

COMPANHIA DE SANEAMENTO BASICO DO ESTADO DE SAO PAULO-SABESP

Form 20-F

July 15, 2010

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

FORM 20 F

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

OR

**ý ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE
ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2009**

OR

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

For the transition period from _____ to _____

OR

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

Date of event requiring this shell company report _____

Commission file number 001 31317

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

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

Federative Republic of Brazil
(Jurisdiction of incorporation or organization)

Rua Costa Carvalho, 300

05429 900 São Paulo, SP, Brazil
(Address of principal executive offices)

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Rua Costa Carvalho, 300 05429 900 São Paulo, SP, Brazil

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

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

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

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

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

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

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

227,836,623 Common Shares, without par value, as of December 31, 2009

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

Yes No

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

Yes No

Indicate by check mark whether the registrant has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports).

Yes No

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

Yes No

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

Large accelerated filer Accelerated filer Non accelerated filer

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

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

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

Item 17 Item 18

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

Yes No

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Presentation of Financial and Other Information

We maintain our books and records in *reais*. We prepared our consolidated financial statements included in this annual report in accordance with International Financial Reporting Standards, or IFRS, as issued by the International Accounting Standards Board, or IASB. These consolidated annual financial statements are our first financial statements prepared in accordance with IFRS. IFRS 1 First time Adoption of International Financial Reporting Standards has been applied in preparing these financial statements. Until December 31, 2008, our consolidated financial statements were prepared in accordance with accounting practices adopted in Brazil (Brazilian GAAP). Brazilian GAAP, which is based on Brazilian Corporate Law No. 6,404 of December 15, 1976, as amended, including the provisions of Law No. 11,638/2007 and Provisional Measure No. 449/2008, converted into Law No. 11,941, dated May 27, 2009; accounting standards issued by the Brazilian Institute of Independent Auditors (*Instituto dos Auditores Independentes do Brasil*), or IBRACON; accounting standards issued by the Brazilian Federal Accounting Council (*Conselho Federal de Contabilidade*), or the CFC; accounting standards issued by the Accounting Standards Committee (*Comitê de Pronunciamentos Contábeis*), or the CPC, and the rules and regulations issued by the Brazilian Securities Commission (*Comissão de Valores Mobiliários*), or the CVM.

Brazilian GAAP differs in certain significant respects from IFRS. When preparing our 2009 consolidated financial statements under IFRS, management has amended certain accounting methods in the Brazilian GAAP financial statements to comply with IFRS. The comparative figures in respect of 2008 have been restated to reflect these adjustments. Reconciliations and descriptions of the effect of the transition from Brazilian GAAP to IFRS are given in Note 3 to our consolidated financial statements included elsewhere in this annual report.

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

In this annual report, references to *real*, *reais* or R\$ are to the Brazilian *real*, the official currency of Brazil. All references to U.S. dollars or US\$ are to the United States dollar, the official currency of the United States. As a result of the recent fluctuations in the *real*/U.S. dollar exchange rate, the commercial selling rate may not be indicative of current or future exchange rates. See *Item 3.A. Selected Financial Data Exchange Rates* for information regarding the *real*/U.S. dollar exchange rate since 2005.

Other Information

In this annual report, unless the context otherwise requires, references to *we*, *us*, *our*, *Company*, or *SABESP* refer to Companhia de Saneamento Básico do Estado de São Paulo SABESP. *Brazil* refers to the Federative Republic of Brazil and *State* refers to the State of São Paulo, which is also our controlling shareholder. The terms *federal government* and *Brazilian government* refer to the federal government of the Federative Republic of Brazil and *state government* refers to the state government of the State of São Paulo.

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

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

References to urban and total population in this annual report are estimated based on a research made by the State System Foundation Data Analysis (*Fundação Sistema Estadual de Análise de Dados*), or the SEADE: Projections for the State of São Paulo Population and Residences until 2025 (*Projeções para o Estado de São Paulo População e Domicílios até 2025*).

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

Forward Looking Statements Contained in this Annual Report

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

- general economic, political and other conditions in Brazil and in other emerging market countries;
- existing and future governmental regulation, including taxes on, and charges to, us;
- changes to tax laws in Brazil;
- inflation and currency devaluation in Brazil;
- the interests of our controlling shareholder;
- our ability to collect amounts owed to us by our controlling shareholder and by municipalities;
- our ability to continue to use certain reservoirs under current terms and conditions;
- our capital expenditure program and other liquidity and capital resources requirements;
- changes in the Brazilian environmental laws;
- droughts, water shortages and climate events;
- power shortages or rationing in energy supply or significant changes in energy tariffs;
- the effects of the agreement for provision of water and sewage services in the city of São Paulo, that we recently executed with the State and the city of São Paulo;
- our lack of formal agreements with certain municipalities to which we render our water and sewage services to, including the cities comprising the São Paulo metropolitan region except in the municipality of São Paulo;
- the right municipalities have to terminate our existing concession agreements prior to their expiration date;
- our ability to provide water and sewage services in additional municipalities and to maintain rights to provide the currently contracted services;
- the size and growth of our customer base;
- our ability to maintain universalization of water coverage ratio in the municipalities to which we provide water services and to increase sewage coverage ratio in the municipalities to which we provide sewage services;
- our level of indebtedness and limitations on our ability to incur additional indebtedness;
- our ability to access financing with favorable terms in the future;

- our costs relating to compliance with environmental laws and potential penalties for failure to comply with these laws;
- the outcome of our pending or future legal proceedings;

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- our management's expectations and estimates relating to our future financial performance;
- the regulation issued by the São Paulo State Sanitation and Energy Regulatory Agency, or ARSESP, regarding several aspects of our business, including limitations on our ability to adjust our tariffs; and
- other risk factors as set forth under *Item 3.D. Risk Factors*.

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

PART I

ITEM 1. Identity of Directors, Senior Management and Advisers

1.A. Directors and Senior Management

Not applicable.

1.B. Advisers

Not applicable.

1.C. Auditors

Not applicable.

ITEM 2. Offer Statistics and Expected Timetable

2.A. Offer Statistics

Not applicable.

2.B. Method and Expected Timetable

Not applicable.

ITEM 3. Key Information

3.A. Selected Financial Data

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

The selected consolidated financial information as of and for the years ended December 31, 2008 and 2009, prepared in accordance with IFRS, has been derived from our audited consolidated financial statements, which appear elsewhere in this annual report.

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

IFRS	As of and for the year ended December 31,	
	2008	2009
	(in millions of <i>reais</i> , except per share and per ADS data)	
Statement of operations data:		
Net revenue from sales and services	7,809.3	8,579.5
Cost of sales and services	(4,482.9)	(5,087.3)
Gross profit	3,326.4	3,492.2
Selling expenses	(499.7)	(610.4)
Administrative expenses	(580.0)	(717.1)
Operating profit	2,121.2	2,120.3
Financial income (expenses), net	(973.0)	(10.0)
Net income	862.9	1,507.7
Earnings per share basic and diluted	3.79	6.62
Earnings per ADS basic and diluted	7.58	13.24
Dividends and interest on shareholders equity per share	1.30	1.73
Weighted average number of common shares outstanding	227,836,623	227,836,623
Balance sheet data:		
Property, plant and equipment, net	49.3	50.6
Intangible assets, net	15,592.8	17,057.3
Total assets	18,711.3	20,243.1
Short term loans and financing	1,446.6	1,009.9
Long term loans and financing	5,414.3	5,548.0
Interest on shareholders equity payable	275.0	365.4
Total liabilities	11,386.3	11,804.5
Shareholders equity	7,325.0	8,438.6

Capital stock	6,203.7	6,203.7
Other financial information:		
Cash provided by operating activities	2,103.9	2,072.5
Cash used in investing activities	(1,640.3)	(1,964.0)
Cash provided by (used in) financing activities	(295.2)	36.9
Capital expenditures	(1,545.9)	(1,982.4)

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	As of and for the year ended December 31,				
	2005	2006	2007	2008	2009
Operating data (at period end):					
Number of water connections (in thousands)	6,489	6,609	6,767	6,945	7,118
Number of sewage connections (in thousands)	4,878	5,002	5,167	5,336	5,520
Percentage of population with water connections (in percentages)	100	99	99	99	99
Percentage of population with sewer connections (in percentages)	78	78	79	79	80
Volume of water billed during period (in millions of cubic meters)	1,759	1,807	1,847	1,878	1,917
Water loss percentage during period (average)(in percentages) ⁽¹⁾	32.4	31.9	29.5	27.9	26.0
Water loss per connection (average) ⁽²⁾	520	511	467	436	402
Number of employees	17,448	16,978	16,850	16,649	15,103

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

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

Exchange Rates

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

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

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

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

Month	Period end	Average for period⁽²⁾ (<i>reais</i> per U.S. dollar)	Low	High
January 2010	1.8748	1.7798	1.7227	1.8748
February 2010	1.8110	1.8416	1.8046	1.8773
March 2010	1.7810	1.7858	1.7637	1.8231
April 2010	1.7306	1.7566	1.7306	1.7806
May 2010	1.8167	1.8132	1.7315	1.8811
June 2010	1.8015	1.8065	1.7663	1.8658
July 2010 (through July 7, 2010)	1.7719	1.7786	1.7665	1.8006

Source: Central Bank

- (1) Represents the average of the exchange rates on the closing of each business day during the period.
- (2) Represents the average of the lowest and highest rates in the month.

Exchange rate fluctuations will affect the U.S. dollar equivalent of the *real* price of our common shares on the São Paulo Stock Exchange (*Bolsa de Valores, Mercadorias e Futuros de São Paulo*), or the BM&FBOVESPA, as well as the U.S. dollar equivalent of any distributions we make in *reais* with respect to our common shares.

3.B. Capitalization and Indebtedness

Not applicable.

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

Not applicable.

3.D. Risk Factors

Risks Relating to Brazil

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

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

- the regulatory environment related to our business operations and concession agreements;
- interest rates;
- exchange controls and restrictions, such as those which were briefly imposed in 1989 and 1990;
- currency fluctuations;
- inflation;
- liquidity of the Brazilian capital and lending markets;
- tax and regulatory policies; and
- other political, social and economic developments in or affecting Brazil.

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

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

Brazil experienced extremely high rates of inflation in the past. Inflation and the Brazilian government's measures to fight inflation have had significant negative effects on the Brazilian economy, contributing to economic uncertainty and heightened volatility in the Brazilian securities markets. The Brazilian government's measures to control inflation have often included maintaining a tight monetary policy with high interest rates, thereby restricting the availability of credit and reducing economic growth. The Special Clearing and Settlement System (*Sistema Especial de Liquidação e Custódia*), or SELIC, the official overnight interest rate in Brazil, at the end of 2007, 2008 and 2009 was 11.18%.

13.66% and 8.65%, respectively in line with the target rate set by the Brazilian Committee on Monetary Policy (*Comitê de Política Monetária*), or COPOM.

