

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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**(+55 11 3388 8247)**

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

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

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

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\* 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.

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

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**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)	
<b>Statement of operations data:</b>		
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
<b>Balance sheet data:</b>		
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
<b>Other financial information:</b>		
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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	<b>As of and for the year ended December 31,</b>				
	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>
<b>Operating data (at period end):</b>					
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) <sup>(1)</sup>	32.4	31.9	29.5	27.9	26.0
Water loss per connection (average) <sup>(2)</sup>	520	511	467	436	402
Number of employees	17,448	16,978	16,850	16,649	15,103

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(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.

<b>Year</b>	<b>Year end</b>	<b>Average for year<sup>(1)</sup></b> ( <i>reais</i> per U.S. dollar)	<b>Low</b>	<b>High</b>
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

<b>Month</b>	<b>Period end</b>	<b>Average for period<sup>(2)</sup></b> ( <i>reais</i> per U.S. dollar)	<b>Low</b>	<b>High</b>
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 11<sup>th</sup> 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
<b>Total</b>	<b>1,750</b>	<b>1,753</b>	<b>1,748</b>	<b>1,726</b>	<b>6,977</b>

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.**



## ***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)		
<b><i>Produced</i></b>			
São Paulo metropolitan region	2,115.0	2,107.9	2,091.7
Regional systems	758.7	744.7	753.2
<b>Total</b>	2,873.7	2,852.6	2,844.9
<b><i>Invoiced</i></b>			
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
<b>Total</b>	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:

<b>System</b>	<b>Production Rate<sup>(1)</sup></b>	
	(in cubic meters per second)	
	<b>2008</b>	<b>2009</b>
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
<b>Total</b>	<b>65.6</b>	<b>65.0</b>

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(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.

	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2010-2018</b>
	<b>Actual</b>					<b>Forecast</b>						
												(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
<b>Total</b>	<b>189.4</b>	<b>200.9</b>	<b>157.7</b>	<b>148.7</b>	<b>158.6</b>	<b>158.9</b>	<b>159.3</b>	<b>159.3</b>	<b>155.0</b>	<b>155.7</b>	<b>157.8</b>	<b>1,411.0</b>

*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.

	<b>2007</b>	<b>As of December 31, 2008</b>	<b>2009</b>
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.

	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2010-2018</b>
	<b>Actual</b>					<b>Forecast</b>					
						(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
<b>Total</b>	<b>184.1</b>	<b>224.9</b>	<b>178.9</b>	<b>167.1</b>	<b>154.0</b>	<b>163.9</b>	<b>174.3</b>	<b>187.9</b>	<b>191.2</b>	<b>197.9</b>	<b>1,640.1</b>

### *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.

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

## 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 m<sup>3</sup>/month to 3,000 m<sup>3</sup>/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 <sup>(2)</sup>
<b>Residential:</b>			
<b>Standard Residential:</b>			
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
<b>Social:</b>			
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
<b>Favela (shantytown):</b>			
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
<b>Non Residential:</b>			
<b>Commercial/Industrial/Governmental:</b>			
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
<b>Social Welfare Entities:</b>			
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
<b>Government entities that employ the Rational Use of the Water Program (Programa de Uso Racional da Água), or PURA with reduction agreement:</b>			

0 10 <sup>1</sup>	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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(1) The minimum volume charged is for ten cubic meters per month.

(2) Since September 11, 2009.

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

## Energy Consumption

Energy is essential to our operations, and as a result we are one of the largest users of energy in the State of São Paulo. We use 1.8% of the total energy consumption in the State of São Paulo. In 2009, 44.6% of the energy that we used was provided by *Companhia Energética São Paulo*, or CESP, pursuant to a long term contract expiring in 2012. To date, we have not experienced any major disruptions in energy supply. Any significant disruption of energy to us could have a material adverse effect on our business, financial condition, results of operations or prospects. See *Item 3.D. Risk Factors Risks Relating to Our Business We are exposed to risks associated with the provision of water and sewage services.*

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

## Insurance

We maintain insurance covering, among other things, fire or other damage to our property, office buildings and third party liability. We also maintain insurance coverage for directors and officers liability (D&O insurance). We currently obtain our insurance policies by means of public bids involving major Brazilian and international insurance companies. As of December 31, 2009, we had paid a total aggregate amount of R\$4.58 million in premiums, covering approximately R\$1,270.3 million on assets, third party liabilities and D&O insurance. We do not have insurance coverage for business interruption risk because we do not believe that the high premiums for such insurance are justified by the low risk of major interruption. In addition, we do not have insurance coverage for liabilities arising from water contamination or other problems involving our water supply to customers and for environmental related liabilities and damages. We believe that we maintain insurance at levels customary in Brazil for our type of business.

## Environmental Matters

Our environmental policy, adopted in January 2008, established environmental management directives that allow us to become a contributing force to environmental sustainability and excellence. These directives were based on a systematic approach to the environment, which allowed us to develop a plan that integrated economic, environmental and social dimensions of our work with sustainable use of natural resources.

In order to coordinate the environmental demands with the specific needs of the different places we operate, we have implemented 20 Environmental Management Centers (*Núcleos de Gestão Ambiental*), or the NGAs.

We have the following environmental management programs:

- the structuring of the progressive program for ISO 14001 certification for the 65 water and/or sewage treatment stations by 2010;
- creation of the Corporate Management of Greenhouse Effects Program (*Programa Corporativo de Gestão de Emissões de Gases de Efeito Estufa*);
- the development of an environment balance sheet model, as of 2009 and 2010, in order to improve our balance sheet illustrating our environmental investments;
- the structuring and implementation of the program for review of our environmental liabilities, fulfillment/execution of the conduct adjustment terms and judicial agreements and for maintaining environmental licenses and granting permits for the use of water resources operational facilities;
- structuring of the SABESP Corporate Environmental Education Program (*PEA SABESP*), including environmental education projects involving the community;

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

In addition to corporate environmental management initiatives, we launched several projects in 2008 to benefit the environment by engaging the community and third parties with non governmental organizations, including:

- Oil Recycling Program (*Programa de Reciclagem de Óleo de Fritura*), or PROL;
- Sustainable Planet (*Planeta Sustentável*);
- One million Trees in Cantareira (*Programa Um Milhão de Árvores no Cantareira* );
- Eyes in the Atlantic Rainforest (*De Olho na Mata Atlântica*); and
- Supporters of Sustainability (*Audiências de Sustentabilidade*).

## Government Regulation

Basic sanitation services in Brazil are subject to an extensive federal, state and local legislation and regulation that, among other matters, regulates:

- the granting of concessions to provide water and sewage services;
- the development of public private partnerships;
- the need of a public bidding process for the appointment of private water and sewage services providers;
- the need of setting up an agreement for the appointment of public water and sewage services providers;
- the joint management of public services through cooperation, allowing for a program contract without the need for a public bidding process for the service provider, subject to the condition that the planning, execution and monitoring activities are not executed by the service provider;
- minimum requirements for water and sewage services;
- water usage;
- water quality and environmental protection; and
- governmental restrictions on the incurrence of indebtedness applicable to state controlled companies.

## ***General***

Pursuant to Article 23 of the Brazilian Constitution, water and sewage services are the joint responsibility of the federal government, the states and the municipalities. Article 216 of the Constitution of the State of São Paulo provides that, by law, the State must provide the conditions for efficient management and adequate expansion of water and sewage services rendered by its agencies and State controlled companies or any other concessionaire under its control. State law authorized our formation to plan, provide and operate water and sewage services in the State and also acknowledged the autonomy of the municipalities.

Pursuant to Article 175 of the Brazilian Constitution, the rendering of public services, such as water and sewage services, is the responsibility of the applicable public authority. However, any such public authority has the right to render these services directly or through a concession granted to a third party.

The Consortium Law and the Basic Sanitation Law have caused significant impacts in the development of the state sanitation policy and the regulatory structuring of the industry.

Because we are the legal concessionaire for the State of São Paulo for water and sewage services, serving approximately 60.0% of the State's population and providing sanitation services through concession agreements, we notice the impacts of the Consortium Law on the expiration of our concession agreements in the 1970's when the Brazilian Sanitation Plan (*Plano Nacional de Saneamento*), or the PLANASA, was created. The Consortium Law has caused important changes in the relationship among municipalities, states and public sanitation service providers, most notably in mixed capital companies, such as us, because of the implementation of the program agreements as a substitute for concession agreements.

In addition, the Basic Sanitation Law in its role of general guideline for the development of the Brazilian sanitation industry, addresses the conditions for the delegation of water and sewage services, the exercise of ownership by the granting authority and the regulatory conditions for the industry. The Basic Sanitation Law also provides for a significant amendment to Article 42 of the Concessions Law which establishes the termination of concessions prior to the due expiration date and the reversibility conditions of unamortized assets. The amendment requires that the service provider be compensated for unamortized assets, prioritizing an agreement between the parties setting out the criteria for calculation and payments of indemnity.

## ***The Basic Sanitation Law***

On January 5, 2007, the Federal Law No. 11,445, or the Basic Sanitation Law, was enacted, establishing nationwide guidelines for basic sanitation and seeking to create appropriate solutions for the situation of each state and municipality, facilitating the technical cooperation between the state and municipalities. In addition, the federal government will enact its public policy to facilitate access to financing alternatives that are compatible with the costs and terms of the sanitation industry, in substitution of the PLANASA model.

The Basic Sanitation Law establishes the following principles for basic sanitation public services: universalization, integrality, efficiency and economic sustainability, transparency of actions, social control and integration of infrastructure and services with the management of water resources. It does not define the ownership of the sanitation services, but establishes the minimum liability for the exercise of ownership, such as the development of the sanitation plan, definition of the person responsible for regulation and control, establishment of the rights and obligations of the users and of the social control mechanisms. It also defines the regionalized performance of the services (i.e., one single provider serves two or more owners, for which there may be one plan for the combination of services).

In addition, the Basic Sanitation Law defines the guidelines and objectives of the federal basic sanitation policy to be observed when securing public funds generated or operated by agencies or entities of the federal government, and foresees the possibility of having subsidies as an instrument of social policy to ensure access to basic sanitation services to everyone, particularly the low income population. The subsidies may be granted either directly, through tariffs or indirectly, depending on the characteristics of the beneficiaries and on the source of the funds.

Furthermore, the Basic Sanitation Law also provides that the sanitation services may be interrupted by the service provider, in the event of default of payment of the tariffs by the customer, among other reasons, after written notice, as

long as minimum health requirements are met.

The Basic Sanitation Law also establishes the criteria for the reversal of assets at the time of termination of the agreement and with regard to the concessions, such as those that have expired or are effective for an indefinite term, or those that were not formalized by an agreement. In addition, the Basic Sanitation Law provides the basis for calculating the amount of an indemnity due, which must be calculated by a specialized institution chosen by mutual agreement between the parties.

Pursuant to the Basic Sanitation Law, the parties of the concession may enter into an agreement with respect to the payment of the indemnification due to the concessionaire. However, in the absence of an agreement, the Basic Sanitation Law establishes that the indemnization must be paid in no more than four equal and successive annual installments upon presentation of security interest, with the first installment payable until the last business day of the fiscal year in which the assets are reversed.

### ***Concessions***

Concessions for providing water and sewage services are formalized by agreements executed between the state or municipality, as the case may be, and a concessionaire to which the performance of these services is granted in a given municipality or region. Our concessions normally have a contractual term of up to 30 years, although some of these concessions have an indefinite term of effectiveness. However, our concessions in general can be revoked at any time if certain standards of quality and safety are not met, or in the event of default of the terms of the concession agreement.

A municipality that chooses to assume the direct control of its water and sewage services must terminate the current relationship by duly compensating the service provider. Subsequently, the municipality will be in charge of rendering services or of conducting a public bidding process to grant the concession to potential concessionaires, including agreements with public companies directly. Although the Constitution of the State of São Paulo determines that the relevant municipality would have to pay us for the unamortized book value of the assets related to the concession and assume any correlated debt, with the exclusion of any amounts that have been paid to us by the municipality, upon termination or non-renewal of the concession, the payment for termination may not be effected immediately, and any termination could negatively affect our cash flows, operating results and financial situation. See *Item 3.D. Risk Factors Risks Relating to Our Business Municipalities may, under certain circumstances, terminate our concessions before their expiration and the compensation may be inadequate to recover the full value of our investments.*

The Federal Concessions Law and the State Concessions Law require that the granting of a concession by the government be preceded by a public bidding process. However, the Federal Public Bidding Law provides that a public bidding process can be waived under certain circumstances, including in the case of services to be provided by a public entity created for such specific purpose on a date prior to the effectiveness of this law, provided that the contracted price is compatible with what is practiced in the market. Furthermore, a provision of the Federal Constitution determines waiver of the public bidding requirement in similar situations. Based on this provision, the municipalities granted concessions with waiver of public bidding processes to us after the enactment of the Federal Constitution. Currently, the Basic Sanitation Law provides that the program contracted can be executed with waiver of a public bidding process.

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

On June 18, 2009, the Municipal Law No. 14,934/2009 was enacted, authorizing the city of São Paulo to enter into an agreement with SABESP. This law revoked the Municipal Law No. 13,760/2003, pursuant to which the state was the

owner of the basic sanitation services in metropolitan region. Such revocation is the basis of a suit pending before the São Paulo State Court of Appeals regarding the unconstitutionality of such action. 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.

