluoridation treatment.

Water Distribution

Water is distributed by Sabesp through our own networks of water pipes and mains, ranging in size from 2.5 meters to 100 millimeters in diameter. As of December 31, 2003, our water network contained approximately 56,777 kilometers of water pipes and mains and 6.0 million water connections.

Approximately 95% 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 and concrete.

We distribute treated water through our networks of mains and service pipes that deliver water through pressurized systems. Storage tanks and pumping stations regulate the volume of water flowing through the networks to maintain adequate pressure and continuous water supply.

We have a program to install valves to regulate water pressure throughout the water mains to correspond to downstream consumption needs during 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. Through December 31, 2003, we had installed such valves at strategic points in the network, with 703 valves installed in the São Paulo Metropolitan Region and 256 in the Regional Systems. We plan to install additional 130 valves through 2005.

As of December 31, 2003, our water distribution pipes and mains included approximately:

26,765 kilometers in the São Paulo Metropolitan Region; and

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30,012 kilometers in the Regional Systems.

We have 313 storage tanks in the São Paulo Metropolitan Region with a total capacity of 1.8 million cubic meters, and 1,666 storage tanks in the Regional Systems. We have 192 treated water pumping stations in the São Paulo Metropolitan Region, including stations at treatment facilities, intermediate trunk transfer pumping stations and small booster stations serving local areas.

Water derived from our water sources is relatively non-corrosive to pipe materials. As a result, structural weakness and leakage arising from internal pipe corrosion have not been problems for Sabesp. Operational experience suggests that the decrease in flow capacity as a result of reduced water pressure due to pipe encrustation in the older cast iron pipes has been a problem for Sabesp in the São Paulo Metropolitan Region. In addition, fractures in the pipes making up the distribution network caused by heavy vehicular traffic loads in the streets of the São Paulo Metropolitan Region have been a further problem for Sabesp. Operational experience also suggests that there is a relatively low incidence of external corrosion of pipe materials in the Coastal Region as a whole. External factors contribute to brittle fractures which are triggered by heavy vehicular traffic loads. These fractures occur most frequently in smaller pipes and house connections.

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 high population and commercial and industrial development, the condition of the water pipes and mains in the São Paulo Metropolitan Region is somewhat more susceptible to degradation than those in the Regional Systems. To counteract the effects of deterioration, we maintain a continuing program for maintenance of water pipes and mains intended to deal with anticipated fractures and clogs due to brittleness and encrustation, and maintain water quality.

Water mains that require maintenance are cleaned and relined. We are typically notified of water main fractures or breaks by the general population through a toll-free number maintained by Sabesp.

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. The installation of the water meter is performed by Sabesp, which also conducts periodical inspections and measurements. After completion of installation, the customer has a fiduciary duty to the network and the water meter.

Our Water Loss Reduction Program initiated in 1995 has two main objectives:

firstly, a reduction in the level of physical losses, which result primarily from leakage; and

secondly, the 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, as well as from clandestine and illegal use by customers.

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We are taking measures to decrease physical losses by reducing response times to broken pipes and mains to less than 24 hours and by better monitoring of non-visible water mains fractures. We currently repair approximately 4,000 broken pipes and mains per month. Among other measures we have adopted to reduce physical water losses are:

the introduction of technically advanced valves which provide for an automatic reduction of water pressure;

the reconfiguration of integrated water distribution to permit the distribution of water at lower pressure; and

routine operational leak detection surveys in high water pressure areas in each case helping to reduce overall water losses.

Measures adopted to decrease non-physical water losses include:

monitoring and better accounting for water connections, especially for large volume customers, regular checking on customers which are accounted for by Sabesp as inactive and monitoring those non-residential customers that are accounted for as residential and therefore are billed at a lower rate;

measures to fight fraud and 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 in the United States and Europe. Under a current Health Ministry regulation in effect in Brazil, we have significant statutory obligations regarding the quality of treated water. These laws set certain standards that govern water quality.

Some of our water sources in the southern area of the São Paulo Metropolitan Region contain low quality water due to the effects of pollution and algae growth. Currently, we successfully treat this water to make it potable; however, during dry periods of the year, this water retains an unpleasant taste and odor in spite of the treatment. If restrictions on the use of water are imposed in the future and if advanced treatment standards are not implemented, water originating from this area may decrease in quality and our customers may use only limited amounts of, or refuse to pay for, this lower quality water.

We have 15 laboratories that monitor water quality and purity as required by standards set by Sabesp and as required by law, which employ approximately 200 technicians, biologists, engineers and chemists. Our laboratories perform an average of 130,000 analyses per month. 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. Five of our laboratories have obtained ISO 9002 certification and two have obtained ISO-17025 certification.

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In addition, we have implemented the Real Time Water Quality Monitoring System for the São Paulo Metropolitan Region . Under this system, the water of some reservoirs located in the São Paulo Metropolitan Region is tested by 12 probes equipped with six sensors each attached to buoys which are set at different depths. This equipment permits Sabesp to make up to 9,000 analyses per probe per month. At the end of 2002, we temporarily stopped performing these analyses when the contract relating to them expired. After conducting a public bid, we have engaged another company to perform the analyses as from December 2003.

Water Source Program

From time to time, we face significant problems with algae growth, as it causes water to have an unpleasant taste and odor. In order to minimize this problem, we have implemented additional treatment processes such as absorption by powdered activated carbon and oxidation by potassium permanganate. We believe that all the chemicals used are safe for human consumption, but the algae problem creates significant additional costs because of the higher volumes of chemicals used to treat the raw water.

Algae growth tends to occur mainly in the Guarapiranga Reservoir, but it has also been frequently detected in the reservoirs that compose the Rio Grande and Alto Tietê systems. Algae growth in the Guarapiranga and Rio Grande reservoirs are basically due to the discharge of untreated sewage from squatters living adjacent to the reservoirs in violation of laws intended to protect the watershed. In the Alto Tietê system the algae growth is mainly caused by effluents from the agricultural use of the drained areas.

To mitigate the pollution problem in the Guarapiranga and Rio Grande reservoirs, we are planning to participate on the *Programa Mananciais* (or Water Source Program) together with other organizations engaged on the promotion of urban development and social inclusion. In this program Sabesp will be responsible for the expansion of sewage systems, pre-treatment of streams and development more sophisticated treatment facilities.

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 of sewage through our sewage systems and for its subsequent disposal with or without prior treatment. On December 31, 2003, we collected 81% and 73% 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 78% of all the sewage produced in the municipalities in which we operate in the State of São Paulo.

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Sewage System

The primary function of our sewage system is to collect, convey and treat sewage. As of December 31, 2003, we were responsible for the operation and maintenance of approximately 35,759 kilometers of sewer lines, trunk lines, interceptors and outflows, of which approximately 17,659 kilometers are located in the São Paulo Metropolitan Region, and 18,100 kilometers are located in the Regional Systems.

Our sewage system is comprised of a number of systems built at different times and constructed primarily from clay pipes and, more recently, PVC tubing. Sewer lines larger than 0.5 meters in diameter are primarily made of concrete. Our sewer 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 by 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 occurring at sewage treatment facilities and, therefore, such 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 such 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.

Effluents from our sludge treatment facilities (*Estações de Tratamento de Esgotos - ETEs*) shall comply with flow and quality 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