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

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

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

The Brazilian currency experienced frequent and substantial devaluations in relation to the U.S. dollar and other foreign currencies during the last decades. Throughout this period, the Brazilian government has implemented various economic plans and utilized a number of exchange rate policies, including sudden devaluations, periodic mini devaluations during which the frequency of adjustments has ranged from daily to monthly, floating exchange rate systems, exchange controls and dual exchange rate markets. From time to time, there have been significant fluctuations in the exchange rate between the Brazilian *real* and the U.S. dollar and other currencies. For example, the *real* depreciated against the U.S. dollar by 9.3% in 2000, 18.6% in 2001 and 52.25% in 2002. The *real* appreciated 11.81%, 8.66% and 17.15% against the U.S. dollar in 2005, 2006 and 2007, respectively. In 2008, the *real* depreciated by 30.1% and in 2009, appreciated by 25.5% against the U.S. dollar. There can be no assurance that the *real* will not further depreciate against the U.S. dollar. As of December 31, 2008, the exchange rate was R\$2.3370 per US\$1.00. As of December 31, 2009, the exchange rate was R\$1.7412 per US\$ 1.00. On June 15, 2010, the exchange rate was R\$1.7971 per US\$1.00.

In the event of a significant devaluation of the *real* in relation to the U.S. dollar or other currencies, our ability to meet our foreign currency denominated obligations could be adversely affected, particularly because our tariff revenue and other sources of income are based solely in *reais*. In addition, because we have foreign currency denominated indebtedness, any significant devaluation of the *real* will increase our financial expenses as a result of foreign exchange losses that we must record. We had total foreign currency denominated indebtedness of R\$1,745.6 million as of December 31, 2009, and we anticipate that we may incur substantial amounts of foreign currency denominated indebtedness in the future. In 2008, our results of operations were negatively affected by the 31.9% depreciation of the *real* against the U.S. dollar, which amounted to R\$438.9 million. In 2009, our results of operations were positively affected by the 25.5% appreciation of the *real* against the U.S. dollar, which amounted to R\$528.4 million. We do not currently have any hedging instruments in place to protect us against a devaluation of the *real* in relation to any foreign currency. A devaluation of the *real* may adversely affect us and the market price of our shares or ADSs.

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

The market value of securities of Brazilian companies is affected to varying degrees by economic and market

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

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

Risks Relating to Our Control by the State of São Paulo

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

The State of São Paulo, through its ownership of our common shares, has the ability to determine our operating policies and strategy, to control the election of a majority of the members of our board of directors and to appoint our senior management. As of June 15, 2010, the State owned 50.3% of our outstanding common shares.

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

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

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

Historically, the State and some State entities have had substantial overdue accounts payable to us relating to (i) the provision of water and sewage services and (ii) State mandated special retirement and pension payments that we make to some of our former employees for which the State is required to reimburse us. As of December 31, 2009, the amounts owed to us by the State for the provision of water and sewage services totaled R\$169.5 million. With respect to payment of pensions on behalf of the State, as of December 31, 2009, we understand that the State owed to us R\$1,394.7 million with respect to payment of pensions on behalf of the State, of which R\$1,167.9 million was not recorded, due to the current stage of the negotiations with the State and the uncertainty regarding the recovery of the amount. Amounts owed to us by the State for water and sewage services and reimbursements for pensions paid may increase in the future.

We have entered into agreements with the State to settle these overdue amounts payable to us. For a detailed discussion of these agreements, see *Item 7.B. Related Party Transactions*, and Note 9 to our consolidated financial statements. Pursuant to these agreements, the amounts due with respect to water and sewage services could be settled through the application of dividends payable to the State by us to the repayment of amounts owed to us through December 2007. In December 2007, the State agreed to pay us the outstanding balance in the amount of R\$133.7 million (as of November 30, 2007), in 60 consecutive monthly installments, beginning on January 2, 2008, and the amount of R\$236.1 million relating to part of the accounts overdue and unpaid from March 2004 through October 2007 regarding the provision of water supply and sewage collection services. We agreed to pay the State the outstanding balance of dividends, in the form of interest on shareholders' equity, due from March 2004 through December 2006, in the amount of R\$400.8 million, in the period from January through March 2008.

In March 2008, we entered into a commitment agreement with the State for the settlement of outstanding debts related to the reimbursement of pension benefits. Pursuant to the commitment agreement, the amounts due to us with respect to payments of pensions on behalf of the State may be partially settled through the transfer to us of certain reservoirs in the Alto Tietê System that we use and are owned by the State. In November 2008, we entered into an agreement with the State relating to payments of pension benefits made by us on its behalf. The State acknowledged that it owed us the outstanding balance of R\$915.3 million as of September 30, 2008 relating to payments of pension benefits made by us on its behalf. We accepted the reservoirs in the Alto Tietê System as partial payment (R\$696.3 million) subject to the transfer of the property rights of these reservoirs to us. It is not virtually certain that the State will be able to transfer the property rights of these reservoirs to us and thus we did not record this amount in our accounts receivable. Since November 2008, the State has been paying the remaining balance in the amount of R\$219.0 million in 114 successive monthly installments, starting in November 2008. We are unable to predict whether and when these reservoirs will be transferred to us because the Public Prosecution Office of the State of São Paulo (*Ministério Público do Estado de São Paulo*) filed a civil public action alleging that a transfer to us of ownership of the Alto Tietê System reservoirs is illegal.

See *Item 8.A. Consolidated Statements and other Financial Information Legal Proceedings Other Legal Proceedings*. The agreement also established that both we and the State should use our best efforts to settle the outstanding balance due to us by the State and we were expecting the State to recognize that it owed to us this amount. While we continue to negotiate directly with the State, we are not able to assure you that we will be successful in these negotiations. Accordingly, as of December 31, 2009, we have not recorded R\$1,167.9 million related to reimbursements for pension benefits paid on behalf of the State and have recorded a R\$1,299.8 million pension obligation.

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

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

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

Risks Relating to Our Business

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

Law No. 11,445, or the Basic Sanitation Law, was enacted on January 5, 2007. While it has been in effect for more than three years, it is still in its early stages of implementation in Brazil and we continue to be unable to anticipate all the effects that it might have on our operations and business. There are still several uncertainties related to the Basic Sanitation Law interpretation. On June 21, 2010, the federal government enacted the Federal Decree 7,217 regulating the Basic Sanitation Law. We cannot anticipate the effects that it will have on our business and operations, if any.

In addition, the ARSESP, the State agency responsible for regulating the basic sanitation industry, presently regulates our tariff structure and adjustments pursuant to the same tariff structure and adjustment formula that we otherwise apply. Pursuant to a cooperation agreement among the State and some municipalities, the ARSESP also regulates our tariffs in municipalities that selected ARSESP to regulate our tariffs.

Since 2008, the ARSESP has been developing new concepts in the tariff structure and adjustment formula in the future. The ARSESP expects to release a revised tariff structure and adjustments formula that includes such new

concepts in 2011. We cannot anticipate the additional changes that the ARSESP will implement on our tariff structure and adjustment formula nor the effects that these changes will have on us, in particular because our contractual rights under the concession agreements may not fully protect us due to its generally open ended nature. If the changes are unfavorable to us, our financial operations could experience a material adverse effect. Moreover, the ARSESP also enacted certain rules establishing (i) the general conditions for the services we render, (ii) the communication process for any failure in our services and (iii) the penalties for deficiencies in the services. We are currently evaluating the enforceability and legality of some of these rules. The compliance with the rules enacted by ARSESP may adversely affect us. In April 2010, the ARSESP submitted for public comments a new methodology for the determination of the compensation of the assets used in the basic sanitation services we render, in view of a future tariff reform. Although ARSESP has indicated that it implement the new methodology by September 2011, we cannot assure when the new rules will be enacted.

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Furthermore, under the Basic Sanitation Law, we are required to enter into contractual arrangements, before December 31, 2010, with every municipality with which we do not have a formal agreement with or with which our agreements have already expired, as is the case of certain municipalities located in the metropolitan regions where we are authorized to operate in accordance with local legislation. With respect to (a) the municipalities located in the metropolitan regions, we may not be in a position to comply with this requirement depending on the final decision of the Brazilian Supreme Court regarding the titularity of the basic sanitation services in the metropolitan regions, and (b) the municipalities located outside the metropolitan regions, the execution of new agreements will depend on certain acts that are beyond our control, such as the compliance by the municipalities of certain legal procedures. However, the Basic Sanitation Law does not provide for any penalty or fine in case of non compliance with this legal requirement. If any penalty or fine is duly imposed on us due to our non compliance with this legal requirement, our operations could experience a material adverse effect. We are currently renegotiating 82 concession agreements with municipalities located outside the São Paulo metropolitan regions that have expired over the last five years. From 2010 through 2030, 80 concession agreements will expire. In addition, we do not hold formal concessions to provide water and sewage services to 32 municipalities located in metropolitan regions. For further information on regulation, see *Item 4.B Business Overview Government Regulation The Basic Sanitation Law and Public Consortia Law and Cooperation Agreement for Joint Management*.

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

Our provision of water and sewage services in the city of São Paulo accounted for 55.5% of our gross revenues in the year ended December 31, 2009.

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

On June 23, 2010, we entered into a formal agreement with the State and the city of São Paulo to regulate the provision of these services. This agreement requires us, among other duties, (i) to invest at least 13.0% of the gross revenues we obtain from this agreement, net of the contribution for social security financing (*Contribuição para Financiamento da Seguridade Social*), or Cofins, and the contribution for the program for government Employee Fund (*Programa de Formação do Patrimônio do Servidor Público*), or Pasep, in the improvement of water and sewage infrastructure in the city of São Paulo; and (ii) to contribute 7.5% of the gross revenues we obtain from this agreement, net of Cofins and Pasep taxes, to the Municipal Fund of Environmental Sanitation and Infrastructure (*Fundo Municipal de Saneamento Ambiental e Infraestrutura*), or the São Paulo Municipal Sanitation Fund, established by Municipal Law No. 14,934/2009. In addition, the agreement provides that ARSESP, the State agency responsible for regulating the sanitation industry, will ensure that the tariffs charged (a) will adequately compensate us for the services we provide and (b) can be adjusted to restore the original balance between each party's obligation and economic gain (*equilíbrio econômico-financeiro*).

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

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

The agreement with the State and the city of São Paulo regulates the provision of water and sewage services in the city of São Paulo. The agreement does not define whether state or municipal governments have the right to execute concession and program agreements in metropolitan regions, since this issue is under discussion before the Brazilian Supreme Court. The Brazilian Supreme Court decision may affect the agreement in manner that we cannot anticipate. Discussion about the validity or terms of this agreement may cause a material adverse effect on us.

We have not entered into formal agreements for the provision of water and sewage services with certain of the municipalities we serve, including the cities comprising the São Paulo metropolitan region except in the municipality of São Paulo, and therefore may not be able to enforce our rights to continue to provide services in these municipalities.