## ***Public Consortia Law and Cooperation Agreement for Joint Management***

On April 6, 2005, the federal government enacted the Federal Consortium Law, which regulates Article 241 of the Brazilian Constitution. This statute provides general principles to be observed when a public consortia enters into contracts with the Brazilian political divisions and subdivisions (the federal government, states, the Federal District and municipalities) aiming at the joint management of public services of common interests.

Federal Decree No. 6,017/2007 details the conditions of establishment of joint management and the execution of the program contract regulating the Public Consortia and Program Contracts Law. This federal legislation introduces significant changes in the relationship among municipalities, states and companies providing public sanitation services, prohibiting the latter from exercising activities of planning, oversight and regulation, including tariff regulation, of the services and creating the program contract for contracting entities whose share control is held by one of the Brazilian political divisions and subdivisions upon waiver of the public bidding process and compliance with concession legislation, as applicable.

On January 13, 2006, the Governor of the State of São Paulo enacted State Decree No. 50,470, amended by State Decrees No. 52,020, dated July 31, 2007, and No. 53,192, dated July 1, 2008, which provide for the rendering of water and sewage services in the State of São Paulo. According to these decrees, we may enter into agreements with municipalities in connection with the provision of water and sewage services by means of the so called program contract without a public bidding process. In addition, these decrees establish that we will continue to render services in the areas covered by the concession granted by the State.

Based on these statutes, in January 2007 we executed our first program agreement with the municipality of Lins, located in the State of São Paulo. Lins created its own regulatory agency to oversee and regulate the basic sanitation services. Subsequently, we formalized agreements with other municipalities in the State of São Paulo. These other municipalities transferred the oversight and regulation of our services to the State of São Paulo through a cooperation agreement.

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

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

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

- complies with and enforces state and federal basic sanitation legislation;
- publishes the organizational platform for the services, indicating the types of services provided by the state, as well as the equipment and facilities that compose the system;
- assumes, where applicable, the legal attributions of the jurisdictional authority;
- establishes, in accordance with the tariff guidelines defined by Decree No. 41,446/96, tariffs and other methods that provide compensation for our services, adjusts and reviews such tariffs and methods to ensure the financial economic balance of services and low cost tariffs through mechanisms that increase service efficiency and lead to the distribution of productivity gains to society; and
- approves, oversees and regulates (including tariff issues) sewage treatment and wholesale water supply agreements entered into between the state supplier and other suppliers, pursuant to Article 12 of the Basic Sanitation Law.

With respect to municipal basic sanitation, ARSESP oversees, controls and regulates (including tariff issues) services that have been delegated by municipalities to the state as a result of cooperation agreements that formalize the

program agreements between municipalities and us that provide for the execution of these services. If possible and convenient for the municipality, it can act on agreements executed prior to the enactment of the current regulation.

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

Supplementary Law No. 1,025/2007 also amended paragraphs 5, 7 and 8 and added paragraphs 9 and 10 to Article 1 of State law 119/73, which created us, expanding the range of services that we can render, with the inclusion of urban rainwater drainage and management, urban cleaning and solid waste management, as well as the operation of power generation, storage, conservation and sales activities, for our own or third party use.

In addition, the rules simplified the process for the expansion of our business in Brazil and abroad, authorizing us:

- to participate in the controlling block or the capital of other companies;
- to create subsidiaries, which may become majority or minority shareholders in other companies; and
- to establish partnerships with national or foreign companies, including other state or municipal basic sanitation companies in order to expand our activities, share technology and expand investments related to basic sanitation services.

Furthermore, the supplementary Law No. 1,025/2007 maintained the State Sanitation Council (*Conselho Estadual de Saneamento* CONESAN), created by Supplementary Law No. 7,750/92, as an advisory council to define and implement the state basic sanitation policy, and the State Sanitation Fund (*Fundo Estadual de Saneamento* FESAN). The State Sanitation Fund is connected to the State Secretariat for Sanitation and Energy, and collects and manages resources that support State approved programs, as well as the development of technology, management and human resources and a sanitation information system, in addition to other support programs.

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

## ***Public Private Partnerships and Growth Acceleration Plan***

The PPP is a form of agreement with the public administration used for the concession of services to private enterprises, as well as for construction works coupled with the provision of services. PPPs are regulated in the State of São Paulo by Law No. 11,688, which was enacted on May 19, 2004. PPPs may be used for: (i) implantation, expansion, improvement, reform, maintenance, or management of public infra structure; (ii) provision of public services; and (iii) exploitation of public assets and non material rights belonging to the State.

Payment is conditional upon performance. The payment may be collected through: (i) tariffs paid by users; (ii) assignment of credits belonging to the Public Administration, except taxes; and (iii) transfer of rights related to the commercial exploitation of public assets.

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

In January 2007, the President of Brazil announced a new Growth Acceleration Plan, known as the PAC , which includes major investments in infrastructure services, including the provision of water and sewage, housing, as well as highways, airports, ports and energy services, that would benefit the poor population of Brazil. PAC calls for a total investment of R\$504.0 billion through 2010, including a R\$40 billion investment in the sanitation sector. The majority of the investment of the PAC would be provided by State-owned companies and the private sector, while the rest would come from the federal government.

### ***Public Bidding Procedures***

Pursuant to the Federal Public Bidding Law, the public bid process commences with publication by the granting authority in a federal, state or municipal official newspaper, as the case may be, and another leading Brazilian newspaper. The publication announces that the granting authority will carry out a public bidding contest pursuant to provisions set forth in an *edital* (invitation to bid). The invitation to bid must specify, among other terms: (i) the purpose, duration and goals of the bid; (ii) the participation of bidders, either individually or forming a consortium; (iii) a description of the qualifications required for adequate performance of the services covered by the bid; (iv) the deadlines for the submission of bids; (v) the criteria used for selection of the winning bidder; and (vi) a list of the documents required to establish the bidder's technical, financial and legal capabilities.

The invitation to bid is binding on the granting authority. Bidders may submit their proposals either individually or in consortia, as provided for in the invitation to bid. After receiving proposals, the granting authority will evaluate each proposal according to the following criteria, which must have been set forth in the invitation to bid:

- the technical quality of the proposal;
- lowest cost or lowest public service tariff offered;
- a combination of the criteria above; or
- the largest amount offered in consideration for the concession.

The provisions of the State Public Bidding Law parallel the provisions of the Federal Public Bidding Law. The Federal and State bidding laws will apply to us in the event that we seek to secure new concessions. Moreover, these bidding laws currently apply to us with respect to obtaining goods and services from third parties for, among other things, our business operations or in connection with our capital expenditure program, in each case subject to certain exceptions.

## ***Water Usage***

State law establishes the basic principles governing the development and use of water resources in the State of São Paulo in accordance with the State Constitution. These principles include:

- rational utilization of water resources, with service to the segments of the population identified as having priority;
- optimizing the economic and social benefits resulting from the use of water resources;
- protection of water resources against actions which could compromise current and future use;
- defense against critical hydrographic events which could cause risk to the health and safety of the population or economic and social losses;
- development of hydro transportation for economic benefit;
- development of permanent programs of conservation and protection of underground water sources against pollution and excessive exploitation; and
- prevention of erosion of land in urban and rural areas, with a view to protecting against physical pollution and silting of water resources.

Under State law, implementation of any project that involves the use of surface or underground water requires prior authorization or licensing from competent government authority. In order to implement these principles, authorizations granting a right of use are required from the relevant public authority for water usage (whether for collection, release of effluents or otherwise), modification of the regime and modification of the quality or the quantity of the existing water. In the case of rivers under the federal government's domain (rivers crossing more than one state), the ANA is the public authority which grants the authorization. With respect to the rivers under a state's domain, the applicable state authority has jurisdiction to grant the right of use. In the State of São Paulo, the DAEE is the public authority responsible for granting such authorizations. The DAEE has, as its objectives, establishing (i) a policy for the use of water resources with a view to developing the water business of the State, and (ii) plans, studies and projects related to the integral use of water resources, directly or by means of agreements with third parties. The DAEE has established the standards which regulate abstraction of water from water resources in the State of São Paulo.

Our main operating units have been granted water usage rights, however we also have several operating units where water grants are not fully in place. To help obtain the remaining water grants, we have established a corporate program for the legalization of grants.

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

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

## ***Water Quality***

Administrative Rule No. 518/2004, issued by the Ministry of Health of the federal government provides the standards for drinking water for human consumption in Brazil. This rule is similar to the U.S. Safe Drinking Water Act and the regulations enacted by the U.S. 70 Environmental Protection Agency, which establishes rules for sampling and limits related to substances that are potentially hazardous to human health.

In compliance with Brazilian law, the physical chemical, organic and bacteriological analyses carried out for water quality control follow the methodologies of the Standard Methods for Water and Wastewater (21<sup>st</sup> edition) of the American Water Works Association.

Decree No. 5,440/2005 provides that the quality of water must be disclosed to consumers. We have been complying with this regulation by publishing the required information in monthly bills and annual reports delivered to all consumers that we serve.

### ***Environmental Regulation***

The implementation and operation of water and sewage systems are subject to strict federal, state and municipal laws and regulations on environmental and water resource protection. The National Environmental Council (*Conselho Nacional de Meio Ambiental*), or the CONAMA, is the federal agency responsible for the regulation of potentially polluting activities. In the State of São Paulo, the *Companhia Ambiental do Estado de São Paulo*, or CETESB, is the governmental entity responsible for the control, supervision, monitoring and licensing of polluting activities, pursuant to State Law No. 997 of 1976 and State Law No. 13,542 of 2009. CETESB regulates the control of environmental pollutants.

The control and environmental planning instruments are defined by several legal instruments, such as (i) State Law No. 997/1976, which regulates the environmental pollution control; (ii) the Conama Resolution 05/1988, the Conama Resolution No. 237/1997 and the State Decree No. 47,400/2002, which regulate environmental licenses; and (iii) State Decree No. 8,468/76 and Conama Resolution No. 357/2005, which classify water resources and environmental guidelines and establish effluent patterns, among other provisions.

Projects with significant environmental impact are subject to specific studies prepared by multidisciplinary teams that present a series of recommendations focused on minimizing the environmental impact. These studies are then submitted for analysis and approval by the relevant government authorities. The licensing process is composed of the following three stages:

- prior license approves the location and concept and attests to the project's environmental feasibility. Granted in the planning stage.
- installation license authorizes the beginning of works for the installation of the project, subject to compliance with approved plans, programs and projects, including environmental control measures and other necessary technical requirements.
- operation license authorizes the operation of a unit or activity, subject to compliance with the technical requirements contained in the installation license.

## ***Sewage Requirements***

State law sets forth regulations regarding pollution control and environmental preservation in the State of São Paulo. State law limits waste discharge that impacts the water, air and soil. State law provides that, in areas in which there exists a public sewage system, all effluents of a polluting source must be discharged to such system. It is the responsibility of the polluting source to connect itself to the public sewage system. All effluents to be discharged are required to meet certain criteria established by the applicable environmental law, which allow such effluents to be treated by our treatment facilities and discharged in an environmentally safe manner. Effluents which do not comply with such criteria are prohibited from being discharged into the public sewage system. State legislation also establishes that liquid effluents, except those related to basic sanitation, be subjected to pre-treatment so that they meet the required mandatory levels before being discharged into the public sewage system. Article 45 of Federal Law No. 11,455/2007 establishes the national sanitation guidelines and regulates the effluent discharge on a national level.

The CETESB is authorized under State law to monitor discharges of pollutants into the environment and to enforce the requirements of State law. CETESB is responsible for issuing installation and operation licenses granted to sewage treatment facilities and other pollution sources.

We have a program aimed at cleaning up the Tietê river, called the Tietê Project, which was launched in 1992 and is considered the largest basic sanitation program ever implemented in Brazil. The Tietê Project is included in our capital expenditure program, and involves work for the collection, removal and treatment of sewage to expand and optimize the basic sanitary sewage system in the São Paulo metropolitan region. See *Capital Expenditure Programs São Paulo Metropolitan Region Investment Programs Tietê Project*.

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

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provision is currently in the final stages of implementation.

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

## ***Tariff Regulation in the State of São Paulo***

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

On December 16, 1996, the governor of the State issued a decree which approved the existing tariff system and allowed us to continue to set our own tariffs. We used to set our tariffs based on the general objectives of maintaining our financial condition and preserving social equity in terms of the provision of water and sewage services to the population while providing a return on investment. The governor's decree also directs us to apply the following criteria in determining our tariffs:

- category of use;
- capacity of the water meter;
- characteristics of consumption;
- volume consumed;
- fixed and floating costs;
- seasonal variations; and
- social and economic conditions of residential customers.

With the enactment of the Basic Sanitation Law and federal consortium law, we are prohibited from planning, inspecting and regulating services, which includes determining the tariff policy to be adopted. Such activities are to be exercised by the State entity that controls the services, which, with the exception of the responsibility for planning, may delegate the exercise of the other applicable responsibilities. Pursuant to the Basic Sanitation Law, tariff regulation is to be performed by an independent regulatory entity and tariff shall be adjusted on an annual basis. Municipalities can choose to delegate tariff regulation to the ARSESP instead of creating their own regulatory agency. With the sole exception of the municipality of Lins, no other municipality has decided to create its own regulatory entity. Many municipalities have already delegated regulation to the ARSESP. As such, we believe that at least in the near future the ARSESP will be in charge of regulating tariffs for most of the concession and program agreements entered into by us. Nonetheless, we cannot be certain that other municipalities will not take the same decision that the municipality of Lins has taken.