We have not entered into formal agreements for the provision of water and sewage services with 31 municipalities in the State, including the municipality of Santos, which is located in the coastal region and has, as of December 31, 2009, a population of approximately 429,000, where we operate under a deed of authorization (*escritura pública de autorização*).

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

The Basic Sanitation Law sets December 31, 2010 as the deadline for water and sewage service companies, such as us, to regularize the provision of water and sewage services to municipalities, in those cases where there is no formal concession agreement to provide services to municipalities in effect. The Basic Sanitation Law did not define any penalty for the municipalities or for the water and sewage service companies in case this deadline is not observed. Consequently, we cannot anticipate if we are going to be subject to any penalty due to the lack of no formal concession agreement with some municipalities or if an eventual penalty will have a material adverse effect on us. We cannot anticipate the terms and conditions of these concession agreements and their effect on the provision of our services in these municipalities. See *Risks Relating to Our Business We cannot anticipate the effects that further developments of the Basic Sanitation Law and its interpretation will have on the basic sanitation industry in Brazil and on us.*

In addition, it remains uncertain whether state or municipal governments have the authority to plan and regulate basic sanitation services rendered to metropolitan regions, as well as the right to execute concession and program agreements. This issue is under discussion before the Brazilian Supreme Court, in a suit initiated by third parties. If the Brazilian Supreme Court grants this authority to municipal governments, under certain circumstances, we may be required to cease our operations in certain areas of the São Paulo metropolitan region in the event that certain municipalities opt to use another water and sewage service provider.

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

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

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

- we may become subject to substantial water related and sewage related charges imposed by governmental water agencies of the State and of the federal government related to the abstraction of water from, or dumping of sewage into, water resources controlled by these agencies, which we may not be able to pass on to our customers. See *Item 4.B. Business Overview Government Regulation Water Usage*;
- in some cases, we are required to continue providing services to certain municipalities to which we provide water on a wholesale basis that have overdue amounts owed to us and are not paying us on a regular basis and we cannot assure you of when or whether these municipalities will pay us in a timely manner;
- the degradation of watershed areas may affect the quantity and quality of water available to meet our costumers demand. See *Item 4.A History and Development Of the Company Capital Expenditure Program*;
- our tariffs may not increase in line with increases in inflation and operating expenses, including taxes, or increase in a timely manner, which may hinder us from passing on to our customers increases in our cost structure. These constraints may also have an adverse effect on our capability to fund our capital expenditure program and financing activities, and to meet our debt service requirements. See *Item 5.A. Operating and Financial Review and Prospects Factors Affecting Our Results of Operations Effects of Tariff Increases*;
- we are exposed to eventual droughts that may adversely affect our water supply systems, resulting in a decrease in the volume of water distributed and billed as well as in the revenue derived from water supply distribution services. See *Item 5.A. Operating and Financial Review and Prospects Factors Affecting Our Results of Operations Effects of Drought*; and
- we are dependent upon energy to conduct our operations and eventual shortages or rationing of energy may prevent us from providing water and sewage services and may also cause material damage to our water and sewage systems when we resume operations. Also, we may not be able to pass on to our customers significant increases in energy tariffs.

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

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

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

We have entered into 22 program agreements since January 1, 2010, bringing the total program agreements entered into since 2007 to 196. These 22 new agreements amount to 1.99% of our total revenues and 1.24% of our assets as of December 31, 2009. In addition, with the execution of the formal agreement with the State and city of São Paulo to regulate the provision of water and sewage services in the city of São Paulo on June 23, 2010, 24 municipalities remain without a formal agreement. These remaining municipalities account for 7.28% of our total revenues and 16.35% of our assets as of December 31, 2009.

We cannot assure that these municipalities will continue to require our services and enter into new concession agreements or program agreements with us. These municipalities may choose to assume the direct provision of water and sewage services or promote a public bidding process to select another water and sewage service provider. Depending on the eligibility requirements to participate in the public bidding processes, we may not qualify to participate in some or all of these public bidding processes. If we participate in these public bidding processes, we cannot assure you that we will win the bid.

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

In the event that certain municipalities assume the direct provision of water and sewage services or promote a public bidding process to select another water and sewage service provider, or the new terms or conditions of the concession or program agreements are less favorable to us, we may be materially and adversely affected. See *Item 4.B. Business Overview Our Operations and Item 4.B. Business Overview Government Regulation Public Consortia Law and Cooperation Agreement for Joint Management.*

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

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

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

In 1995, the municipality of Diadema terminated the concession agreement that had been entered into with us prior to the expiration of the concession agreement. As a result, we filed a lawsuit against the municipality of Diadema which we eventually settled in 1996. The municipality of Diadema did not comply with this settlement. As a result, in December 2008, we entered into a memorandum of understanding with the State of São Paulo, the municipality of Diadema and State Secretariat for Sanitation and Energy (*Secretaria de Saneamento e Energia do Estado de São Paulo*). This memorandum establishes our agreement to conclude negotiations and settle all outstanding amounts. In addition, it indicates our intent to develop a share infrastructure for the provision of water and sewage services. This memorandum of understanding stayed the collection proceedings we had filed against the municipality of Diadema. We continue to supply water on a wholesale basis to the city of Diadema.

For further information on these lawsuits, see *Item 8.A. Consolidated Statements and other Financial Information Legal Proceedings*.

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

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

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

Our capital expenditure program will require substantial liquidity and capital resources of approximately R\$8.6 billion in the period from 2009 through 2013. We recorded R\$1.8 billion in 2009 with our capital expenditure program.

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

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

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

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

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

lawsuits, see *Item 8.A. Consolidated Statements and other Financial Information Legal Proceedings.*

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

We are a party to a number of legal proceedings involving significant monetary claims. These legal proceedings include, among others, civil, environmental, tax, labor, condemnation and other proceedings. A substantial monetary judgment against us in one or more of these legal proceedings may have a material adverse effect on us. Based on advice from our legal counsel, we have provisioned a total aggregate amount of R\$1,468.8 million as of December 31, 2009 to cover probable losses related to legal proceedings. This provision does not cover all legal proceedings involving monetary claims filed against us and it may be insufficient to cover our liabilities related to these claims.

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

Risks Relating to Our Common Shares and ADSs

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

Investing in securities that trade in emerging markets, such as Brazil, often involves greater risk than investing in securities of issuers in major securities markets, and these investments are often considered to be more speculative in nature. The Brazilian securities market is substantially smaller, less liquid, more concentrated and can be more volatile than major securities markets. Accordingly, although you are entitled to withdraw the common shares underlying the ADSs from the depository at any time, your ability to sell the common shares underlying the ADSs at a price and time at which you wish to do so may be substantially limited. There is also significantly greater concentration in the Brazilian securities market than in major securities markets. The ten largest companies in terms of market capitalization represented approximately 50.4% of the aggregate market capitalization of the BM&FBOVESPA as of December 31, 2009. The top ten stocks in terms of trading volume accounted for approximately 45.8%, 53.14% and 50.4% of all shares traded on the BM&FBOVESPA in 2007, 2008 and 2009, respectively.

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

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

If a holder attempts to obtain his or her own certificate of registration, the holder may incur expenses or suffer delays in the application process, which could delay his or her ability to receive dividends or distributions relating to our common shares or the return of his or her capital in a timely manner. We cannot assure you that the custodian's certificate of registration or any foreign capital registration obtained by a holder may not be affected by future legislative changes, or that additional restrictions applicable to the holder, the disposition of the underlying common shares or the repatriation of the proceeds from disposition will not be imposed in the future.

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

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

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

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

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

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

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

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

ITEM 4. Information on the Company

4.A. History and Development of the Company

Overview

Companhia de Saneamento Básico do Estado de São Paulo SABESP is a mixed capital company (*sociedade de economia mista*) of unlimited duration, with limited liability, duly organized and operating under Brazilian Corporate Law. We were incorporated on September 6, 1973. Our principal executive offices are located at Rua Costa Carvalho, 300, 05429-900 São Paulo, SP, Brazil. Our telephone number is (55 11 3388 8000). Our agent for service of process in the United States is CT Corporation System, with offices at 818 West Seventh Street Team 1, Los Angeles, CA 90017. As set forth in Article 2 of our by laws, our corporate purpose is to render basic sanitation services aimed at the universalization of basic sanitation in the State of São Paulo without harming our long term financial sustainability. Our activities include water supply, sanitary sewage services, urban rainwater management and drainage services, urban cleaning services, solid waste management services and related activities, including the planning, operation, maintenance and commercialization of energy, and the commercialization of services, products, benefits and rights that directly or indirectly arise from our assets, operations and activities. We are allowed to operate, in a subsidiary form, in other Brazilian locations and abroad. See *Item 4.B. Business Overview Government Regulation Public Consortia Law and Cooperation Agreement for Joint Management*.

We believe we are one of the largest water and sewage service providers in the world based on the number of customers in 2009, according to the 11th edition of the Pinstent Masons Water Yearbook. We operate water and sewage systems in the State of São Paulo in which the city of São Paulo, Brazil's largest city, is located. According to the Brazilian Institute of Geography and Statistics (*Instituto Brasileiro de Geografia e Estatística*), or IBGE, the State of São Paulo is Brazil's most populous state and the state with the highest gross domestic product, or GDP, in Brazil. We had consolidated net revenue from sales and services of R\$8,579.5 million and consolidated net income of R\$1,507.7 million for the year ended December 31, 2009. Our total consolidated assets was R\$20,243.1 million and our total shareholders' equity was R\$8,438.6 million as of December 31, 2009.

We provide water and sewage services to a broad range of residential, commercial, industrial and governmental customers in 366 of the 645 municipalities in the State of São Paulo, including the city of São Paulo. We also supply water on a wholesale basis to six municipalities in the São Paulo metropolitan region in which we do not operate water systems. The total estimated urban population of these six municipalities is approximately 3.3 million. For the year ended December 31, 2009, the São Paulo metropolitan region (including the municipalities to which we provide water on a wholesale basis) and the Regional Systems accounted for 75.6% and 24.4% of our gross revenue from sales and services, respectively.

As of December 31, 2009, we provided water services to approximately 23.4 million people, approximately 60% of the urban population of the State of São Paulo, and effectively had a water coverage ratio of 100% through 63,732 kilometers of water pipes and mains to approximately 7.1 million water connections. As of December 31, 2009, we provided sewage services to approximately 19.6 million people through 42,895 kilometers of sewer lines to approximately 5.5 million sewage connections.

On August 15, 2008, we established a special purpose company called SESAMM – Serviços de Saneamento de Mogi Mirim S/A to provide sewage treatment services to the municipality of Mogi Mirim. The company has a period of duration of 30 years from the date that the concession agreement with the municipality of Mogi Mirim was executed. We control 36.0% of SESAMM's capital stock, which as of December 31, 2009 amounted to R\$10.7 million divided into 10,669,549 common shares with no par value.