The current tariff structure maintains three different tariff schedules, depending upon whether a customer is located in the São Paulo metropolitan region or the Regional Systems. There are four levels of volume consumed for each category of customer, except for the residential social and *favelas* (shantytowns), where there are five levels of volume consumed. Customers are billed on a monthly basis. We are also authorized to enter into individual contracts with certain customers, such as municipalities, to supply water or sewage services on a wholesale basis.

Before the enactment of the Basic Sanitation Law, we were subject to a federal law which provided that tariffs charged for water and sewage services that are provided pursuant to certain concessions could not produce a return on assets in excess of 12% per annum. Return on our assets was calculated using operating income (before financial and certain other expenses) measured against our operational assets (property, plant and equipment and certain other assets), based on our consolidated financial statements prepared in accordance with Brazilian GAAP. The Basic Sanitation Law revoked this law and extinguished this rule. Currently, the ARSESP is in charge of establishing a criteria to calculate the return on assets, provided that for existing concession agreements, we and the municipalities agree with such criteria. 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.

### ***Governmental Restrictions on Incurrence of Debt***

On June 30, 1998, the Central Bank issued a resolution amending certain conditions that must be observed with respect to the external credit operations (i.e., foreign currency borrowings) of states, the Federal District of Brasilia, municipalities and their respective *autarquias* (agencies), foundations and non financial companies, including us. This resolution provides, among other things, that, with certain exceptions applicable to the importation of goods and services:

- the proceeds of external credit operations must be exclusively used to refinance outstanding financial obligations of the borrower, with preference given to those obligations that have a higher cost and a shorter term, and, until used for such purposes, the proceeds shall remain deposited, as directed by the Central Bank, in a pledged account; and
- the total amount of the contractual obligation must be subject to monthly deposits in a pledged account, equal to the total debt service obligation, including principal and interest, divided by the number of months that the obligation is to be outstanding.

The Central Bank resolution further provides that the requirements described above do not apply to financing transactions involving multilateral or official organizations such as the World Bank, the IDB or the JICA. The Central Bank regulation implementing this resolution provides, among other things, that the account referred to in the first bullet point above must be an account opened in a federal financial institution, which is to hold such funds until released for the purpose of refinancing outstanding obligations of the borrower. The Central Bank regulation further provides that the account described in the second bullet point above must be an escrow account to be opened in a federal financial institution and to secure the payment of principal and interest on the external debt.

Our external credit transactions are also subject to the approval of the National Secretariat of Treasury and the Central Bank. After reviewing the financial terms and conditions of the transaction, the National Secretariat of Treasury and the Central Bank will issue an approval for the closing of the foreign exchange transaction relating to the entry of the funds into Brazil and, following such entry and at our request, an electronic certificate of registration through which all scheduled payments of principal, interest and expenses will be remitted by us. The electronic certificate of registration grants the borrower access to the market for foreign exchange.

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

### ***Lending Limits of Brazilian Financial Institutions***

The National Monetary Council limits the amount that Brazilian public financial institutions may lend to public sector companies, such as us. Financing of projects which are put up for international bid and any financing in *reais* provided to the Brazilian counterpart of such international bids are excluded from these limits.

## **4.C. Organizational structure**

Not applicable.

## **4.D. Property, Plant and Equipment**

Our principal properties consist of reservoirs, water treatment facilities, water distribution networks consisting of water pipes, water mains, water connections and water meters, sewage treatment facilities, and sewage collection networks consisting of sewer lines and sewage connections, which are recorded as intangible assets (concession assets) under IFRS. As of December 31, 2009, we operated 208 water treatment facilities and 63,732 kilometers of water pipes and mains, 475 sewage treatment facilities and 42,895 kilometers of sewer lines, as well as 16 water quality control laboratories.

We own our headquarters building and all other major administrative buildings. We have pledged some of our properties as collateral to the federal government in connection with a long term financing transaction we have entered into with the World Bank that was guaranteed by the federal government. We have also pledged part of our assets in the amount of R\$249.0 million as collateral with respect to our indebtedness under the Special Program for Payment of Federal and Social Security Related Taxes in Installments (*Programa de Parcelamento Especial para Impostos Federais e Previdenciários*), or PAES program.

As of December 31, 2009, the total net book value of our property, plant and equipment and intangible assets (including concession assets) was R\$17.1 billion.

All of our material properties are located in the State of São Paulo.

#### ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

## ITEM 5. Operating and Financial Review and Prospects

*The following management's discussion and analysis of financial condition and results of operations should be read in conjunction with our audited consolidated financial statements included elsewhere in this annual report. The consolidated financial statements included elsewhere in this annual report have been prepared in accordance with IFRS. This annual report contains forward looking statements that involve risks and uncertainties. Our actual results may differ materially from those discussed in the forward looking statements as a result of various factors, including, without limitation, those set forth in Risk Factors.*

*In the following discussion, references to increases or decreases in any period are made by comparison with the corresponding prior period, except as the context otherwise indicates.*

### 5.A. Operating and Financial Review and Prospects

#### Overview

We operate water and sewage systems in the State of São Paulo, including in the city of São Paulo, Brazil's largest city, and in 366 municipalities in the State of São Paulo, which represent 56.7% of all municipalities in the State. We also provide water services on a wholesale basis to six additional municipalities in which we do not operate water systems.

The São Paulo metropolitan region, which includes the city of São Paulo, is our most important service region. With a population of approximately 20.2 million, the São Paulo metropolitan region accounted for approximately 76.1% and 75.6% of our gross revenue from sales and services in 2008 and 2009, respectively. Approximately 62.6% of the concession intangible assets reflected on our balance sheet as of December 31, 2009 was located in this region. In an effort to respond to demand in the São Paulo metropolitan region and because the region represents the principal opportunity to increase our net revenue from sales and services, we have concentrated a major portion of our capital expenditure program to expand the water and sewage systems and to increase and protect water sources in this region.

Our capital expenditure program is our most significant liquidity and capital resource requirement.

## **Factors Affecting Our Results of Operations**

Our results of operations and financial condition are generally affected by our ability to raise tariffs, general economic conditions in Brazil and, in some previous periods, meteorological conditions.

In 2008, the global financial and economic crisis, which commenced in 2008 and whose effects were still present in 2009, resulted in a depreciation of the Brazilian *real* against the US dollar, which adversely affected our foreign currency denominated obligations.

In order to ensure its economic and financial strength, the Company has been working on increasing its efficiency and productivity gains. For this reason, the Company has been attempted to reduce costs. In 2009, we decreased our staff by 9.3% due to the execution of an Agreement for the Adjustment of Conduct (*Termo de Ajustamento de Conduta* or TAC ) with the State Public Attorney's Office (*Ministério Público Estadual*). The TAC laid off retirees who were still working for the Company and laid off 2% of the Company's payroll. The results for the 2009 fiscal year were also affected by the provision for the payment of severance in the amount of R\$146.6 million for employees who resigned in 2009 and the employees who will resign in 2010 and 2011.

### **Effects of Tariff Increases**

Our results of operations and financial condition are highly dependent upon our ability to increase tariffs for our water and sewage services. Since the enactment of Law No. 11,445/2007 dated December 5, 2007, as a general rule, ARSESP will be responsible for setting, adjusting and reviewing tariffs, taking into consideration, among other factors, the following:

- political considerations arising from our status as a State controlled company;
- anti inflation measures enacted by the federal government from time to time; and
- when necessary, the readjustment to maintain the financial economic balance of the agreement.

Readjustment of our tariffs would continue to be set annually, but would be dependent on the parameters established by the Basic Sanitation Law and the ARSESP. The guidelines also establish procedural steps and the terms for annual adjustments. The annual adjustments must be announced 30 days prior to the effective date of the new tariffs, which occur in September, and remain in place for a period of at least 12 months. See *4.B. Business Overview Tariffs*.

The following table sets forth, for the periods indicated, the percentage increase of our tariffs, as compared to three inflation indexes:

	<b>Year ended December 31,</b>	
	<b>2008</b>	<b>2009</b>
Increase in average tariff <sup>(1)</sup>	5.1%	4.4%
Inflation IPC FIPE	6.2%	3.7%
Inflation IPCA	5.9%	4.3%
Inflation IGP M	9.8%	(1.7)%

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

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

*Effects of Brazilian Economic Conditions*

As a company with all of its operations in Brazil, our results of operations and financial condition are affected by general economic conditions in Brazil, particularly by exchange rate fluctuations, inflation rates and interest rate levels. For example, the general performance of the Brazilian economy affects demand for water and sewage services, and inflation affects our costs and margins. The Brazilian economic environment has been characterized by significant variations in economic growth rates.

**General Economic Conditions.** By the end of 2007, Brazil had US\$180.3 billion in currency reserves. The average unemployment rate in the principal metropolitan regions of Brazil remained stable at 6.8% for the years ended December 31, 2008 and 2009, according to IBGE estimates.

Fiscal year 2008 was characterized by the worsening of the global financial and economic crisis. As a result, the *real* depreciated by 30.1% against the U.S. dollar in 2008. Nonetheless, Brazil had R\$206.8 billion in currency reserves and a trade surplus of R\$24.8 billion. The worsening of the financial crisis during the last quarter of 2008 reduced the activity level of the Brazilian economy. The Brazilian economy experienced higher lending rates, currency devaluation, decreasing stock prices and shrinking industrial production. In order to ease the impact of the financial crisis on the Brazilian economy, the Brazilian government implemented measures for the flexibility of its monetary policy and tax relief. These measures strengthened the domestic market and were key to the economic recovery and in 2009, the Brazilian GDP decreased 0.2% in comparison with 2008. Nonetheless, Brazil had US\$239.1 billion in currency reserves in 2009. Brazil's trade surplus was US\$25.3 billion in 2009.

**Interest Rates.** Interest rates in Brazil are closely linked to exchange rate fluctuations and inflation rates. High domestic interest rates result in increases in our financial expenses and also negatively affect our ability to obtain financing, on a cost effective basis, in the domestic capital and lending markets. As a result, we may continue to require substantial amounts of foreign currency denominated indebtedness in order to satisfy our liquidity and funding requirements, which increase our exposure to exchange rate fluctuations as discussed below.

As a result of the global financial and economic crisis, the official interest rate set by the Central Bank was 13.66% on December 31, 2008. In 2009, in order to boost the economy, the Central Bank reduced significantly the official interest rate, reaching 8.65% on December 31, 2009. We have not utilized any derivative financial instruments, or any hedging instruments to mitigate interest rate fluctuations. We do, however, continually monitor market interest rates in order to evaluate the possible need to refinance our debt.

**Inflation.** Inflation affects our financial performance by increasing our costs of services rendered and operating expenses. In addition, all of our *real* denominated debt is indexed to take into account the effects of inflation. Most of our *real* denominated debt provides for inflation based increases in the respective principal amounts of that indebtedness, which increases are determined by reference to the daily government reference interest rate (*Taxa Referencial*), or the TR, plus an agreed margin. We cannot assure that our tariffs will be increased, in future periods, to offset, in full or in part, the effects of inflation.

The following table shows Brazilian inflation for the periods indicated:

		Year ended December 31,	
		2008	2009
Inflation	IPC FIPE	6.2%	3.7%
Inflation	IGP M	9.8%	(1.7)%

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

**Currency Exchange Rates.** We had total foreign currency denominated indebtedness of R\$1,745.6 million as of December 31, 2009, of which R\$81.7 million refer to our short term foreign currency denominated obligations. In the event of significant devaluations of the *real* in relation to the U.S. dollar or other currencies, the cost of servicing our foreign currency denominated obligations would increase as measured in *reais*, particularly as our tariff and other revenue are based solely in *reais*. In addition, any significant devaluation of the *real* will increase our financial

expenses as a result of foreign exchange losses that we must record. For example, the 25.5% appreciation of the *real* against the U.S. dollar in 2009 led to a foreign exchange gain of R\$528.4 million. In contrast, the 31.9% devaluation of the *real* in 2008 increased our financial expenses and negatively affected our overall results of operations for the year.

We manage our indebtedness portfolio closely to decrease the cost of servicing our indebtedness as a whole and our exposure to exchange rate fluctuations. We do not speculate in foreign currencies nor do we have any material exposure to derivatives tied to foreign currencies.

The following table shows the fluctuation of the *real* against the U.S. dollar, the period end exchange rates and average exchange rates for the years 2008 and 2009:

	<b>Year ended December 31,</b>	
	<b>2008</b>	<b>2009</b>
Devaluation (appreciation) of the <i>real</i> versus U.S. dollar	31.9%	(25.49)%
Period end exchange rate US\$1.00	R\$2.3370	R\$1.7412
Average exchange rate US\$1.00 <sup>(1)</sup>	R\$1.8375	R\$1.9976

(1) Represents the average for period indicated.

Source: Central Bank.

At times, we enter into forward exchange transactions and financial funding transactions in *reais* to mitigate foreign currency exposure. In addition, we have monitored, overseen and controlled our foreign currency denominated indebtedness, taking advantage of market opportunities to improve the profile of our indebtedness and reduce our costs. On December 31, 2009 we had no forward exchange transactions.