The State, our controlling shareholder, is required by law to own at least 50% plus one of our common shares. The State currently owns 50.3% of our outstanding common shares. As a mixed capital company, we are an integral part of the State governmental structure. Our strategy and major policy decisions are formulated in conjunction with the State Secretariat for Sanitation and Energy as part of the overall strategic planning for the State. The majority of the members of our board of directors and our board of executive officers are nominated by the State Council for Protection of Capitals of the State (*Conselho de Defesa de Capitais do Estado de São Paulo*), or CODEC, a State agency presided over by the Secretary of the State Treasury (*Secretaria da Fazenda*) and reporting directly to the State governor.

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

Our Strengths

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

Well established business with significant size, scale and know how to operate in complex urban settings. We are one of the largest water and sewage service providers in the world. We provide water services directly to approximately 23.4 million people and supply water on a wholesale basis to an additional urban population of 3.3 million people. As of December 31, 2009, we effectively had a water coverage ratio of 100%. We also provide sewage services directly to approximately 19.6 million people, achieving a sewage coverage ratio of 80% as of December 31, 2009. From 2004 through 2009, our net revenue from sales and services has increased by an average of 8.89% per year. Our significant size and scale have required us to operate in complex urban settings such as *favelas* (shantytowns) and environments without urban planning, which has enabled us to develop skills to operate in adverse and have well trained personnel and a specialized structure that our competitors lack.

Operations in Brazil's most populous and wealthy state. The State of São Paulo, part of the most developed and economically active region of Brazil, is the most populous state in Brazil, with an estimated population of 42.4 million as of December 31, 2009. The city of São Paulo had an estimated population of 10.9 million as of December 31, 2009, with 20.2 million inhabitants in the São Paulo metropolitan region. Based on its GDP, the State of São Paulo is the wealthiest state and largest economy in Brazil. The GDP of the State of São Paulo was approximately R\$902.8 billion in 2007, representing approximately 34% of Brazil's total GDP. The State of São Paulo generates more revenue from water and sewage services than any other Brazilian state.

High quality operations. We believe that we adhere to high standards of service and utilize the best available technology in the sanitation business to control the quality of the water captured, produced and distributed. All 16 of our water quality control laboratories operate in accordance with the NBR ISO 9001, which follows the highest international standards. From our 16 laboratories, 13 are accredited by the National Institute of Metrology, Standardization and Industrial Quality, or INMETRO, thereby assuring the quality and accuracy of our test results, according to NBR/IEC ISO 17.025. Moreover, our laboratories and field teams use the latest equipment to detect substances controlled by regulations and have highly trained teams to handle contingencies and customer complaints. We believe our technology enhances the efficiency and quality of our operations

Access to low cost and diverse sources of financing. Our strong cash flow generation from operations and our role as an essential public service provider place us in a privileged position in our industry to obtain low cost, long term financing from Brazilian public banks, and domestic and international multilateral agencies and development banks.

In addition, we are not dependent upon a limited number of sources of financing. We benefit from various funding alternatives available in the Brazilian and international markets for our working capital needs and our capital expenditure programs.

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

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

Our Strategy

Our mission is to provide water and sewage services, contributing to the improvement of the quality of life and of the environment.

To this end, our strategic objectives are based upon the guiding principles of growth, quality, universalization of water services, social, economic and environmental sustainability. We also base our strategic objectives on our political and institutional relationships as well as on our commitment to the market to increase shareholder value. We seek to implement these guiding principles through the following strategies:

Reduce operating costs and increase productivity and profitability. We intend to make our best efforts to reduce operating costs and increase productivity and profitability. To achieve this goal, we plan to improve the management of our assets, as well as to continue to reduce our total salary and payroll expenses by decreasing the number of our employees, automating some of our operations, streamlining operational processes, implementing integrated planning and further investing in internal technological research and development. We will also continue our efforts to improve our collection of overdue accounts receivable from municipalities to which we provide services, from the State and from other governmental entities, including by exploring opportunities to offset these outstanding debts against certain possession or property rights over utilities relating to water and sewage systems.

Ensure the quality and availability of our services in our existing service area. Our goal is to maintain an effective water coverage ratio of 100% coupled with a high standard of quality and availability. We intend to continue to effectively have a water coverage ratio of 100% and meet the expected population growth by adding 1.4 million water connections by 2018 and to increase our sewage coverage ratio to 90% by 2018. To ensure the quality and availability of our services, we also intend to improve customer relations by shortening response times for customer installations as well as through a focused public relations program to enhance our image. In addition, we are also developing short, medium and long term marketing strategies, such as client segmentation and tailor made solutions for each type of client, which we believe will help us increase our customer base.

Maintain and continue to expand our existing service areas. We intend to maintain our operating base through the execution of new concession or program agreements. To this end, we are actively seeking to develop closer relationships with the municipal governments that we currently serve in order to increase customer loyalty and thereby renew all or substantially all our expiring concession agreements. Between 2007 and 2009, we have entered into 174 30 year term program agreements with municipalities, of which 14 were entered into in 2009. These 174 municipalities accounted for 8.2% of our total revenues for the year ended December 31, 2009 and 8.7% of our total assets as of December 31, 2009. As of December 31, 2009, 82 of our concession agreements had expired and are presently under renegotiation. These 82 municipalities accounted for 12.1% of our total revenues for the year ended December 31, 2009 and 12.9% of our total assets as of December 31, 2009. From 2010 to 2030, 80 concession agreements accounting for 9.1% of our total revenues for the year ended December 31, 2009 and 6.4% of our total assets as of December 31, 2009 will expire. We have entered into 22 program agreements since January 1, 2010, bring the total program agreements entered into since 2007 to 196. These 22 new agreements amount to 1.99% of our total revenues and 1.24% of our assets as of December 31, 2009. We have entered into an agreement with the State and city of São Paulo for the provision of water and sewage services in the city of São Paulo for a 30-year term, which in the year ended December 31, 2009, accounted for 55.5% of our gross revenues.

We have also developed a platform to offer unique services relating to sustainability, environmental preservation and water resource management to our large industrial, commercial and residential customers in order to encourage these customers to continue to use our water services. We also intend to continue to expand our sewage services. A significant portion of our capital expenditure program, of approximately R\$8.6 billion between 2009 and 2013, is designed to achieve this goal. We also regularly explore the possibility of executing agreements for the provision of water and sewage services in municipalities of the State of São Paulo in which we currently have no operations or to which we currently supply water and provide sewage treatment solely on a wholesale basis, representing a total population of approximately 16.4 million. We evaluate possible expansion opportunities in terms of proximity to our existing service areas to maximize return on investment and improve our financial performance. We also intend to study, and take advantage of, opportunities in other Brazilian states and in other countries to expand our services and increase our market share.

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

Continue to prudently manage our levels of indebtedness. We intend to continue to fund our working capital needs and estimated capital expenditure programs with diversified sources of financing, such as Brazilian public banks, domestic and international multilateral agencies, and development banks. We will continue to seek market opportunities for low cost financing and restructuring of our indebtedness if and when advantageous and appropriate to us. Our total financial indebtedness decreased by 4.4%, from R\$6,860.9 million as of December 31, 2008 to R\$6,558.0 million as of December 31, 2009. In addition, in 2009, our total foreign denominated indebtedness recorded a 23.4% decrease, from R\$2,280.1 million as of December 31, 2008, to R\$1,745.6 million as of December 31, 2009, as a result of the appreciation of the *real* versus the U.S. dollar and the amortization of international financing installments.

Improve operating efficiency and reduce water losses. We seek to reduce both real water losses and commercial water losses. To achieve long term and more consistent results, we have created a company wide program to reduce water losses. After a series of discussions with local and international institutions to obtain funding for the program, we were successful in obtaining funding for the first three years of the program (2009 through 2011) with the Brazilian National Bank for Economic and Social Development (*Banco Nacional de Desenvolvimento Econômico e Social*), or BNDES, and are at advanced stages of negotiation with the Government of Japan through the Japan International Cooperation Agency (JICA) for the funding of the next two years (2012 and 2013) of the program. Our focus is to renew our infrastructure in order to reduce real water losses, mainly through the implementation of supply

centers and districts of water measurement, which are water supply districts with a smaller number of connections. These measures will enable us to detect and repair leaks more efficiently. The program will also reduce commercial water losses by upgrading and replacing inaccurate water meters and by increasing supervision of irregular water consumption in active and inactive water connections. We reduced our water losses from 27.9% in 2008 to 26.0% in 2009.

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

State of São Paulo

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

The State of São Paulo occupies 3.0% of Brazil's land mass and encompasses an area amounting to approximately 96,000 square miles. According to the SEADE, the State of São Paulo had an estimated population of 42.4 million as of December 31, 2009. The city of São Paulo, the State of São Paulo's capital, had an estimated population of 10.9 million, with 20.2 million inhabitants in the São Paulo metropolitan region, as of December 31, 2009. The São Paulo metropolitan region encompasses 38 cities and is the third largest metropolitan region in the Americas and the fifth largest metropolitan region in the world, according to the United Nations' World Urbanization Prospects, 2007 Revision. The São Paulo metropolitan region accounted for approximately 48.0% of the population of the State of São Paulo as of December 31, 2009.

According to the IBGE, the GDP of the State of São Paulo was approximately R\$902.8 billion in 2007, representing approximately 34.0% of the Brazil's total GDP, making it the largest economy of any state in Brazil, based on the GDP. According to IBGE, the State of São Paulo is also the leading Brazilian state in terms of manufacturing and industrial activity, with a strong position in car manufacturing, pharmaceuticals, computer manufacturing, steel making and plastics, among other activities, as well as a leading position in the banking and financial services industries. The State of São Paulo is the most important exporting state in Brazil, according to the Brazilian Ministry of Development, Industry and Foreign Trade (*Ministério do Desenvolvimento, Indústria e Comércio Exterior*).

History

Until the end of the nineteenth century, water and sewage services in the State of São Paulo were generally provided by private companies. In 1877, the Province of São Paulo granted a concession for the rendering of water and sewage services to *Companhia Cantareira de Água e Esgotos*. In 1893, the government of the Province of São Paulo assumed responsibility for the rendering of water and sewage services from the *Companhia Cantareira de Água e Esgotos* and formed the Office of Water and Sewers (*Repartição de Água e Esgotos*), a governmental agency. Since that time, water and sewage services in the São Paulo metropolitan region have been administered by the State government. Historically, water and sewage services in substantially all other municipalities of the State were administered by the municipalities directly either by municipal water and sewage departments or through *autarquias* of the municipal government. *Autarquias* are relatively autonomous public bodies with separate legal standing, assets and revenues, created by law to undertake administration of public services, which are considered to be better managed by a decentralized administrative and financial structure.