### ***Effects of Drought***

Brazil experienced a prolonged and severe drought during 2000 and 2001, although historically droughts have not impacted all of our water supply systems equally. As a result, from mid June to mid September of 2000, we rationed water in the south of the São Paulo metropolitan region, affecting approximately 3.5 million people, or approximately 20% of the total population of this region, which reduced our total water production by approximately 8%. From April 2001 through January 2002 and from October to December 2003, we also rationed water in certain regions of the São Paulo metropolitan region, but at a much smaller scale. The rationing at smaller scale caused our total water production volume to be reduced by only 0.8%. The effects of the drought continued to affect our systems through 2004. Due to the water usage reduction bonus program and the return to normal rainfall levels that occurred throughout 2004 and early 2005, the conditions of our reservoirs improved in 2005. In 2006, the rainfall was sufficient to enable us to maintain our reservoirs at historical levels. In 2007 and 2008, the rainfall exceeded the levels of the previous years, increasing the volume of water held in our reservoirs and thereby providing a cushion to meet demand. In 2009, the rainfall levels were higher than the historic average and by the end of 2009, our reservoirs had a utilization rate of 87.0%, compared to a 50.0% and 41.0% utilization in 2008 and 2007, respectively.

## **Critical Accounting Estimates and Assumptions**

We make estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results. The estimates and assumptions that have a significant risk of causing material adjustment to the carrying amounts of our assets and liabilities within the next financial year are addressed below.

### ***Allowance for doubtful accounts***

We record allowance for doubtful accounts in an amount that our management considers sufficient to cover probable losses, based on an analysis of customer accounts receivable, in accordance with the accounting policy stated in Note 2.8 to our consolidated financial statements.

The methodology for determining the allowance for doubtful accounts receivable requires significant estimates, considering a number of factors including historical collection experience, current economic trends, estimates of forecast write offs, the aging of the accounts receivable portfolio and other factors. While we believe that the estimates used are reasonable, actual results could differ from those estimates.

In addition, we have substantial assets consisting of amounts owed by the State. These amounts consist primarily of accounts receivable for services and reimbursement for pensions paid. We have not recorded reimbursements totaling R\$1,167.9 million, corresponding to the balances which were not considered virtually certain that will be reimbursed by the São Paulo State Government. Additional information on the accounts receivable from the São Paulo State Government is disclosed in Note 9 to our consolidated financial statements.

## ***Intangible assets arising from concession contracts***

We recognize intangible assets arising from concession contracts under IFRIC 12, based on the intangible asset model; we estimate the fair value of construction and other work on the infrastructure to recognize the cost of the intangible asset, which is recognized when the infrastructure is built and provided that it will generate future economic benefits. The great majority of our contracts for service concession arrangements entered with each grantor is under service concession agreements in which we have the right to receive, at the end of the contract, a payment equivalent to the unamortized asset balance of the concession intangible asset, which in this case, are amortized over the useful life of the underlying physical assets, thus at the end of the contract, the remaining value of the intangible would be equal to the residual value of the related physical asset. Concession intangible assets under Concession contracts and Program contracts are amortized on a straight line basis over the useful life of the contract. Additional information on the accounting for intangible assets arising from concession contracts is disclosed in Note 2.11(a) to our consolidated financial statements.

The recognition of fair value for the intangible assets arising on concession contracts is subject to assumptions and estimates, and the use of different assumptions could affect the balances recorded. The estimated useful lives of the underlying assets also requires significant assumptions and estimates, which different assumptions and estimates and changes in future circumstances, could affect the remaining useful lives of the intangible assets and can have a significant impact on our results of operations.

## ***Impairment of long lived assets***

We review long lived assets for impairment, primarily intangible assets arising from concession contracts, which include water and sewage system physical assets to be held and used in the business, for the purpose of determining and measuring impairment when events or changes in circumstances indicate that the carrying value of an asset or group of assets may not be recoverable, in accordance with the accounting policy stated in Note 2.12 to our consolidated financial statements.

In evaluating impairment of long lived assets, the evaluation requires significant assumptions and estimates regarding matters that are inherently uncertain, including projections of our future operating income and cash flows, future growth rates, and the remaining useful lives of the assets, among other factors. In addition, projections are computed over an extended period of time, which subjects those assumptions and estimates to an even larger degree of uncertainty. While we believe that the estimates used are reasonable, the use of different assumptions could materially affect the recoverable amount.

No impairment provisions were required in 2009 and 2008.

## ***Provision for contingencies***

We are party to a number of legal proceedings involving significant claims. These legal proceedings include, among other types, tax, labor, civil, environmental, dispute with customers and suppliers and other proceedings. Additional information of these legal proceedings is disclosed in Note 16 to our consolidated financial statements. We accrue for probable losses resulting from these claims and proceedings when we determine that the likelihood that a loss has occurred is probable and the amount of such loss can be reasonably estimated. Therefore, we are required to make judgments regarding future events. As a result of the significant judgment required in assessing and estimating these provisions for contingencies, actual losses realized in future periods could differ significantly from actual estimates and could exceed the amounts provisioned.

***Pension benefits***

The present value of our pension obligations depends on a number of factors that are determined on an actuarial basis using a number of assumptions. The assumptions used in determining the net cost (income) for pensions include the discount rate. Any changes in these assumptions will impact the carrying amount of pension obligations.

We determine the appropriate discount rates at the end of each year. This is the interest rate that should be used to determine the present value of estimated future cash outflows expected to be required to settle the pension obligations.

Other key assumptions for our pension obligations are based in part on current market conditions. Additional information on the pension plans under Plan G0 and G1 is disclosed in Note 17 to our consolidated financial statements.

Differences in actual experience or changes in assumptions could affect the carrying amount of pension obligations and expenses recognized in our results of operations.

## Indemnities Receivable

Indemnities receivable is a long term asset representing amounts receivable from the municipalities of Diadema and Mauá as indemnification for their unilateral termination of our water and sewage service concessions in 1995. As of December 31, 2009, this asset amounted to R\$146.2 million.

Pursuant to our concession contracts, we invested in the construction of water and sewage systems in these municipalities to meet our concession service commitments. Upon the unilateral termination of the concessions by the municipalities of Diadema and Mauá, our assets were impounded by the municipal authorities, which took on the responsibility of providing water and sewage services in these areas. At that time, we reclassified our property, plant and equipment balances relating to the impounded assets as long term assets (indemnities receivable) and recorded impairment charges to reduce the carrying value of the assets to the estimated recoverable amounts for which we had contractually agreed as fair compensation with these municipal authorities.

Our rights to recover these amounts are being disputed by the municipalities and no amounts have been received to date. Based on the advice of legal counsel, we continue to believe that we have the right to receive those amounts and we continue to monitor the status of the legal proceedings. The ultimate amounts to be received however, if any, will most likely be subject to a final court decision. Therefore, actual amounts received could differ from those recorded. For more information, see Note 10 to our consolidated financial statements.

## Certain Transactions with Controlling Shareholder

**Reimbursement Due from the State.** Reimbursement due from the State for pensions paid represent supplementary pensions (Plan G0) that we pay, on behalf of the State, to former employees of the State owned companies which merged to form our company. These amounts must be reimbursed to us by the State, as primary obligor. In November 2008, we entered into the third amendment to the 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 in the amount of R\$696.3 million, subject to the transfer of the property rights of these reservoirs to us. Since November 2008, the State has been paying the remaining balance in the amount of R\$219.0 million in 114 successive monthly installments, starting in November 2008. We have not recorded reimbursements totaling R\$1,167.9 million, represented by R\$696.3 million related to the transfer of the reservoirs in the Alto Tietê System and R\$471.6 million which the State does not believe that it is responsible for paying such amount. See Note 9 to our consolidated financial statements and *Item 7.A. Major Shareholder*.

**Accounts Receivable from the State for Water and Sewage Service Provided.** Certain of these accounts receivable have been overdue for a long period and we do not reserve against such accounts receivable as we fully expect to

recover these amounts and loss is not considered probable. We have entered into agreements with the state with respect to these accounts receivable. For further information on these agreements, see Note 9 to our consolidated financial statements and *Item 7.A. Major Shareholder*.

***Use of Certain Assets Owned by the State.*** We currently use certain reservoirs in the Billings and Guarapiranga reservoirs which are owned indirectly by the State. We currently do not pay any fees with respect to the use of these reservoirs. However, we are responsible for maintaining and meeting the operating costs of these reservoirs. If these facilities had not been made available for our use, we would have had to obtain water from more distant sources, which would be more costly. The State does not incur operating costs on our behalf.

The arrangement for use of the Billings and Guarapiranga reservoirs is provided for through a grant issued by the DAEE. We have a right to use these reservoirs so long as we remain responsible for maintaining and meeting their operating costs.

## Results of Operations

The following table sets forth, for the periods indicated, certain items in our statement of operations, each expressed as a percentage of net revenue from sales and services:

	Year ended December 31,		2009	
	2008		R\$ millions	%
	R\$ millions	%	R\$ millions	%
Net revenue from sales and services	7,809.3	100.0	8,579.5	100.0
Cost of sales and services	(4,482.9)	(57.4)	(5,087.3)	(59.3)
Gross profit	3,326.4	42.6	3,492.2	40.7
Selling expenses	(499.7)	(6.4)	(610.4)	(7.1)
Administrative expenses	(580.0)	(7.4)	(717.1)	(8.4)
Other operating expenses, net	(125.5)	(1.6)	(44.4)	(0.5)
Operating profit	2,121.2	27.2	2,120.3	24.7
Finance cost, net	(973.0)	(12.5)	(10.0)	(0.1)
Income before income taxes	1,148.2	14.7	2,110.3	24.6
Income taxes	(285.3)	(3.7)	(602.6)	(7.0)
Net income	862.9	11.0	1,507.7	17.6

## Year Ended December 31, 2009 Compared to Year Ended December 31, 2008

### *Net Revenue from Sales and Services*

Net revenue from sales and services increased by R\$770.2 million, or 9.9%, to R\$8,579.5 million in 2009, from R\$7,809.3 million in 2008. This increase was principally due to:

- an average 2.1% increase in the total volume invoiced in 2009 (an 2.1% increase in the volume of water invoiced and a 3.2% in the volume of sewage services invoiced); and
- the effect of the 5.1% tariff increase in September 2008, and the 4.4% tariff increase in September 2009.

The increase was partially offset by:

- a decrease in the volume produced in the industrial segment, due to the termination or decrease in the production of certain industrial units and the execution of fixed demand agreements; and
- a decrease in the volume invoiced to both state and municipal entities, due to the incentives created by the Rational Use of Water Program (*Programa de Uso Racional da Água*) to decrease water consumption.

### ***Cost of Sales and Services***

The cost of sales and services increased by R\$604.4 million, or 13.5%, to R\$5,087.3 million in 2009, from R\$4,482.9 million in 2008. As a percentage of net revenue from sales and services, cost of sales and services increased to 59.3% in 2009 from 57.4% in 2008.

The increase in costs of sales and services was principally due to the following factors:

- an increase of R\$152.1 million, or 14.8%, in payroll expenses and related charges, due to (i) annual salary adjustments of 6.7% that came into effect in May 2009; and (ii) an increase in TAC (a program to dismiss employees already retired, but that are still working for us), that comprises prior notice amount, severance payments and related charges totaling R\$67.0 million;

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- an increase of R\$108.7 million, or 24.5%, in outsourced services, mainly due to an increase of (i) R\$41.2 million in sewage and water network and connections maintenance; (ii) R\$29.6 million in preventive and corrective maintenance of water and sewage treatment stations; (iii) R\$10.4 million in a provision for expenditures that we are committed to under our agreement with the city of São Paulo; (iv) R\$7.0 million in technical services; (v) R\$6.2 million related to the rental of vehicles, which started in 2008, in substitution of our own fleet; and (vi) R\$6.1 million in treatment and transportation of sludge;
- an increase of R\$359.2 million, or 21.8%, in construction costs, mainly due to an increase in capital expenditures of concession intangible assets in 2009 compared to 2008;
- an increase of R\$25.9 million, or 5.7%, in energy costs, principally as a consequence of an average increase of 8.5% in energy tariffs which was partially offset by a decrease of 1.6% in our energy consumption; and
- an increase of R\$8.7 million, or 23.9%, in general expenses, mainly due to the payments for the municipality of São Paulo, that amounted R\$5.1 million in 2009, and general insurance expenses of R\$0.7 million.

The increase was partially offset by:

- a decrease of R\$60.1 million, or 10.1%, in depreciation and amortization in 2009 when compared to 2008.

***Gross Profit***

As a result of the factors discussed above, gross profit in 2009 increased by R\$165.8 million, or 5.0%, to R\$3,492.2 million in 2009, from R\$3,326.4 million in 2008. As a percentage of net revenue from sales and services, gross profit decreased to 40.7% in 2009 from 42.6% in 2008.

***Selling Expenses***

Selling expenses in 2009 increased by R\$110.7 million, or 22.2%, to R\$610.4 million in 2009, from R\$499.7 million in 2008. As a percentage of net revenue from sales and services, selling expenses increased to 7.1% in 2009, from 6.4% in 2008.

The increase in selling expenses was primarily due to the following factors:

- an increase of R\$72.3 million, or 54.8%, in outsourced services expenses, principally due to (i) R\$24.5 million expenses related to the PURA program in municipal schools, pursuant to our agreement with the city of São Paulo, (ii) an increase of R\$19.7 million in outsourced accounts receivable collection services, resulting from an increase in our collection claims; (iii) R\$16.4 million in a provision for future expenses that we commit to incur pursuant to our agreement with the city of São Paulo; and (iv) R\$8.6 million in verification and billing services, resulting from the outsourcing of these services and the adoption of new technologies in the verification and billing processes; and
- an increase of R\$32.6 million, or 18.2%, in payroll expenses and related charges, due to (i) annual salary adjustments of 6.69% that came into effect in May 2009; (ii) a R\$9.1 million increase in TAC (a program to dismiss employees already retired, but that are still working for us), that comprises prior notice amount, severance payments and related charges.

***Administrative Expenses***

Administrative expenses for 2009 increased by R\$137.1 million, or 23.6%, to R\$717.1 million in 2009, from R\$580.0 million in 2008. As a percentage of net revenue from sales and services, administrative expenses increased to 8.4% in 2009, from 7.4% in 2008.

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The increase in administrative expenses was primarily due to:

- a increase of R\$63.5 million, or 42.7%, in payroll expenses and related charges, due to (i) annual salary adjustments of 6.69% that came into effect in May 2009; and (ii) a R\$6.6 million increase in TAC (a program to dismiss employees already retired, but that are still working for us), that comprises prior notice amount, severance payments and related charges;
- an increase of R\$41.6 million, or 36.9% in outsourced services, mainly due to (i) R\$25.9 million in advertising expenses related to our advertising campaigns that focus on our social and environmental actions, such as Projeto Verão, Onda Limpa, Soluções Ambientais, PURA, among others; (ii) R\$4.7 million in consulting and other services, and (iii) R\$2.2 million in maintenance of information technology, equipment and software licenses;
- an increase of R\$21.2 million, or 8.5%, in general expenses, consisting in the increase of our provisions for contingencies; and
- an increase of R\$6.5 million, or 13.3%, in tax expenses, mainly due to (i) a R\$3.1 million expense related to the Imposto sobre a Propriedade Predial e Territorial Urbana (IPTU), a tax on properties; and (ii) a R\$3.2 million expense paid to ARSESP, the regulatory agency.

***Other Operating Expenses, Net***

Other operating expenses, net, for 2009 decreased by R\$81.1 million, or 64.6%, to R\$44.4 million in 2009 from R\$125.5 million in 2008. The decrease is primarily due to an expense recorded in 2008 amounting to R\$137.1 million related to a write off of property, plan and equipment and concession intangible assets after the negotiation of the third amendment with the State Government of São Paulo.

***Finance Cost, Net***

Finance cost, net consist primarily of interest on our indebtedness, foreign exchange losses (or gains) in respect of our indebtedness, offset partially by interest income on cash and cash equivalents and inflation based indexation accruals, mainly relating to agreements entered into with some customers to settle overdue accounts receivable.

Finance cost, net in 2009 decreased by R\$963.0 million, or 99.0%, to R\$10.0 million, from R\$973.0 million in 2008.

The decrease was mainly due to:

- a change of R\$967.3 million caused by the foreign exchange variation, from a foreign exchange expense of R\$438.9 million in 2008 to a foreign exchange income of R\$528.4 million in 2009, especially due to the 25.5% depreciation of the U.S. dollar against the real in 2009, compared to the 31.9% appreciation of the U.S. dollar against the real in 2008;
- a decrease of R\$126.6 million in monetary indexation expenses on loans and financing, that was primarily attributable to (i) a decrease of R\$105.6 in monetary indexation expenses caused by the 1.71% negative

variation of the IGP M in 2009, compared to a 9.81% positive variation in 2008; (ii) a decrease of R\$20.9 million in monetary indexation expenses caused by the decrease of the TR, to 0.71% in 2009 from 1.63% in 2008;

- a decrease of R\$95.0 million in interest and other charges related to our real denominated indebtedness, mainly due to the payments we made and the related decrease in the outstanding balance of our indebtedness;
- an increase of R\$13.5 million, or 8.9%, in the remuneration of our financial investments, interest income and other financial revenues; and
- the settlement of US\$98 million Eurobonds in June 2008, with a R\$9.9 million variation.

The decrease in the finance cost, net was partially offset by:

- a R\$95.2 million decrease in the income from monetary indexation, especially due to the R\$82.5 million update of the undisputed amount regarding the reimbursement of supplemental retirement and pension benefits in accordance with the agreement with the State and the DAEE made in 2008 and not recurrent in 2009;

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- an increase of R\$87.5 million in the financial expenses related mainly to interest and monetary indexation of provision for contingencies; and
- an increase of R\$64.0 million in other financial expenses, mainly due to (i) adjustment in the interest calculations regarding the Special Program for Payment of Federal and Social Security Related Taxes in Installments (Programa de Parcelamento Especial para Impostos Federais e Previdenciários), or PAES program, as set forth by Law No. 10,684, dated May 30, 2003, totaling R\$58.7 million in 2008; and (ii) financial expenses related to commitments made to the municipalities in order to formalize the concession agreements, amounting R\$15.8 million.

*Income before Income Taxes*

As a result of the factors discussed above, income before income taxes in 2009 increased by R\$962.1 million, or 83.8%, to R\$2,110.3 million, from R\$1,148.2 million in 2008. As a percentage of net revenue from sales and services, our income before income taxes increased to 24.6% in 2009, from 14.7% in 2008.

*Income Taxes*

Income taxes in 2009 increased by R\$317.3 million, or 111.2%, to R\$602.6 million in 2009 from R\$285.3 million in 2008. This increase was primarily due to the increase of our income before income taxes in 2009.

*Net Income*

**As a result of the factors discussed above, net income increased by R\$644.8 million, or 74.7%, to R\$1,507.7 million in 2009, from R\$862.9 million in 2008. Net income margin increased to 17.6% in 2009 from 11.0% in 2008.**

As a result of the factors discussed above, net income increased by R\$644.8 million, or 74.7%, to R\$1,507.7 million

## 5.B. Liquidity and Capital Resources

### ***Capital Sources***

In order to satisfy our liquidity and capital requirements, we have primarily relied on cash provided by operating activities, borrowings from Brazilian federal and state governmental financial institutions, and financing from multilateral organizations and from domestic and international capital markets. As of December 31, 2009, we had R\$771.0 million of cash and cash equivalents. Outstanding short term indebtedness was R\$1,009.9 million as of December 31, 2009, of which R\$81.7 million was denominated in foreign currency. Long term indebtedness was R\$5,548.0 million as of December 31, 2009, of which R\$1,663.9 million consisted of foreign currency denominated obligations. We believe that we have sufficient sources of liquidity and capital to meet our liquidity and capital requirements for the next few years, in light of our current financial position and our expected cash generated by operating activities.

***Cash Provided by Operating Activities.*** Cash provided by operating activities is, and we anticipate that it will continue to be, the single largest source of our liquidity and capital resources in future years and financial periods. Our cash generated by operating activities was R\$2,103.9 million and R\$2,072.5 million in 2008 and 2009, respectively.

We have overdue accounts receivable from the State and from the municipalities to which we provide water on a wholesale basis. For more information, see *Item 7.B. Major Shareholders and Related Party Transactions Related Party Transactions*.

***Indebtedness Financing.*** As of December 31, 2009, we had R\$5,548.0 million in long term indebtedness outstanding (excluding the current portion of long term indebtedness), of which R\$1,663.9 million consisted of foreign currency denominated long term debt. We had outstanding short term indebtedness of R\$1,009.9 million as of December 31, 2009, representing the current portion of our long term indebtedness. As of December 31, 2009, R\$81.7 million of this short term indebtedness was denominated in foreign currency.

The following table sets forth information on our indebtedness outstanding as of December 31, 2009:

Facility	As of December 31, 2009		Total Aggregate Principal Amount	Final Maturity	Interest Rate <sup>(1)</sup>
	Current	Long Term			
	<i>(in millions of reais)</i>				
<i>Real-denominated loans and financings:</i>					
Federal Government/Banco do Brasil	288.8	1,127.1	1,415.9	2014	8.50% plus UPR
Debentures 6th Issue	225.4	-	225.4	2010	11.00% plus IGPM
Debentures 7th Issue	121.2	-	121.2	2010	10.80% plus IGPM
Debentures 8th Issue	-	417.9	417.9	2011	10.75% plus IGPM
Debentures 9th Issue	-	223.7	223.7	2015	CDI+2.75% and 12.87% plus IPCA
Debentures 10th Issue	-	274.5	274.5	2020	TJLP+1.92% (1st and 3rd series) and 9.53% (2nd series) plus IPCA
Caixa Econômica Federal <sup>(2)</sup>	78.9	680.0	758.9	2010/2031	6.8% (weighted) plus UPR
Promissory notes	-	898.4	898.4	2015	CDI+3.5%
FIDC SABESP 1	55.5	13.9	69.4	2011	CDI+0.70%
BNDES	42.9	83.9	126.8	2013	3% + TJLP (limited to 6.00%)
BNDES (South coast area)	-	130.5	130.5	2019	2.5% + TJLP (limited to 6.00%)
BNDES (PAC)	-	14.6	14.6	2023	2.15% + TJLP (limited to 6.00%)
Other	3.2	11.6	14.8	2010/2018	12.00%, CDI and TJLP + 6.00% and UPR
Accrued interest	112.3	8.0	120.3		
	928.2	3,884.1	4,812.3		
<i>Foreign currency denominated loans and financings:</i>					
IADB	64.2	588.1	652.3	2016/25	3.00% to 4.93% plus monetary adjustment
Eurobonds	-	243.0	243.0	2016	7.50%
JBIC Yens 2,316,000 thousand	-	400.9	400.9	2029	1.8% and 2.5%
IADB	-	431.9	431.9	2023	4.47% to 4.97%
Accrued interest	17.5	-	17.5		
	81.7	1,663.9	1,745.6		
<b>Total Debt</b>	<b>1,009.9</b>	<b>5,548.0</b>	<b>6,557.9</b>		

(1) UPR stands for Standard Reference Unit (*Unidade Padrão Referência*) and is equal to the *TR*, which was 0.0533% per month as of December 31, 2009; CDI stands for Interbank Deposit Rate (*Certificado de Depósitos Interbancários*), which was 8.55% per annum as of December 31, 2009; IGP M was (1.71)% per annum as of December 31, 2009; TJLP stands for Long term Interest Rate (*Taxa de Juros a Longo Prazo*), published quarterly by the Central Bank, which was 6.0% per annum as of December 31, 2009.

(2) Agreements to provide up to approximately R\$311.6 million in financing for our capital expenditure program until final maturity. We have pledged amounts in certain bank accounts as collateral for these loans.

Substantially all of our foreign currency denominated indebtedness of R\$1,745.6 million as of December 31, 2009 was denominated in U.S. dollars or in baskets of foreign currencies. This indebtedness consisted principally of:

- R\$659.4 million (US\$374.6 million) in U.S. dollar denominated loans from the Inter American Development Bank, or the IADB. Under these loans, payments of principal are made in semi annual installments with final maturity in July 2025. The principal amount is adjusted semi annually for the variation in a basket of foreign currencies and accrues interest at a rate varying from 3.00% to 4.93%. We have pledged part of our receivables from our sales and services up to the amount due as collateral. For further information on the terms of these loan agreements, see *Item 4.A. History and Development of the Company Capital Expenditure Program Tietê Project.* ; and
- R\$434.5 million (US\$250.0 million) in U.S. dollar denominated loans from the AB Loan financing contracted with the IADB in June 2008. Under this loan, payments of principal are made in annual installments with final maturity in May 2023. The principal amount is adjusted semi-annually for the LIBOR6M plus spread and accrued interest at a rate varying from 4.47% to 4.97%. This loan was used in the settlement of Eurobonds and in the implementation of our investment plan.

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Our borrowings from multilateral institutions, such as the IADB, have in the past been, and in the future are likely to be, guaranteed by the government of the State or the federal government. We do not pay fees for these guarantees. Under some of the loan agreements with the IADB, we have granted a guarantee (*contra garantia*) to the federal government.

In addition, we entered into a credit agreement on August 6, 2004 with the JBIC (today JICA) for the financing of the Clean Wave Program, which was guaranteed by the federal government for an aggregate principal amount of ¥21,320 million (R\$337.7 million). The disbursements began in January 2006. As of December 31, 2009, the total amount outstanding was R\$405.3 million. Under this financing agreement, amortizations are made in semi annual installments in August and February, with final maturity in 2029. This obligation is guaranteed by the federal government. For further information on the terms and guarantees of this financing agreement, see *Item 7. Major Shareholders and Related Party Transactions Related Party Transactions Government Guarantees of Financing* and *Item 4.A. History and Development of the Company Capital Expenditure Program Clean Wave Program*.

Our outstanding domestic debt was R\$4,812.3 million as of December 31, 2009 and consisted primarily of *real* denominated loans from Federal and State owned banks, in particular, Banco do Brasil S.A., Caixa Econômica Federal and the BNDES, as well as debentures issued in September 2004, March and June 2005, October 2008 and November 2009, and promissory notes issued in December 2009.