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

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

On June 29, 1973, COMASP, SAEC and SANESP merged to form our Company with the purpose of implementing the directives of the Brazilian government set forth in the National Water Supply and Sanitation Plan (*Plano Nacional de Saneamento*). The National Water Supply and Sanitation Plan was a program sponsored by the Brazilian government, which financed capital investments in, and assisted in the development of, state controlled water and sewage companies. Since our formation, other State governmental and State controlled companies involved in water supply and sewage collection and treatment in the State of São Paulo have been merged into us.

Corporate Organization

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

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

- the Corporate Management Officer, who is responsible for marketing, human resources and quality control programs, legal affairs, information technology, asset management, legal and procurement, and contracts.
- the Chief Financial Officer and Investor Relations Officer, who is responsible for financial planning, raising and allocating financial resources to all divisions within the Company, conducting capital markets and other indebtedness related transactions and managing indebtedness levels, control department, accounting, corporate governance and investor relations.
- the Technology, Enterprises and Environment Officer, who is responsible for the environmental planning and management, technological and operating, quality control, developments and coordination and execution of special investment programs, projects and new businesses.
- the Chief Operating Officer of the São Paulo Metropolitan Region Division and the Chief Operating Office of the Regional Systems Division, who are responsible for managing the operation, maintenance, execution of planning and works for the water and sewage supply systems including planning and works for our services

rendered on a wholesale basis, sales and call center services, as well as the control of economic financial and operational performance of its division. These Chief Operating Officers are also responsible for sanitation advisory services to autonomous municipalities and for the mediation and the negotiation with communities and local governments, aimed at aligning our interests with the interests of our clients.

Capital Expenditure Program

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

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

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

	2010	Planned Capital Expenditures			2010-2013
		2011	2012	2013	
		(in millions of <i>reais</i>)			
Water	590	664	653	668	2,575
Sewage	948	835	867	827	3,477
Others	212	254	228	231	925
Total	1,750	1,753	1,748	1,726	6,977

Our capital expenditure program from 2009 through 2013 will continue to focus on achieving our targets by making regular investments in and expanding our infrastructure as well as making investments in the reduction of water losses throughout the 366 municipalities we serve. The following is a description of the main projects in our capital expenditure program.

Metropolitan System Investment Program

Metropolitan Water Program

Demand for our water services has grown steadily over the years in the São Paulo metropolitan region and has exceeded at times the capacity of our water systems. As a result, prior to September 1998, part of our customers in this region received water only on alternate days of the week. We refer to this as rotation. In order to remedy this situation, we implemented the Metropolitan Water Program to improve regular water supply to the entire São Paulo metropolitan region. This program terminated in 2000 and the rotation was eliminated, but we have maintained our investment projections for the region. The infrastructure of water storage tanks will be expanded by 210,000 cubic meters, 44 water pumping stations and 240 kilometers of mains will be constructed. The investment will reach R\$2.7 billion and the construction will expand the water production capacity in 13.2 cubic meters per second until 2014. We have been working on this project since 2006 and we expect to complete it by 2014. In 2007, 2008 and 2009, we invested R\$176.0 million, R\$223.0 million and R\$327.0 million, respectively, in this region. The Alto Tietê Public Private Partnership was the most significant project of the Metropolitan Water Program in 2009.

Alto Tietê Public Private Partnership (PPP)

In June 2008, we entered into a Public Private Partnership, or PPP, with Cab Spat, a special purpose company whose main shareholders are Cab Ambiental and Galvão Engenharia S.A. Cab Spat will be responsible for (i) expanding the Taiaçupeba water treatment plant capacity from 10 cubic meters per second to 15 cubic meters per second, (ii) building 17.7 kilometers of water connections and mains, (iii) building four water storage tanks with total capacity of 70,000 cubic meters, (iv) installing boosters, and (v) building pumping stations. The total investment in projects to be done by Cab Spat is estimated at R\$300.0 million. Cab Spat will also perform maintenance on the dams of the Alto Tietê System, at which time Cab Spat will also provide civil engineering, electromechanical and operational services, as well as sludge treatment and the corresponding services regarding water adduction and water supply. The total value of the project is estimated at R\$1.0 billion. We intend to pay these investments over 15 years upon the completion of the contracted projects and services. We initiated the provision of the services on February 1, 2009, and the works of construction on February 11, 2009. Throughout 2009, we executed 39.0% of the construction work.

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Tietê Project

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

In connection with the first phase of the Tietê Project, in June 1998, we completed the construction of three additional sewage treatment facilities and invested a total of US\$1.1 billion, of which US\$450.0 million was financed by the IDB, US\$100.0 million by *Caixa Econômica Federal*, or the Caixa, and US\$550.0 million by us.

The second phase of the project was carried out from 2000 through 2008, with investments of approximately US\$500.0 million, of which US\$200.0 million were financed by the IDB, R\$60.0 million by the BNDES, and R\$180.0 million by the BNDES through another financial institution. In this phase, 290,000 sewage connections and more than 1,500 kilometers of sewage collection networks, branch collectors and interceptors were installed and/or built. Upon the conclusion of the second phase of the project in 2008, we were able to collect approximately 5,000 liters of raw sewage per second and send it for treatment in the five sewage treatment plants of our integrated system.

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

As part of the second phase of the Tietê Project, we implemented the geographic information system named SIGNOS. SIGNOS is a management information system which automates and integrates various business processes, including project management, maintenance, operations and customer service and maps out our entire municipal infrastructure in the São Paulo metropolitan region.

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

As of December 31, 2009, we owed US\$164.5 million to the IDB for the financing it provided. For further information on the agreement entered into with the IDB, see *Item 5. Operating and Financial Review and Prospects Liquidity and Capital Resources Capital Sources*. We now provide secondary treatment to approximately 70.0% of the sewage collected in the São Paulo metropolitan region. The five principal sewage treatment facilities in the São Paulo metropolitan region have an aggregate installed capacity of 18 cubic meters of sewage per second and currently treat an aggregate of 15 cubic meters of sewage per second. We plan to build additional collection lines to direct more raw sewage to our treatment facilities.

The third phase of the Tietê Project, designated as the decontamination of the Tietê river, aims at contributing to the recuperation of the water quality of the Tietê river basin through the expansion of the level of collection and treatment of sewage in the São Paulo metropolitan region. The total estimated cost of the third phase is US\$1.1 billion.

The program plan of the third phase comprises mainly (i) drainage collection (collection networks and home connections), (ii) removal and transport of the drainage for treatment (branch collectors and interceptors), and (iii) the construction of sewage treatment plants, not only of the integrated drainage system of the São Paulo metropolitan region, but also of various isolated systems in the same region, during a six year period from 2009 to 2015. After the third phase of the Tietê Project, the sewage collection system will benefit an additional 1.5 million people and the sewage treatment will benefit an additional 3.0 million people.

Corporate Program for Water Loss Reduction

The objective of the Corporate Program for Water Loss Reduction is to decrease water losses more efficiently by means of the integration and expansion of the existing initiatives in our business units. We began structuring the program in the second semester of 2007 and finalized it in 2008. We anticipate investments of approximately R\$3.0 billion throughout the program's 11-year term, beginning in 2009. The program aims to reduce the incidence of water loss from 436 liters per connection per day in December 2008 to 211 liters per connection per day in 2019, which is equivalent to reducing water losses from 27.9% in December 2008 to 13.0% in 2019. In 2009, we invested approximately R\$200.0 million in this program and the water losses were reduced to 26.0%, or 402 liters per connection per day.

New Life

The New Life Program includes projects focused on the improvement and preservation of water reserves in the São Paulo metropolitan region and the urban development of the region, especially in the Guarapiranga and Billings mains. The resources will be mostly invested in the creation of infrastructure to collect sewage in the region, and to direct it to treatment plants, while avoiding its pouring directly into the springs. The program also includes protection activities of green areas and the urbanization of *favelas* (shantytowns) and will directly benefit 45,000 families.

The State government, local authorities and the federal government will invest approximately R\$1.2 billion in the program. We will fund this program with R\$300.0 million. The State Secretariat for Sanitation and Energy coordinates the program with our involvement and that of the Urban Development Company of São Paulo (*Companhia de Desenvolvimento Habitacional e Urbano*), or the CDHU, and local governments in the region.

Clean Stream Program

This program is a partnership between the State, through us, and the mayor's office of the city of São Paulo, and aims to clean and recover 100 urban streams in the city of São Paulo, with an investment of R\$197.1 million, of which R\$143.0 million will be funded by us. The program will benefit 1.8 million people who live in the hydrographic basins of the streams. As of December 31, 2009, 42 urban streams had been decontaminated, benefiting 800,000 people. The second phase of the program will clean and recover an additional 58 streams, with a total investment of R\$118.7 million, of which R\$99.3 million will be funded by us.

Regional Systems Investment Programs

We currently have a number of projects in progress and planned for the Regional systems, including projects relating to abstraction of water and collection, removal and final disposal of sewage. We invested R\$321.0 million, R\$707.0 million and R\$1,091 million in these projects in 2007, 2008 and 2009, respectively, and we have budgeted for additional capital expenditures of approximately R\$2.7 billion from 2009 through 2013.

Clean Wave Program

On August 6, 2004, we entered into a credit agreement with the Japan Bank for International Cooperation, or the JBIC for the financing of the environmental recovery for the Baixada Santista metropolitan region, which was guaranteed by the Federative Republic of Brazil, for a total amount of R\$382.8 million. On October 1, 2008, JICA incorporated the loan transactions of JBIC. For further information on the agreement entered into with the JICA, see *Item 5. Operating and Financial Review and Prospects Liquidity and Capital Resources Capital Sources*. The total investment to be made with respect to this project for sewage systems is approximately R\$1.4 billion and the remaining R\$1,080.4 million will be funded by us, for which we will seek further financial support from local and international banks and agencies. The first disbursements under this agreement began in August 2005 with the commencement of the management agreement. The construction works began in the second quarter of 2007. The main goals of this program are to improve and expand the water and sewage systems in the municipalities comprising the Baixada Santista metropolitan region, increasing the sewage collection from 54.0% to 95.0% and treat 100.0% of the collected sewage. As of December 31, 2009, the total disbursements for this program reached approximately R\$960.0 million and 67.0% of the project was already built.

Northern Coast Clean Wave Program

The program will expand the collection and treatment of sewage in the Northern coast of the State of São Paulo, benefiting 600,000 people. By 2015, the program will increase the collection and treatment of sewage index of the region from 30.0% to 85.0%, improving the health and well being of the population, in addition to stimulating the economic development by allowing for an increase in tourism in the region.

In 2008, we inaugurated the Porto Novo sewage treatment plant in the city of Caraguatatuba and began working in the sewage systems projects in the cities of Ilhabela, Ubatuba and Caraguatatuba. We expect to complete these sewage systems in the first semester of 2010. In February 2009, we began other sewage systems projects in the cities of Caraguatatuba, Ilhabela and São Sebastião, which are expected to be completed in the second semester of 2010. The total investment in the program will be R\$412.0 million. As of December 31, 2009, the total disbursements for this program reached R\$20.1 million.

Coastal Water Program

The program is the main combination of long term activities to expand water production capacity in the entire coastal region of the State of São Paulo, of which Mambu/Branco is part of. More than four million people in coastal cities in the State of São Paulo will benefit from this program. This program will enable us to increase the level of reliability of the systems, eliminating existent and potential deficiencies and irregularities in the water supply. It will also permit us to expand our services to reach universal coverage in the Baixada Santista metropolitan region, assure the availability of treated water to the local population and tourists, and also to improve the quality of water available to the population. We expect to invest R\$1.1 billion in the program through 2012.

Research and Development

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

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

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

In order to further develop our expansion plans, we created a new division for Research, Technology Development and Innovation in May 2010. This new division will be responsible for coordinating studies of technological trends, defining our research projects portfolio and obtaining funding from development agencies. The new division will also enable us to increase the quality of our procedural processes and our technology portfolio, which we offer to the

4.B. Business Overview

Our Operations

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

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

Government Regulation The Basic Sanitation Law and Public Consortia Law and Cooperation Agreement for Joint Management.

The Basic Sanitation Law requires water and sewage service providers, such as us, to execute a formal agreement by December 31, 2010 with every municipality to which they provide services without a valid legal and binding instrument. See *3.D Risks Factors Risks Relating to Our Business We cannot anticipate the effects that further developments of the Basic Sanitation Law and its interpretation will have on the basic sanitation industry in Brazil and on us.*

Concessions

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

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

At the end of 2009, we were a provider of water and sewage services to 366 municipalities. Substantially all of these concessions have 30 year terms. Due to court orders, we temporarily suspended our services for two other municipalities (Araçoiaba da Serra and Cajobi), that accounted for less than 0.1% of our gross revenues. For more information, see *Item 8.A. Financial Information Consolidated Statements and other Information Legal Proceedings Concession Related Legal Proceedings.* Between 2007 and 2009, we entered into program contracts with 174 municipalities in accordance with the Basic Sanitation Law, of which 14, were entered into in 2009. In addition to the contracts that have 30 year terms, the municipalities entered into cooperation contracts with the State of São Paulo, delegating the regulation and monitoring of the provision of services to the ARSESP. As of December 31, 2009, 82 concessions expired, and we have been in negotiation with the municipalities who are parties to these expired concessions to execute program contracts to substitute the expired concessions. From 2010 through 2030,

80 concessions will expire. The remaining municipalities have an undetermined term. Some of the expired concession agreements have been extended for a short term while we negotiate the new contract. Despite the expiration of the concession agreements, we continue to provide water and sewage services to all 366 municipalities at the end of 2009. In 2010, we have entered into 22 program agreements, amounting to 196 agreements since 2007. We have entered into an agreement with the State and city of São Paulo for the provision of water and sewage services in the city of São Paulo for a 30 year term, which in the year ended December 31, 2009, accounted for 55.5% of our gross revenues.

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

The current concessions are based on a standard form of agreement between us and the relevant municipality. Each agreement received the prior approval of the legislature council of each municipality. The main provisions of the existing concession agreements are as follows:

- we assume all responsibility for providing water and sewage services in the municipality;
- according to the municipal laws authorizing the concession, we could collect tariffs for our services without prior authorization of the municipality. Tariff readjustments would follow the guidelines established by the Basic Sanitation Law and the ARSESP;
- the assets comprising the existing municipal water and sewage systems are transferred from the municipality to us. Until 1998, we acquired municipal concessions and the existing water and sewage assets in exchange for our common shares issued at book value. Since 1998, we have acquired concessions and water and sewage assets by paying the municipality an amount equal to the present value of 30 years of estimated cash flows, assuming at least a 12.0% discount factor to us, from the concession being acquired. Payment was made in cash;
- as a general rule, to date we are exempt from municipal taxes, and no royalty is payable to the municipality with respect to the concession;
- we are granted rights of way on municipal property for the installation of water pipes and mains, and sewage lines; and
- upon termination of the concession, for any reason, we are required to return the assets comprising the municipality's water and sewage system to the municipality and the municipality is required to pay us the non-amortized book value of our assets relating to the concession.

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

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

Concession agreements that we have entered into since 1998 provide that after a 30-year term from the commencement of the concession, the total value of the concession and assets will be amortized to zero on our books and we receive no payment for the assets. If the concession is terminated prior to the end of the 30-year term, we are paid an amount equal to the present value of the expected cash flow from the concession over the years remaining in the concession, using the same assumptions used to determine the value of the concession at its inception (adjusted for inflation).

The federal concessions law (Law No. 8,987/95) and the federal consortium law (Law No. 11,107/2005) established a new regime that gave municipalities a greater role and set out more clearly the provision of services and the

responsibilities of the parties. Following the enactment of these two federal laws, all new agreements to be entered into by us, and the new agreements to be executed after the expiration of the concessions will follow this new agreement model. See *4.B Business Overview Government Regulation Public Consortia Law and Cooperation Agreement for Joint Management*.

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

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

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

Municipalities have the inherent power under Brazilian law to terminate concessions prior to their contractual expiration dates for reasons of public interest. The municipalities of Diadema and Mauá, two municipalities we previously served, terminated our concessions in February 1995 and December 1995, respectively. The municipality of Diadema terminated our concession without our consent after asserting that we did not provide adequate water and sewage services, while the municipality of Mauá terminated our concession with our consent. However, we currently serve both municipalities through the supply of water on a wholesale basis.

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

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

Operations in the city of São Paulo and certain metropolitan regions

As of December 31, 2009, we did not hold a formal agreement to provide water and sewage services to 31 municipalities in the State of São Paulo and the city of São Paulo, that jointly accounted for 65.7% of our gross revenues. We have entered into 22 program agreements since January 1, 2010, bring the total program agreements entered into since 2007 to 196. These 22 new agreements amount to 1.99% of our total revenues and 1.24% of our assets as of December 31, 2009. We believe that we have a vested and exclusive right to provide water and sewage services to these municipalities based, in some cases, upon a deed (*escritura pública*) and also, among other factors, based on our ownership of the water and sewage systems serving these other municipalities and certain succession rights resulting from the merger that formed us.

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

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

On June 23, 2010, we entered into a formal agreement with the State and the city of São Paulo to regulate the provision of water and sewage services in the city of São Paulo for a 30 year period, which may be extended for an additional 30 year period. The Municipal Law No. 14,934/2009 authorized the city of São Paulo to enter into an agreement with us. The agreement establishes, among other things, how specific amounts of gross revenues from the services we render should be allocated (after deduction of Cofins and Pasep). Pursuant to the agreement, we are required to (i) invest at least 13.0% of the gross revenues we obtain from this agreement in the improvement of water and sewage infrastructure in the city of São Paulo; and (ii) contribute 7.5% of the gross revenues we obtain from this agreement to the São Paulo Municipal Sanitation Fund. In addition, the agreement provides that ARSESP, the State agency responsible for regulating the basic sanitation industry, will ensure that the tariffs charged (a) will adequately compensate us for the services we provide and (b) can be adjusted to restore the original balance between each party's obligation and economic gain (*equilíbrio econômico financeiro*). Finally, the agreement envisages the remuneration of the net assets in operation, calculated preferably through asset valuation or by the monetarily updated book value, to be established by ARSESP. The Contract also foresees the remuneration of the investments to be made by SABESP, such that there will be no residual value at the end of the Contract period.

Wholesale Operations

Water Services On a Wholesale Basis

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

The agreements to provide water services on a wholesale basis must comply with the Basic Sanitation Law, which regulates the stages of the provision of each service, designating them as interdependent activities whose provision requires the supervision of an independent agency, a specific registration for the activities' cost and assurance of payment among the several service providers in order to continue the provision of the services, in accordance with the rules to be published by ARSESP.

In December 2008, we, the State, the city of Diadema and the SANED executed a memorandum of understanding, in which the parties declared their intention to conclude negotiations to liquidate the outstanding debt with us and develop a shared structure of operations between us and the city of Diadema for the operation and provision of water and sewage services. The municipal law authorizing the city of Diadema to enter into an agreement with us was submitted to vote in April 2010. While no definitive date has been scheduled for voting, we expect to reach a final agreement with the city of Diadema and settle all the pending judicial claims in 2010.

Sewage Services On a Wholesale Basis

We provide sewage services on a wholesale basis to the municipalities of Mogi das Cruzes, Santo André, São Caetano, Mauá and Diadema. The negotiation of the agreement for the provision of sewage services on a wholesale basis with the municipality of Santo André had the intervention of the Public Prosecution Office, and in other

municipalities the negotiation of the agreements was a result of our efforts concerning the environment and the awareness of the municipal public authorities regarding to environmental issues. Through these agreements, in 2009 we treated about 31.1 million cubic meters of sewage from these municipalities. This is an example of our social-environmental responsibility actions and our commitment to these actions. In 2009, the revenues from these services were approximately R\$21.9 million.

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

Description of Our Activities

As set forth in Article 2 of our by laws, our corporate purpose is to render basic sanitation services with the goal of the universalization of basic sanitation in the State of São Paulo without harming our long term financial sustainability. Our activities comprise water supply, sanitary sewage services, urban rainwater management and drainage services, urban cleaning services, solid waste management services and related activities, including the planning, operation, maintenance and commercialization of energy, and the commercialization of services, products, benefits and rights that directly or indirectly arise from its assets, operations and activities. We are allowed to act in a subsidiary form in other Brazilian locations and abroad. See *Government Regulation Public Consortia Law and Cooperation Agreement for Joint Management*.

We set forth below a description of our activities.

Water Operations

Our supply of water to our customers generally involves abstraction of water from various sources, subsequent treatment and distribution to our customers premises. In 2009, we produced approximately 2,844,9 million cubic meters of water. The São Paulo metropolitan region (including the municipalities to which we supply water on a wholesale basis) currently is, and has historically been, our core market, accounting for approximately 71.5% of water invoiced by volume in 2009, respectively.

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

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

The difference between the volume of water produced and the volume of water invoiced generally represents both real and commercial water loss. See *Water Resources Water Losses*. In addition, we do not invoice:

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

- water supplied for municipal uses such as firefighting;
- water consumed in our own facilities; and

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

Generally, the São Paulo metropolitan region experiences higher water demand during the summer and lower water demand during the winter. In the São Paulo metropolitan region, the summer coincides with the rainy season, while the winter corresponds to the dry season. Demand within the Regional systems will vary depending on the area; while the countryside region experiences seasonality in demand similar to the São Paulo metropolitan region. The demand in the coastal region is driven by tourism, with the greatest demand occurring during the Brazilian summer holiday months.

Water Resources

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

In order to supply water to the São Paulo metropolitan region, we rely on 20 reservoirs of non treated water and 192 reservoirs of treated water, which are located in the areas under the influence of the eight water producing systems comprising the interconnected water system of the São Paulo metropolitan region. The capacity of the water sources available for treatment in this area is 71.7 cubic meters per second. Total current capacity is 67.7 cubic meters per second, which can be treated from the interconnected water system of the São Paulo metropolitan region. Average verified production during 2009 on the interconnected water system of the São Paulo metropolitan region was 65.0 cubic meters per second. The Cantareira, Guarapiranga and Alto Tietê systems, as a whole, supplied approximately 84.0% of the water we produced for the São Paulo metropolitan region in 2009.