The following summarizes our principal borrowings from federal and state owned banks:

- In March 1994, we entered into a loan agreement with Banco do Brasil S.A. Amortizations of principal amount are made in 240 successive monthly installments, with final maturity in 2014. The principal amount accrues interest at the daily government interest rate plus 8.50% per annum and monetary adjustment;
- We have entered into several line of credit agreements with Caixa Econômica Federal, pursuant to which amortizations of principal are paid in 120 or 180 months in monthly installments after 30 days following a grace period, which varies from 14 to 36 months from the date of the first draw down. The final maturity is 2031. The principal amount accrues interest at a weighted rate of 6.8%;
- In August 2002, we entered into a line of credit agreement with BNDES. The final maturity date is February 2013. The principal amount accrues interest at the long term rate fixed by the federal government (*Taxa de Juros de Longo Prazo*), or TJLP, limited to 6.0%, plus 3.0% per annum. If the TJLP exceeds 6.0%, such excess will be added to the principal amount payable at maturity;
- In November 2007, we entered into a credit agreement with BNDES for the financing of the Clean Wave Program. Amortizations of principal amount will be made in 96 successive monthly installments, with final maturity in 2019. The principal amount accrues interest at the TJLP, but limited to 6.0%, plus 2.50% per annum; and
- In March 2010, we entered into a R\$294.4 million financing agreement with BNDES. Amortizations of principal amount will be made in 156 successive monthly installments after 30 days following the 24 month grace period, with final maturity in 2025. The principal amount accrues interest at the TJLP, but limited to 6.0% plus 1.92% per annum.

In addition, we are currently negotiating with IADB, JICA and Caixa Econômica Federal for additional loans to finance portions of our capital expenditure program.

With respect to the debentures issued on September 17, 2004, we filed a securities shelf program with the CVM through which we were able to offer non convertible debentures in the aggregate amount of R\$1.5 billion. We issued the total amount available under this shelf program by July 2005. As part of the program we issued:

- R\$600.0 million in aggregate principal amount of debentures in September 2004 (our sixth issuance), offered in three separate series. The debentures of the first and second series matured in September 2007 and 2009, respectively, and the debentures of the third series will mature in September 2010. The debentures of the first series in the aggregate amount of R\$231.8 million beared interest at the interbank deposit rate (CDI) plus 1.75% per year, and the debentures of the second series in the aggregate amount of R\$188.3 million, and of the third series, in the aggregate amount of R\$179.9 million, bear interest at rates of IGP-M index plus 11.0% per year;

- R\$300.0 million in aggregate principal amount of debentures in March 2005 (our seventh issuance), offered in two series. The debentures of the first and second series matured in March 2009 and 2010, respectively. The debentures of the first series, in the aggregate amount of R\$200.0 million, bore interest at the interbank deposit rate (CDI) plus 1.5% per year, and the debentures of the second series, in the aggregate amount of R\$100.0 million, bore interest at the rate of IGP M index plus 10.8% per year; and
- R\$700.0 million in aggregate principal amount of debentures in June 2005 (our eighth issuance), offered in two series. The debentures of the first series matured in June 2009 and the second series will mature in 2011. The debentures of the first series, in the aggregate amount of R\$350.0 million, bore interest at the interbank deposit rate (CDI) plus 1.5% per year, and the debentures of the second series, in the aggregate amount of R\$350.0 million, bore interest at the rate of IGP M index plus 10.75% per year.

On October 23, 2008, we filed a securities shelf program with the CVM through which we were able to offer non convertible debentures in the aggregate amount of R\$3.0 billion.

As part of the shelf program with the CVM, we issued R\$220.0 million in aggregate principal amount of debentures in October 2008 (our ninth issuance), offered in two series. The debentures of the first and second series will mature in October 2013 and 2015, respectively. The debentures of the first series, in the aggregate amount of R\$100.0 million, bear interest at the interbank deposit rate (CDI) plus 2.75% per year, and the debentures of the second series, in the aggregate amount of R\$120.0 million, bear interest at the rate of IPCA index plus 12.87% per year.

We issued in three series our tenth issuance of debentures in aggregate principal amount of R\$275.4 million in November 2009. The debentures of the first, second and third series will mature in 2020. The debentures of the first and third series, in the aggregate amount of R\$77.1 million and R\$115.7 million, respectively, bear interest at the TJLP plus 1.92% per year, and the debentures of the second series in the aggregate amount of R\$82.6 million bear interest at the rate of IPCA index plus 9.53% per year. Our tenth issuance was entirely subscribed by BNDES. The financial covenants for this issuance are: (i) EBITDA to net revenue equal or greater than 38.0%; (ii) coverage ratio equal to or higher than 2.35; and (iii) net bank debt to EBITDA equal to or greater than 3.65.

We will use the funds raised from this tenth issuance for investments primarily in the Corporate Program for Water Loss Reduction and on improvements and reforms of the Rio Grande's water treatment station infrastructure, including others projects for water supply and sewage collection systems in the São Paulo Northern Coast, Paraíba Valley and Mantiqueira Regions.

In December 2009, we issued promissory notes totaling R\$900.0 million as a bridge loan, corresponding to an advance of the eleventh issuance of debentures.

In April 2010, we issued in two series our eleventh issuance of debentures in aggregate principal amount of R\$1,215.0 million. The first and the second series will mature in March 2015 and 2013, respectively. The debentures of the first series, in the aggregate amount of R\$810.0 million, bear interest of the interbank deposit rate (CDI) plus 1.95% per year and the second series, in the aggregate amount of R\$405.0 million, bear interest of interbank deposit rate (CDI) plus 1.4% per year. The net proceeds from our eleventh issuance of debentures was partially used to redeem the promissory notes issued in December 2009. The rest was used as cash injection.

On June 22, 2010, we issued 500,000 debentures to the Government Severance Indemnity Fund for Employees (*Fundo de Garantia por Tempo de Serviço*), or FGTS, based on the FGTS program to finance companies in the sanitation, transport and real estate businesses (our twelfth issuance). The proceeds will be released in three series within a six month-period each, totaling R\$500 million, of which R\$170 million was already transferred to us. The

debentures will bear interest based on the TR plus 9.5% per year. The debentures have a grace payment period of four years and we have an option to redeem the debentures as from July 2014 and a final maturity in June 2025. We intend to use the proceeds from the twelfth issuance to fund a portion of our capital expenditure program in the water supply and sewage systems.

All of our *real* denominated indebtedness is indexed to take into account the effects of inflation. Most of our *real* denominated debt provides for inflation based increases in their respective principal amounts; the increases are determined by reference to the TR plus an agreed margin.

Furthermore, in March 2006, a securitization fund (*Fundo de Direitos Creditórios*) was created having our future account receivables as its underlying assets. In March 2006, the fund issued senior and junior quotas to investors in Brazil with a value per unit of R\$500.0 thousand. The senior quotas are being amortized in 54 monthly installments, with final maturity in March 2011. The fund is designed to have a return to investors corresponding to 100% of the interbank deposit rate (CDI) variation, plus a fixed interest rate of 0.7% per annum. We subscribed, paid for and maintain in a deposit account 26 junior, or subordinated, quotas of this fund in the aggregate amount of R\$18.2 million.

In March 2006, the fund advanced proceeds to us derived from the provision of water and sewage services in the aggregate amount of R\$250.0 million, representing a portion of the payments due under the underlying receivables during a five year period. We retain the right to receive the balance of additional payments accounting for the remaining portion of the receivables, provided that no event of default under the by laws of the fund has occurred or is continuing. Once payments to the fund are made in full, which is expected to happen five years after the creation of the fund, we will be entitled to all payments received under the underlying receivables. The fund manager is Caixa Econômica Federal.

*Financial Covenants.* We are subject to financial covenants under the agreements evidencing or governing our outstanding indebtedness. As of December 31, 2009, we were in compliance with our financial covenants.

With respect to our indebtedness denominated in U.S. dollars or in baskets of foreign currencies, we are subject to financial covenants, including but not limited to those set forth in the loan agreements entered into with the IADB. Each of these agreements contains, among other provisions, limitations on our ability to incur debt. The indenture relating to the 7.5% notes due 2016 is the most stringent of these debt agreements. This indenture prohibits, subject to some exceptions, the incurrence of additional debt in the event that (i) the ratio of Adjusted Total Debt to Adjusted EBITDA (as defined in the related indenture) is greater than 3.65 or (ii) the Debt Service Coverage Ratio (as defined in the indenture) is less than 2.35x. We do not believe that these covenants will impose constraints on our ability to finance our capital expenditure program or, more generally, to develop our business and enhance our financial performance.

In addition, with respect to our outstanding domestic indebtedness, we entered into a financing agreement with the federal government and Banco do Brasil S.A. and also into several credit agreements with Caixa Econômica Federal that do not contain material financial covenants. Under our credit agreement with BNDES we are required to keep (i) an EBITDA/net operational income ratio equal to or higher than 38%, (ii) an asset/short term liability (excluding the short term portion of long term liabilities) ratio higher than 1.0x, (iii) total connections (water and sewage)/employees ratio equal to or higher than 520, (iv) EBITDA/debt service equal to or higher than 1.5 and (v) a shareholders equity/total debt ratio equal to or higher than 0.8.

With respect to our debentures, the sixth, seventh, eighth, ninth and eleventh issuances require us to maintain a current debt ratio higher than 1.0 and an EBITDA/financial expenditures ratio equal to or higher than 1.5.

The ninth issuance requires us to maintain an EBITDA/net operational revenue ratio equal to or higher than 38 percent, an EBITDA/financial expenditures ratio equal to or higher than 2.35x and net financing and loans/EBITDA ratio equal to or higher than 3.65x.

Brazilian regulations provide that a state owned company, such as us, must use the proceeds of external credit operations (i.e., foreign currency borrowings), subject to some exceptions, exclusively to refinance outstanding financial obligations. The use will be restricted according to the declared use of proceeds, and until so used, these proceeds must be deposited as directed by the Central Bank. The deposit requirement does not apply in the case of import financing and financing transactions involving multilateral and official organizations, such as the JICA and the IADB. On December 31, 2009, there was no restricted cash under this regulation.

## **Capital Requirements**

We have, and expect to continue to have, substantial liquidity and capital resource requirements. These requirements include debt service obligations, capital expenditures to maintain, improve and expand our water and sewage systems, and dividend payments and other distributions to our shareholders, including the State.

*Capital Expenditures.* Historically, our capital expenditures have been significantly financed with resources from international and national multilateral agencies and development banks. We generally include in our capital expenditure program for the following year the amount of investment that was not realized in the previous year. In 2008, we invested approximately R\$1.7 billion under our capital expenditure program. In 2009, we invested R\$1.8 billion under our capital expenditure program. We have budgeted investments in the amount of approximately R\$7.0 billion from 2010 through 2013.

*Dividend Distributions.* We are required by our by laws to make dividend distributions, which can be made as payments of interest on shareholders equity to our shareholders in an amount equal or higher than 25% of the amounts available for distribution. The aggregate amount of distributions we made for 2008 and 2009 were R\$296.2 million and R\$394.2 million, respectively.

On October 18, 2007 and February 21, 2008, our board of directors approved the payment of dividends, in the form of interest on shareholders equity, in the amount of R\$268.8 million and R\$31.9 million, respectively. The payments of these dividends began being paid on June 27, 2008.

On July 31, 2008 and January 15, 2009, our board of directors approved the payment of dividends, in the form of interest on shareholders equity, in the amount of R\$200.5 million and R\$95.7 million, respectively. These dividends were paid on June 29, 2009.

As of December 31, 2009, our dividends payable to the State were in the amount of R\$198.1 million. The dividends due from 2005 to 2007, in the amount of R\$552.0 million have been paid during the first quarter of 2008. We are currently unable to determine the amount, if any, of the remaining portion of these declared dividends that the State will apply to the current and future accounts receivable owed to us by the State or its controlled entities.

### **5.C. Research and Development, Patents and Licenses, Etc.**

**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 department is divided into committees according to strategy and complexity. In 2008 and 2009 we spent R\$3.5 million and R\$3.8 million, respectively, on research and development. We have also formed associations with several research institutions.**

#### *Trademarks*

We have secured registration of our logo and composite trademark at the Brazilian Institute of Industrial Property (*Instituto Nacional da Propriedade Industrial*), or INPI. We have registered with the INPI the following trademarks: PROJETO TIETÊ, REUSO DA ÁGUA, REVISTA DAE, LIGAÇÃO SABESP, PURA, GOTUCHO, GOT BORRALHEIRA, DR. GASTÃO and RATANTAN . *Gotucho, Gota Borrallheira, Dr. Gastão* and *Ratantan* are some of the characters of the SABESP's mini club (*Clubinho SABESP*), which is a tool for environmental education directed to children in our website).

We have also filed applications with the INPI for registration of the trademarks: PARQUE DA INTEGRAÇÃO, PROGRAMA DE RECUPERAÇÃO AMBIENTAL, PROGRAMA CÓRREGO LIMPO, SIGNOS (*Sistema de Informação Geográfica no Saneamento*), SCORPION, PROGRAMA ONDA LIMPA, PROL PROGRAMA DE RECICLAGEM DO ÓLEO DE FRITURA , SABESP SOLUÇÕES AMBIENTAIS, AGENTE DA GENTE SABESP NA COMUNIDADE, SABESP INTELIGÊNCIA AMBIENTAL, CLUBINHO SABESP, and the following characters of the *Clubinho SABESP*: SUPER H2O, CAUÃ, IARA, SAYURI, CADU, DENIS and GABI.