The Cantareira system accounted for 48.2% of the water that we supplied to the São Paulo metropolitan region (including the municipalities to which we supplied water on a wholesale basis) in 2009, which represented 75.6% of our gross revenues for the year. The authorization (*outorga*) for the Cantareira system to use the water in the Piracicaba water basin was renewed on August 6, 2004, for a ten year period.

With respect to water usage, federal and state agencies are authorized to collect charges from entities, such as us, for the abstraction of water from, or dumping of sewage into, water resources. Since February 2003, we have been incurring expenses in connection with the use of water from the Paraíba do Sul river basin and, since January 2006, from the Piracicaba, Capivari and Jundiaí river basins. In 2011, we will start to incur expenses in connection with the use of water from the Sorobaca and Médio Tietê river basins. We also expect to start being charged for the use of water from the Baixo Tietê river basin. The ARSESP, has so far regulated our tariff structure and adjustments according to the same structure and adjustment formula that we ordinarily follow, which takes into consideration the variation of expenses considered as non administrable, which these expenses fall under. We expect to continue to be able to pass on these expenses to our customers. However, we are uncertain as to the likely charges that may be assessed against us in connection with the abstraction of water from or the dumping of sewage into other water resources that we use, or whether we will be able to continue to pass on the cost of all of these charges to our customers. For more information on water usage regulation, see *Water Usage*.

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

metropolitan region:

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

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

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

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

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

Statewide, we estimate that we are able to supply nearly all of the demand for water in all of the areas where we operate, subject to droughts and extraordinary climate events. We were able to meet the demand for water in the São Paulo metropolitan region, primarily as a result of our water conservation program, reductions in water losses, and the installation of new water connections. We installed 174,000, 189,000 and 201,000 new water connections in 2007, 2008 and 2009, respectively.

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

In order to reach the final customer, the water is stored and transported through a complex and interconnected system comprising 32,014 kilometers of water mains and 192 reservoirs. This water system requires permanent operational supervision, engineering inspection, maintenance, quality monitoring and measurement control.

To ensure the continued provision of regular water supply in the São Paulo metropolitan region, we intend to invest R\$2.1 billion from 2009 to 2013 to increase our water production and distribution capacities as well as to improve the water supply systems. In 2009, our total investment in water supply systems amounted to R\$506.2 million.

Water Treatment

We treat all water at our water treatment facilities prior to placing it into our water distribution network. We operate 208 treatment facilities, of which the eight largest, located in the São Paulo metropolitan region, account for approximately 74.0% of all water we produce. The type of treatment used depends on the nature of the source and quality of the untreated water. Water abstracted from rivers requires extensive treatment, while water drawn from groundwater sources requires less treatment. All water treated by us also receives fluoridation treatment.

Water Distribution

We distribute water through our own networks of water pipes and mains, ranging in size from 2.5 meters to 100 millimeters in diameter. Storage tanks and pumping stations regulate the volume of water flowing through the networks to maintain adequate pressure and continuous water supply. As of December 31, 2009, our water network contained 63,732 kilometers of water pipes and 7.1 million water connections. The following table sets forth the total

number of kilometers of water pipes and mains and the number of connections in our network for the periods indicated.

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

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

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

We have 384 storage tanks in the São Paulo metropolitan region with a total capacity of 1.9 million cubic meters, and 1,672 storage tanks in the Regional systems. We have 122 treated water pumping stations in the São Paulo metropolitan region aqueduct system, including stations at treatment facilities, intermediate trunk transfer pumping stations and small booster stations serving local areas.

Water mains that require maintenance are cleaned and their lining is replaced. We are typically notified of water main fractures or breaks by the public through a toll free number maintained by us. We consider the condition of the water pipes and mains in the São Paulo metropolitan region to be adequate. Due to age, external factors such as traffic, the dense population, and commercial and industrial development, water pipes and mains in the São Paulo metropolitan region are somewhat more susceptible to degradation than those in the Regional systems. To counter these effects, we have a maintenance program in place for water pipes and mains that is intended to address anticipated fractures and clogs due to brittleness and encrustation, and to help ensure water quality in the region.

We expect that new customers will be responsible for covering part of the costs of connecting to our water distribution network. Our water connection policy pays for the cost of installation of up to 15 meters of pipe between our distribution network and the point of connection. The customer pays for any further pipe that is necessary for connection. Thereafter, the customer must cover the costs of connecting to the network from the customer's premises, including costs of purchasing and installing the water meter and related labor costs. Industrial customers are responsible for the entire cost of connection. We perform the installation of the water meter and conduct periodical inspections and measurements. After completion of installation, the customer is responsible for the water meter.

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

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2010-2018
	Actual											
												Forecast
												(in thousands)
São Paulo metropolitan region	119.2	130.1	92.6	82.8	89.2	88.4	87.9	88.2	85.3	85.5	84.7	784.6
Regional systems	70.2	70.8	65.1	65.9	69.4	70.5	71.4	71.1	69.7	70.2	73.1	626.4
Total	189.4	200.9	157.7	148.7	158.6	158.9	159.3	159.3	155.0	155.7	157.8	1,411.0

Water Losses

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

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

Using this calculation method, as of December 31, 2009, we experienced 477 liters/connections per day of water losses in the São Paulo metropolitan region and 290 liters/connections per day in the Regional systems, averaging 402 liters/connections per day. We plan to reduce water losses to 348 liters/connections per day for the São Paulo metropolitan region and 247 liters/connections per day for the Regional systems, which we expect will result in a total average water loss reduction of 307 liters/connections per day by 2013. In terms of percentage, we intend to reduce water losses from 28.0% to 21.0% in the São Paulo metropolitan region, and from 27.1% to 21.0% in the Regional systems between 2009 and 2013. In 2009, we experienced a total water loss of 26.0% and we expect the water losses to decrease to 20.0% in 2013.

Our strategy to reduce water loss has two approaches:

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

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

- the introduction of technically advanced valves to regulate water pressure throughout the water mains in order to maintain the appropriate water pressure to the downstream consumption needs each day. These valves are programmed to respond automatically to variations in demand. During peak usage, the flow of water in the pipes is at its highest point; however, when demand decreases, pressure builds up in the water mains and the resulting stress on the network can cause significant water loss through cracks and an increase in ruptures of the pipes. The technically advanced valves are equipped with probes programmed to feed data to the valve in order to reduce or increase pressure to the water mains as water usage fluctuates. As of December 31, 2009, we had installed 1,714 valves at strategic points in the network, with 1,032 valves being installed in the São Paulo metropolitan region and 682 in the Regional systems;
- the reconfiguration of interconnected water distribution to permit the distribution of water at lower pressure;
- the implementation of routine operational leak detection surveys in high water pressure areas to reduce overall water losses;
- the monitoring of and improved accounting with respect to water connections, especially for large volume customers; regular checking on inactive customers and monitoring non residential customers that are accounted for as residential customers and, therefore, billed at a lower rate;

- preventing fraud with the use of new, more sophisticated water meters that are more accurate and less prone to tampering;
- installing water meters where none are present; and
- conducting preventive maintenance of existing and newly installed water meters.

Water Quality

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

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

Water quality is monitored at all stages of the distribution process, including at the water sources, water treatment facilities and on the distribution network. We have 15 regional laboratories, one central laboratory, and laboratories located in all water treatment facilities that monitor water quality, as required by our standards and those set by statute. These laboratories employ approximately 300 technicians, biologists, engineers and chemists. Our laboratories perform an average of 60,000 analyses per month on distributed water, with samples collected from residences. Our central laboratory located in the city of São Paulo is responsible for organic compound analysis using the chromatographic and spectrometric methods, as well as heavy metals analysis by atomic absorption technique. All of our laboratories have obtained the ISO 9001/2000 certification and 13 of our 16 water control and quality laboratories have obtained the NBR ISO/IEC 17,025 accreditation (accreditation for general requirements for the competence of testing and calibration laboratories) awarded by the National Institute of Metrology, Standardization and Industrial Quality (*Instituto Nacional de Metrologia, Normalização e Qualidade Industrial*), or the INMETRO.

All chemical products used for water treatment are analyzed and follow strict specifications set out in recommendations made by the National Health Foundation (*Fundação Nacional de Saúde*), or NHF, the Brazilian Association of Technical Rules (*Associação Brasileira de Normas Técnicas*), or the ABNT, and American Water Works Association, or the AWWA, to eliminate toxic substances that are harmful to human health. From time to time, we face problems with the proliferation of algae, which may cause an unpleasant taste and odor in the water. In order to mitigate this problem, we work on: (i) fighting algae growth at the water source and (ii) using advanced treatment processes at the water treatment facilities, which involve the use of powdered activated carbon and oxidation by potassium permanganate. The algae growth creates significant additional costs for water treatment because of the higher volumes of chemicals used to treat the water. In 2009, we did not detect significant algae growth.

We participate in the New Life Program, that includes a Water Source Program (*Programa Mananciais*), together with other organizations engaged in the promotion of urban development and social inclusion to mitigate the pollution problem in the São Paulo metropolitan region. In addition, we also participate in the Clean Stream Program to clean up important streams in city of São Paulo. See *Capital Expenditure Program New Life and Clean Stream Program*.

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

Fluoridation

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

Sewage Operations

We are responsible for the collection and removal of sewage through our sewage systems and for its subsequent disposal with or without prior treatment. As of December 31, 2009, we collected approximately 85.0% of all the sewage produced in the municipalities in which we operate in the São Paulo metropolitan region. In addition, during the year ended December 31, 2009, we collected approximately 72.0% of all the sewage produced in the municipalities in which we operate in the Regional systems. During 2009 we accounted for approximately 80.0% of all the sewage produced in the municipalities in which we operated in the State of São Paulo.

Sewage System

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

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

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

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

The public sewage system operated by us was structured in order to receive industrial sewage and sewage from non domestic sources for treatment together with domestic sewage. Industrial sewage has physical, chemical and/or biological characteristics that are qualitatively different from household effluents. As a result, the discharge of industrial sewage into the public sewage system is subject to compliance with specific legal demands with the purpose to protect the sewage collection and treatment systems, the health of operators and the environment. The current environmental legislation establishes standards for the discharge of these effluents into the public sewage system. These standards are defined in Article 19 of State Decree 8,468 dated September 8, 1976, as amended and supplemented. To ensure compliance with legislation, periodic audits of the sewage produced by all industrial clients are conducted, and we also request self monitoring reports from non domestic sewage producing sources.