### ***Patents***

We have the following patents granted by the INPI:

- water consumption measurement unit;
- an engine powered starting system to automatically correct chemical products dosage in conventional dispensers by gravity;
- equipment to clean the filters of water treatment facilities;
- equipment for alignment of motor pump sets; and
- a constructive device in a building hydraulic simulator for didactic purposes.

### ***Software***

We adopted an internal policy that provides for an active and effective fiscalization and repression of unauthorized software. We have acquired the software licenses for all our workstations.

We have also developed certain computer programs for management and control of water and sewage treatment facilities, as well as for third party services management, called AQUALOG, SGL (Bid Management System), Electronic Price Quotation (*Cotação Eletrônica de Preços*), and SCORPION, SISDOC Sistema de Controle de Documentos and SACE Sistema de Atendimento Comercial Externo. We have also secured registration of these programs at the INPI and The Brazilian Association of Software Companies (*Associação Brasileira de Empresas de Software*).

AQUALOG is the only Brazilian software designed to monitor water treatment through the employment of artificial intelligence. We completed the first rendering of services based on the AQUALOG software to a third party with the automatization of a water treatment plant in the city of Jaguará do Sul, State of Santa Catarina. We entered into an agreement to license the software to Sanesul, in the State of Mato Grosso do Sul, to Teuto's drugs factory, in the city of Anapólis, State of Goiás, and to a water and sewage station in the city of Aparecida do Norte, State of São Paulo.

SGL is an electronic price quotation system that allows us to view and control all bid and acquisition proceedings in real time.

### ***Domain Names***

We own the domain names described below that have been registered with the relevant entity in Brazil, Registro.br:

- [www.sabesp.com.br](http://www.sabesp.com.br);
- [www.corregolimpo.com.br](http://www.corregolimpo.com.br);
- [www.projetotiete.com.br](http://www.projetotiete.com.br);
- [www.revistadae.com.br](http://www.revistadae.com.br);
- [blogdasabesp.com.br](http://blogdasabesp.com.br);
  
- [blogsabesp.com.br](http://blogsabesp.com.br);
  
- [sustentabilidadesabesp.com.br](http://sustentabilidadesabesp.com.br);

- clubinhosabesp.com.br; and
- superh2o.com.br.

#### 5.D. Trend Information

Not applicable.

#### 5.E. Off Balance Sheet Arrangements

We had no off balance sheet arrangements as of December 31, 2009.

#### 5. F. Tabular Disclosure of Contractual Obligations

*Debt Service and Other Contractual Obligations.* Our debt obligations and other contractual obligations as of December 31, 2009 were as follows:

	less than 1 year	1-3 years	3-5 years	More than 5 years	Total
	<i>(in millions of reais)</i>				
Loans and financing	1,009.9	1,694.4	1,402.4	2,451.3	6,558.0
Estimated interest payments <sup>(1)</sup>	243.0	522.8	306.4	731.2	1,803.4
Operating lease obligations	7.4	4.5			11.9
Pension plan contributions <sup>(2)</sup>	108.3				108.3
PAES program <sup>(3)</sup>	34.0	68.0	17.0		119.0
Purchase obligations	215.2	285.8	8.4		509.4
<b>Total</b>	<b>1,617.8</b>	<b>2,575.5</b>	<b>1,734.2</b>	<b>3,182.5</b>	<b>9,110.0</b>

(1) Estimated interest payments on loans and financing were determined considering the interest rates as of December 31, 2009. However, our loans and financing is subject to variable interest indexation and foreign exchange fluctuations and these estimated interest payments may differ significantly from payments actually made.

(2) Consists of pension plan contributions estimated for the following year.

(3) The Special Program for Payment of Federal and Social Security Related Taxes in Installments (*Programa de Parcelamento Especial para Impostos Federais e Previdenciários*), or PAES program, as set forth by Law No. 10,684, dated May 30, 2003.

We believe that we can meet the maturity schedule through a combination of funds generated by operations, the net proceeds of new issuances of debt securities in the Brazilian and international capital markets and additional

borrowings from domestic and foreign lenders. Our borrowings are not affected by seasonality. For information concerning the interest rates on our indebtedness outstanding as of December 31, 2009, see Note 13 to our consolidated financial statements.

## **ITEM 6. Directors, Senior Management and Employees**

### **6.A. Directors and Senior Management**

Under our by laws and Brazilian Corporate Law, we are managed by our board of directors (*Conselho de Administração*), which currently consists of eleven directors, and a board of executive officers (*Diretoria*), which currently consists of six executive officers.

As our controlling shareholder, the State has the ability to control the election of our board of directors and, therefore, our direction and future operations. Upon the election of a new State governor and any resulting change in the administration of the State, all or some of the members of our board of directors, including our chairman, have historically been replaced by designees of the new administration. Our board of directors may in turn replace some or all of the executive officers. See *Item 3.D. Risk Factors Risks Relating to Our Control by the State of São Paulo* We are controlled by the State of São Paulo, whose interests may differ from ours or from minority shareholders interests, and which could have a material adverse effect on us.

**Board of Directors**

Our by laws provide for a minimum of five and a maximum of 15 directors. The members of our board of directors are elected at a general shareholders meeting to serve renewable two year terms. Each member of our board of directors must be our shareholder, under Brazilian Corporate Law. Pursuant to our by laws, our employees have the option to elect one member of our board of directors. Currently, our employees have not elected a director. In addition, pursuant to Brazilian Corporate Law, at least one member of the board of directors of mixed capital companies, such as us, must be appointed by the minority shareholders. Finally, according to the *Novo Mercado* rules, at least 20% of the board of directors must be comprised of independent members.

The current members of our board of directors were elected in the general shareholders meeting held on April 29, 2010. The tenure of the directors will end upon the election of the new members at the general shareholders meeting to be held in April 2012. Currently, we have three directors considered independent under the *Novo Mercado* rules.

Our board of directors ordinarily meets once a month or when called by a majority of the directors or the chairman. Its responsibilities include the establishment of policy and general orientation of our business, and the appointment and supervision of our executive officers.

The following are the names, ages, position and brief biographical descriptions of the current members of our board of directors:

<b>Director</b>	<b>Age</b>	<b>Position</b>	<b>Date Elected</b>
Dilma Seli Pena	60	Chairman	April 29, 2010
Humberto Rodrigues da Silva	53	Director	April 29, 2010
Alexander Bialer	63	Independent Director*	April 29, 2010
Reinaldo Guerreiro	57	Independent Director*	April 29, 2010
Roberto Yoshikazu Yamazaki	54	Director	April 29, 2010
Manuelito Pereira Magalhães Júnior	42	Director	April 29, 2010
Mario Engler Pinto Junior	53	Director	April 29, 2010
Jeronimo Antunes	54	Independent Director*	April 29, 2010
Gesner José de Oliveira Filho	54	Director	April 29, 2010
Heraldo Gilberto de Oliveira	46	Director	April 29, 2010
Stela Goldenstein	57	Director	April 29, 2010

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\* These directors comply with the independence requirements established by the *Novo Mercado* rules.

*Dilma Seli Pena.* Mrs. Pena has been the chairman of our board of directors since January 2007. She holds a master's degree in public administration from *Escola de Administração de Empresas de São Paulo – Fundação Getúlio Vargas*, or FGV, and a degree in geography from *Universidade de Brasília*. In 1976, she began her career as a public servant working for the Research Institute of Applied Economics (*Instituto de Pesquisa Econômica Aplicada*), or IPEA. She was director of the sanitation division of the Urban Policy Secretariat of the Ministry of Planning Office (*Secretaria de Política de Saneamento Urbano*), director of the strategic investments division of the Ministry of Planning (*Investimentos Estratégicos do Ministério de Planejamento*) and director of the Brazilian National Water

Agency (*Agência Nacional de Águas*). She was a deputy secretary of the Economics and Planning Secretariat of the São Paulo state government (*Adjunta da Secretaria de Economia e Planejamento do Estado de São Paulo*). She was an effective member of the Environmental Board of the Industry Federation of the State of São Paulo (*Conselho Ambiental da Federação das Indústrias do Estado de São Paulo*). Since January 2007, she has been responsible for the State Secretariat of Sanitation and Energy and has managed the board of directors of the following companies owned by the State of São Paulo: SABESP, EMAE, CESP. She has published a number of articles, texts and books in the areas of sanitation, water resources and planning.

*Humberto Rodrigues da Silva.* Mr. Silva has been a member of our board of directors since January 2007. He holds a post-graduate degree in methodology and projects of municipal and urban development from Escola Nacional de Serviços Urbanos, or ENSUR and a post graduate degree in hospital management from *Universidade Federal da Bahia*. He also holds a degree in public administration from FGV. Currently, he is the deputy secretary of the Political Affairs Department of the government of the State of São Paulo. He was the chief of the Secretariat of the city of São Paulo, of the Secretariat of Science, Technology and Economic Development of the State of São Paulo and also of the *Companhia Metropolitana de Habitação de São Paulo*, or COHAB. From 1999 to 2004, he was a consultant and the director of planning and projects of the São Paulo Development Corporation. He was a member of the board of directors of the *Fundação Paula Souza*, of the *Instituto de Pesquisa Tecnológica de São Paulo* and of the *São Paulo Turismo S.A.*, or SPTURIS. He worked for the government of the State of Bahia and for the municipality of Camaçari.

*Alexander Bialer.* Mr. Bialer has been a member of our board of directors since April 2003. He holds a degree in mechanical engineering from *Instituto Tecnológico da Aeronáutica ITA* and a specialization degree in systems administration from the FGV. He is the chairman the board of directors of GE Hydro Inepar. In addition, Mr. Bialer is a member of the advisory councils of *GE Brasil Previdência*, *GE Celma*, *Synergy Group and Associação Brasileira de Infraestrutura e Indústrias de Base*, or ABDIB. He had previously worked with Avon, Máquinas Piratininga and ASEA. Mr. Bialer was a member of the board of directors of COPLEN S/A, CELMA Motores Elétricos S/A, GEVISA S/A, Inepar Eletrônica S/A, GE CELMA S/A, GE Dako S/A, GE VARIG S/A and GE Hydro Inepar S/A.

*Reinaldo Guerreiro.* Mr. Guerreiro has been a member of our board of directors since January 2007. He holds a PhD in accounting and controllership, a master's degree in accounting and controllership and a bachelor's degree in accounting sciences, all of them from the School of Economics, Business and Accounting at the University of São Paulo (*Faculdade de Economia, Administração e Contabilidade da Universidade de São Paulo*), or FEA USP, where he is the vice director of the Economy, Business and Accounting College. Mr. Guerreiro also headed the Department of Accounting and Actuarial Sciences at FEA USP for many years. He was a corporate consultant/cooperator for some international consultancy offices such as *Roberto Dreyfuss Consultores*, *Klynveld Main Goerdeler Auditores S/C*, *Sérgio Bio, Splendore & Associados S/C Ltda. Consultores em Administração*, or SBS, *Artur Young Consultores*, *Biedermann, Bordasch, Ernest & Whinney, Directa* and *BDO Consultores*. He is also a consultant specialized in economic management. He has worked in many projects in the areas of economic management, costs, budgeting and information systems in several companies such as *Grupo Zillo Lorenzetti*, *Grupo Feital*, *Construtora Mendes Junior*, *Starret Indústria e Comunicação*, *Companhia Municipal de Transporte Coletivo de Araucária*, or CMTC, *Ferrovia Paulista S.A.*, or FEPASA, *Companhia Siderúrgica Paulista*, or COSIPA, *Mafersa S.A.*, *Usina Santa Elisa*, *Gillete do Brasil*, *Hansen Máquinas e Equipamentos*, *Cipla Indústria do Lar*, *Metalúrgica Matarazzo*, *Elebra Informática*, *NEC do Brasil*, Caixa Econômica Federal and Banco do Brasil.

*Roberto Yoshikazu Yamazaki.* Mr. Yamazaki has been a member of our board of directors since January 2007. He holds a degree in business administration. He currently acts as technical advisor of the Treasury Secretariat of the State of São Paulo. From 2006 to January 2007, he was deputy secretary of the Treasury Secretariat of the State. From 2003 to 2006, he was coordinator of the Financial Administration of the State. From 1997 to 2003, he was technical director of the State Treasury Department. From 1995 to 1997, he acted as technical assistant of the State Coordination of Financial Administration. From 1993 to 1994, he was advisor of the Secretariat of Education of the State of São Paulo. From 1992 to 1993, he was technical advisor of the Administrative and Financial Board of Executive Officers at *Companhia de Entrepósitos e Armazéns Gerais de São Paulo*, or CEAGESP. From 1976 to 1992, he was administrative and financial manager of *Terrafoto S.A. Atividades de Aerolevantamentos*.