The discharge of these effluents into the public sewage system is based on technical and administrative procedures. Before the discharge is permitted, we carry out acceptance studies that assess the capacity of the public sewage system to receive the discharge as well as the compliance with regulations. Upon the conclusion of these studies, the technical and commercial conditions for receiving the discharge are established, which are then formalized in a document signed by us and the effluent producer. Failure to comply with these conditions can lead to the suspension of the connection and notification of the environmental protection agency (*Companhia Ambiental do Estado de São Paulo*), or the CETESB, in order for the applicable measures to be taken. Effluents from our sewage treatment facilities (*Estações de Tratamento de Esgotos*), or the ETEs, must comply with discharge standards established by federal and state regulations and also must comply with emission standards and observe the water quality of the bodies of water established by federal and state legislation. Emission standards consist of a set of parameters that must be verified before the effluents are discharged into a body of water. Quality standards are based on the

classification of bodies of water, taking into account the expected use of the water, with these standards becoming more stringent for bodies of water with more important use profiles.

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

Unlike the São Paulo metropolitan region, the countryside region does not generally suffer obstructions caused by sewage system overload. The coastal region, however, experiences obstructions in its sewage lines primarily due to infiltration of sand, especially during the rainy season in the summer months. In addition, the sewage coverage ratio in the coastal region is significantly lower than in the other regions served by us, with approximately 51% of all residences in the coastal region currently connected to our sewage network.

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

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

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2010-2018
	Actual					Forecast					
						(in thousands)					
São Paulo											
metropolitan region	112.9	69.5	65.1	65.9	72.6	89.6	97.6	116.7	117.4	120.4	814.8
Regional systems	71.2	155.4	113.8	101.2	81.4	74.3	76.7	71.2	73.8	77.5	825.3
Total	184.1	224.9	178.9	167.1	154.0	163.9	174.3	187.9	191.2	197.9	1,640.1

Sewage Treatment and Disposal

In 2009, approximately 72.0% and 80.0% of the sewage we collected in the São Paulo metropolitan region and the Regional systems, respectively, or 74.0% of the sewage we collected in the State of São Paulo, was treated at our treatment facilities and afterwards discharged into receiving water bodies such as inland waters and the Atlantic Ocean, in accordance with applicable legislation. Our sewage treatment facilities have a limited capacity. Flows in excess of this capacity are discharged directly, untreated, to inland waters and the Atlantic Ocean. We currently operate 467 sewage treatment facilities and eight ocean outfalls.

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

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

We operate 49 activated sewage treatment facilities, each of which also contains a primary treatment facility. The five largest activated sewage treatment facilities located in the São Paulo metropolitan region have treatment capacity of approximately 18 cubic meters of sewage per second.

Sewage treatment in the Regional systems will vary according to the particularities of each area. In the countryside region, treatment consists largely of stabilization ponds where the organic matter is treated and discharged to receiving waters. There are 379 secondary treatment facilities in the countryside region that have treatment capacity of approximately 11.3 cubic meters of sewage per second.

The majority of sewage collected in the coastal region receives treatment and disinfection and is then discharged into rivers and into the Atlantic Ocean. We have 66 sewage treatment facilities in the coastal region.

Our trunk lines are currently not sufficiently extensive to transport all sewage collected by us to our treatment facilities. As a result, a portion of the sewage collected by us is released untreated into receiving waters, resulting in high levels of pollution in these bodies of water. We are a party to a number of legal proceedings related to environmental matters. See *Item 8.A. Financial Information Consolidated Statements and other Information Legal Proceedings*. In addition, our capital expenditure program includes projects to increase the amount of sewage that we treat. See *Item 4.A. History and Development of the Company Capital Expenditure Program and 4.B Business Overview Government Regulation Sewage Requirements*.

Sludge Disposal

Sludge removed from the primary and secondary treatment processes typically contains water and a very small proportion of solids. We use filter presses, belt presses and centrifugation machines to abstract the water from the sludge. In 2009, we produced 42,338 tons of sludge dry base, of which 41,184 tons were discharged into landfills and the remaining was used for agricultural purposes. In addition, we are testing new technologies for sludge disposal as fertilizer in forest projects, fuel development and concrete manufacturing.

Customers

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

	Year ended December 31,	
	2008	2009
São Paulo metropolitan region	4,988.4	5,280.8
Regional systems	1,631.1	1,764.6
Total	6,619.5	7,045.4

Competition

We believe there are at least two reasons behind a possible increase in our participation in the domestic sanitation market. In the State of São Paulo, there are approximately 270 municipalities that operate their own water and sewage systems and that collectively have a population of approximately 13.0 million, or approximately 31.0% of the population of the State of São Paulo, excluding the population of the municipalities to which we provide water services on a wholesale basis. Given our scale, we are well positioned to capture opportunities in these municipalities. In comparison to the companies providing water and sewage services outside the State of São Paulo, we believe we have technological advantages compared to other water and sewage services providers, which should result in our competitively advantageous position in regions outside the State of São Paulo.

The competition for municipal concessions arise mainly from the municipalities, as they may resume the water and sewage services that were granted to us and start providing these services directly to the local population. In this case, the municipal governments would be required to indemnify us for the unamortized portion of our investment. See

Business Overview Our Operations Concessions. In the past, municipal governments have terminated our concessions agreements before the expiration date. Furthermore, municipal governments have tried to expropriate our assets in an attempt to resume the provision of water and sewage services to local populations. See *Item 8.A. Financial Information Consolidated Statements and Other Information Legal Proceedings*. We negotiate expired concession agreements and concession agreements to be expired with the municipalities in an attempt to maintain our existing areas of operations. The competition in the State of São Paulo from private water service providers is limited. Only a small number of municipalities have private companies operating water and sewage services.

In recent years, we have also experienced an increasing level of competition in the market of water supply to large customers. Several large industrial customers located in municipalities served by us use their own wells to supply themselves with water. In addition, competition for the disposal of non residential, commercial and industrial sludge in the São Paulo metropolitan region has increased in recent years as private companies offer stand alone solutions inside the facilities of its customers. We have also established new tariff schedules for commercial and industrial customers in order to assist us in retaining these customers.

Billing Procedures

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

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

Water and sewage bills can be paid at some banks and other locations in the State of São Paulo. These funds are paid over to us after deducting average banking fees ranging from R\$0.29 to R\$1.15 per transaction for collection and remittance of these payments.

Customers must pay their water and sewage bills by the due date if they wish to avoid paying a fine. We generally charge a penalty fee and interest on late bill payments. In 2007, 2008 and 2009, we received, respectively, payment of 92.8%, 97.3% and 94.7% of the amount billed to our retail customers, and 92.5%, 94.4% and 93.9% of the amount billed to those customers other than State entities, within 30 days after the due date. In 2007, 2008 and 2009, we have received 97.9%, 153.1% and 110.1%, respectively, of the amount billed to the State entities. With respect to wholesale supply, in 2007, 2008 and 2009, we received payment of 65.2%, 64.4% and 68.7%, respectively, of the amount billed within 30 days.

In the São Paulo metropolitan region, we monitor water meter readings by use of hand-held computers and transmitters. The system allows the meter reader to input the gauge levels on the meters into the computer and automatically print the bill for the customer. The hand-held computer tracks water consumption usage at each metered location and prepares bills based on actual meter readings. We outsourced this billing system to third-party contractors that employ and train their own personnel whose training we supervise. We have water meter reading and printing by hand-held computers in some municipalities that we serve in the Regional systems and intend to expand this system to other municipalities we serve.

Tariffs

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

Tariffs have historically been adjusted once a year and for periods of at least 12 months. We increased our tariffs for water and sewage services by 6.8%, 9.0% and 6.7% in August 2004, 2005 and 2006, respectively. On September 2007, tariffs rose by 4.12%, except for water supply and sewage collection tariffs for consumption of more than 20 cubic meters in non-residential categories, which were adjusted by the cumulative inflation from August 2006 to July 2007 in the consumer price index (*Índice Nacional de Preços ao Consumidor Amplo*), or IPCA, index published by IBGE, which came to 3.74%.

With the enactment of the Basic Sanitation Law, an independent regulatory entity is responsible for tariff regulation. ARSESP has been the independent regulatory entity, regulating our tariffs, pursuant to a cooperation agreement between each municipality and the State. With respect to other municipalities where ARSESP has not been explicitly selected to perform this task, we will depend on legal interpretation to conclude whether the independent entity will be

in charge of regulating tariffs. For instance, the municipality of Lins decided to create its own regulatory agency. See *Government Regulation Tariff Regulation in the State of São Paulo* for additional information regarding our tariffs.

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

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On July 22, 2009, the ARSESP released a Technical Note (*Nota Técnica*) regarding the methodology for the tariff adjustment process and submitted it for public comments. On August 12, 2009, the ARSESP informed that the new methodology would not be applied for the 2009 adjustment. The ARSESP is currently working on the development and improvement of its new methodology and it expects to release a revised tariff structure and adjustments formula in 2011.

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

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

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

We established a new tariff schedule, effective May 2002, for commercial and industrial customers that consume at least 5,000 cubic meters of water per month and that enter into demand agreements with us for at least one year terms. In October 2007, the minimum volume for the formalization of the agreement declined from 5,000 m³/month to 3,000 m³/month. We believe this tariff schedule will help prevent our commercial and industrial customers from switching to the use of private wells. In the 2008 adjustment authorized by ARSESP, we contested that the tariffs for the provision of water supply and sewage collection for non residential consumption of more than 3,000 cubic meters per

month would have as a maximum limit values referred to in the tables for non residential consumption of more than 50 cubic meters per month. We may charge lower prices depending on the market conditions of category of customer.

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

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

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

Customer Category Consumption	As of December 31,		
	2007	2008	2009 ⁽²⁾
Residential:			
Standard Residential:			
0 10	1.24	1.31	1.36
11 20	1.94	2.04	2.13
21 50	4.84	5.09	5.32
Above 50	5.34	5.61	5.86
Social:			
0 10	0.42	0.44	0.46
11 20	0.73	0.77	0.80
21 30	2.57	2.70	2.82
31 50	3.67	3.86	4.03
Above 50	4.05	4.26	4.45
Favela (shantytown):			
0 10	0.32	0.34	0.35
11 20	0.36	0.38	0.40
21 30	1.21	1.27	1.33
31 50	3.67	3.86	4.03
Above 50	4.05	4.26	4.45
Non Residential:			
Commercial/Industrial/Governmental:			
0 10	2.49	2.62	2.74
11 20	4.84	5.09	5.32
21 50	9.31	9.78	10.21
Above 50	9.69	10.18	10.63
Social Welfare Entities:			
0 10	1.24	1.31	1.37
11 20	2.44	2.56	2.67
21 50	4.67	4.91	5.13
Above 50	4.83	5.08	5.31
Government entities that employ the Rational Use of the Water Program (Programa de Uso Racional da Água), or PURA with reduction agreement:			

0 10)	1.87	1.97	2.05
11 20	3.63	3.82	3.99
21 50	6.98	7.34	7.67
Above 50	7.26	7.63	7.97

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