*Manuelito Pereira Magalhães Júnior.* Mr. Magalhães has been a member of our board of directors since January 2007. He holds a degree in economic sciences and a master's degree in economic sciences from the *Instituto*

*de Economia, Universidade Estadual de Campinas, or UNICAMP. He was a member of the board of directors of the Companhia de Engenharia de Tráfego de São Paulo, or CET SP, of the COHAB and, of the Empresa de Tecnologia de Informação e Comunicação de São Paulo, or PRODAM SP. He was a parliamentary advisor in the Federal Senate. From 1998 to 2002, he was the special advisor of the Minister of Health. From 2005 to 2006 he was the ombudsman of the National Supplementary Health Agency, or ANS. From 2005 to 2006, he was the deputy secretary of the Planning Secretariat and the secretary of Planning of the Municipality of São Paulo. He was also the technical advisor, the secretary of finance and the director of the Department of Advisory, Planning and Management in the municipality of Campinas, State of São Paulo.*

*Mário Engler Pinto Junior*. Mr. Engler has been a member of our board of directors since March 2006. He holds a law degree and a PhD degree in Commercial Law from the *Faculdade de Direito* at USP and is currently a law professor at the FGV. Mr. Engler participated in the State Privatization Council (*Conselho Estadual de Desestatização*), or PED, and in the Public Private Partnership Program of the State of São Paulo (*Programa Estadual de Parcerias Público Privadas*). Mr. Engler has been a member of the Arbitration Panel of the BM&FBovespa (*Câmara de Arbitragem do Mercado da Bolsa de Valores, Mercadorias e Futuros*) since 2001 and a member of the board of directors of the CODEC (*Conselho de Defesa dos Capitais do Estado*) since 2002. Mr. Engler was the Chief Executive Officer for Companhia Paulista de Parcerias CPP was a member of the board of directors at CCP from 2004 to 2006. Mr. Engler was a member of the board of directors of Companhia do Metropolitano de São Paulo from 2004 to 2006. Since 2007, Mr. Engler has been responsible for the legal advisory department for the Secretariat of Treasury. Mr. Engler is a member of ARSESP for energy matters since 2008.

*Jerônimo Antunes*. Mr. Antunes has been a member of our board of directors since April 2008. He holds a master's and PhD degree in controllership and accounting from the Universidade de São Paulo (São Paulo University) and holds a degree in Business Administration and Accounting. He has been a certified independent accountant, and consultant in accountability and corporate finance since 1977. He has been a professor at FEA USP since 1999, a professor of several MBA courses, at the *Fundação Instituto de Pesquisas Contábeis, Atuariais e Financeiras*, or FIPECAFI since 2000, at FEA USP, since 2000, and at FIA *Fundação Instituto de Administração* since 2006. He was a professor at the *Universidade Federal do Ceará* from 2000 to 2005 and in several other institutions. He was a director of FIPECAFI, from 2000 to 2007. He was a board member and director of IBRACON from 1998 to 2006. He was a director of *Associação Nacional dos Executivos de Finanças, Administração e Contabilidade*, or ANEFAC, from 1994 to 2000.

*Gesner José de Oliveira Filho*. Mr. Oliveira Filho has been a member of our board of directors since July 2008 and our chief executive officer since January 2007. He holds a PhD in economics from the University of California, Berkeley, a master's degree in economics from UNICAMP, a bachelor's degree in economics from FEA USP. From 1996 to 2000, he was the chairman of the Administrative Council of Economic Protection, (*Conselho Administrativo de Defesa Econômica*), or CADE. From 1993 to 1995, he was the deputy secretary of the Secretariat of the Economic Policy of the Ministry of Finance. In 1995, he was the interim secretary of the Economic Monitoring of the Ministry of Finance. He was also the managing partner of *Tendências Consultoria Integrada*, a consultant and an arbitrator in the areas of regulation of infrastructure and defense of competition, the chairman of the *Instituto Tendências de Direito e Economia* and a member of several board of directors of private institutions. Additionally, Mr. Oliveira Filho was a professor in the Economics Department at Fundação Getúlio Vargas and Visiting Professor of the Center for Brazilian Studies of Columbia University (USA). Mr. Oliveira Filho was awarded the 2009 Citizenship's Award category Environmentalist Entrepreneur, by *Pensamento Nacional das Bases Empresariais*, or PNBE.

*Heraldo Gilberto de Oliveira*. Mr. Oliveira has been a member of our board of directors since November 2009. He holds a degree in accounting and a degree in business administration. He also holds a master of controllership and accounting from FEA USP. Mr. de Oliveira is a professor of Capital Markets and Investor Relations in the specialization and in the MBA courses at FIPECAFI. Mr. Oliveira is a partner at FCO Consultores Associados and works as an accounting and financial expert consultant. He worked for ten years as an independent accountant. Mr. Oliveira was a member of the board of directors and the coordinator of the audit committee of Banco Nossa Caixa S/A from 2007 to August 2009 and since September 2009 has been the coordinator of the audit committee of Banco Industrial e Comercial S/A BICBANCO. He is a director of the *Instituto de Executivos em Finanças* of São Paulo since September 2009.

*Stela Goldenstein.* Mrs. Goldenstein has been a member of our board of directors since April 2010. She holds a degree in geography with specialization in Urban Planning from Universidade de São Paulo. She is an advisor to the *Empresa Metropolitana de Planejamento*, or EMPLASA and to Governor Alberto Goldman. Ms. Goldenstein has been holding public positions since 1975, with the definition of sector and environmental policies and strategic planning for the state government. She has held several positions, such as Advisor to Governor José Serra, Assistant Secretary of Mayor Gilberto Kassab (2001–2002), Environment Secretary of the city of São Paulo (2001–2002), Special Advisor to Governor Mario Covas (1999–2000), São Paulo State Environment Secretary (1998–1999). She was also member of the Board of Directors of the *Empresa de Tecnologia de Informação e Comunicação Municipal de São Paulo*, or PRODAM, and of São Paulo Transportes, or SPTrans (2006–2009), Chairman of the Board of Directors of *Companhia Ambiental do Estado de São Paulo*, or CETESB (1998–2000), member of our Board of Directors (1995–2001) and member of the Board of Directors of *Companhia Metropolitana de Habitação de São Paulo*, or COHAB SP (1989–1990).

## Board of Executive Officers

Our board of executive officers is composed of six executive officers appointed by our board of directors for renewable two years terms. Our executive officers are responsible for all matters concerning our day to day management and operations. Members of our board of executive officers have individual responsibilities established by our board of directors and our by laws.

The following are the names, ages, position and brief biographical descriptions of our board of executive officers:

<b>Executive Officer</b>	<b>Age</b>	<b>Position</b>	<b>Date Elected</b>
Gesner José de Oliveira Filho	54	Chief Executive Officer	June 18, 2009
Marcio Saba Abud	52	Corporate Management Officer	June 18, 2009
Rui de Britto Álvares Affonso	52	Chief Financial Officer and Investor Relations Officer	June 18, 2009
Paulo Massato Yoshimoto	57	Metropolitan Officer	June 18, 2009
Umberto Cidade Semeghini	60	Regional Systems Officer	June 18, 2009
Marcelo Salles Holanda de Freitas	54	Technology, Enterprises and Environment Officer	June 18, 2009

*Gesner José de Oliveira Filho.* See above *Board of Directors.*

*Marcio Saba Abud.* Mr. Abud has been our corporate management officer since January 2007. He holds a degree in Economic Sciences from FEA USP. He has broad experience in the financial area and in various segments of the domestic and international markets, such as treasury, capital markets, domestic and international structured operations and management of international securities and note issue programs. He also has experience in foreign trade financing, investment fund creation and management, corporate customer service, and establishment and management of credit lines. He worked at Unibanco from March 1980 to August 1984, at Banco Boavista from March 1985 to October 1986, and at *Banco Westlb do Brasil S.A.* from April 1987 to January 2007.

*Rui de Britto Álvares Affonso.* Mr. Affonso has been our chief financial officer and investor relations officer since July 2003. Mr. Affonso holds a PhD and a master's degree in economics from UNICAMP, and a degree in economics from USP. He has been a professor at UNICAMP since 1986, a professor at FEA USP from 1983 to 1999, and a director of public economy at *Fundação do Desenvolvimento Administrativo* from 1994 to 2003. He also represented Brazil on the board of the Forum of Federations (a non-governmental entity based in Canada) from 2000 to 2006. Mr. Affonso has also held several positions at the State government.

*Paulo Massato Yoshimoto.* Mr. Massato has been our metropolitan officer since February 2004. He holds a degree in civil engineering from *Escola de Engenharia de Lins*. Mr. Yoshimoto has been working with us since 1983, and has held the following positions: executive assistant to the operations office and head of the water production, maintenance, technical and management of water losses, and metropolitan planning and development departments. Mr. Yoshimoto has also held a number of different positions at the *Empresa Metropolitana de Planejamento*, from 1975 to 1983.

*Umberto Cidade Semeghini.* Mr. Semeghini has been our regional systems officer since January 2007. He holds a degree in electrical engineering from the *Faculdade de Engenharia Industrial*. He was secretary of planning of the Ministry of Transport and the executive officer of *Gerentec Engenharia*. He has experience in the operation of systems, consulting services in the development of studies and projects for water supply and sanitary sewage systems, highway systems and, through partnerships with domestic and foreign companies, development of economic engineering studies (i.e., definition of tariff structures for public services).

*Marcelo Salles Holanda de Freitas.* Mr. Freitas has been our Technology, Enterprises and Environment officer since January 2007. He holds a degree in civil engineering post graduation degree in sanitation from the *Escola Politécnica* at USP. He also has a specialization degree in business administration from the *Instituto Brasileiro do Mercado de Capitais*. He is a regular member of some of the most important institutions and associations of the sanitation and environment market. He was our vice chairman for the interior and for the metropolitan region. He was the executive officer of projects of the Ondeo Services do Brasil, executive officer of sanitation of *Suez Ambiental*, chief executive officer of *Águas do Amazonas* and executive officer of the sanitation services of *Etep Consultoria, Gerenciamento e Serviços*.

## 6.B. Compensation

Pursuant to Brazilian Corporate Law, our shareholders are responsible for establishing the aggregate amount of compensation we pay to the members of our board of directors, members of our fiscal council and our executive officers. According to Instruction No. 480 issued by CVM, we have to periodically disclose certain information on the individual compensation such as averages and fringe benefits.

For the year ended December 31, 2009, the aggregate compensation, including benefits in kind granted that we paid to members of our board of directors and to our executive officers for services in all capacities was R\$2.6 million.

## ***Profit Sharing and Pension Plans***

We have established a pension and benefits fund (*Fundação SABESP de Seguridade Social*), or SABESPREV, to provide our employees with retirement and pension benefits. This pension plan provides defined benefit payments to former employees and their families. Both we and our employees make contributions to the pension plan. We are also required to pay supplemental pension payments relating to the employment contract of certain employees prior to the creation of SABESPREV. Our total contributions to the pension plan totaled R\$12.5 million and R\$12.9 million in 2008 and 2009, respectively. Based on independent actuarial reports, as of December 31, 2009, our obligation under these plans totaled R\$1,831.8 million. For further information on our pension plans see Note 17 to our consolidated financial statements.

On April 14, 2000, the State issued Decree No. 44,836 which allows for the payment of profit sharing amounts on an exceptional basis, provided that specific authorizations are obtained by us from the Wages Policy Commission (*Comissão de Política Salarial*). We have obtained this authorization every year since 2000 and, therefore, paid profit sharing amounts to our employees during this period.

The profit sharing plan evaluates the business performance from an economic financial, operating and administrative stand point. Beginning in 2008, payments under the profit sharing plan were based both on general goals that evaluate us as a whole and on other goals that evaluate the performance our different business units. Payments are proportionally reduced annually if the goals are not completely achieved.

We recorded profit sharing expenses of R\$53.2 million and R\$53.4 million in 2008 and 2009, respectively. We believe that the profit sharing plan has, in the past, contributed to increased employee productivity. We do not have a stock option plan for our employees.

## 6.C. Board Practices

The members of our board of directors are elected at a general shareholders meeting to serve renewable two year terms. Our board of directors ordinarily meets once a month or when called by a majority of the directors or the chairman. See *Item 6.A. Directors and Senior Management Board of Directors*.

Our board of executive officers is composed of six executive officers appointed by our board of directors for renewable two year terms. Meetings of our board of executive officers are held weekly in the case of ordinary meetings or when called by the chief executive officer in the case of special or extraordinary meetings. See *Item 6.A. Directors and Senior Management Board of Executive Officers*.

None of our directors and/or executive officers is a party to an employment contract providing for benefits upon termination of employment. Those directors and officers who are also our employees will remain as our employees after their tenure as directors and/or officers, in this case, maintaining all benefits granted to our employees.

## Fiscal Council (*Conselho Fiscal*)

Our *Conselho Fiscal*, which is established on a permanent basis and generally meets once a month, consists of five members and five alternates. The current members of our *Conselho Fiscal* were elected in the shareholders' meeting held on April 29, 2010. Their tenure will end in 2011. The primary responsibility of the fiscal council, which is independent from management and from the external auditors appointed by our board of directors, is to review our financial statements and report on them to our shareholders.

The following are the current members and alternate members of our fiscal council:

<b>Fiscal Council Members</b>	<b>Age</b>	<b>Position</b>	<b>Date Elected</b>
Sandra Maria Giannella	53	Fiscal Council Member	April 29, 2010
Alexandre Luiz Oliveira de Toledo	50	Fiscal Council Member	April 29, 2010
Maria de Fátima Alves Ferreira	50	Fiscal Council Member	April 29, 2010
Emilia Ticami	53	Fiscal Council Member	April 29, 2010
Deraldo de Souza Mesquita Junior	51	Fiscal Council Member	April 29, 2010
Vanildo Rolando Neubauer	56	Alternate Fiscal Council Member	April 29, 2010
Cassio Martins Camargo Penteado Junior	62	Alternate Fiscal Council Member	April 29, 2010
José Rubens Gozzo Pereira	62	Alternate Fiscal Council Member	April 29, 2010
Tomás Bruginski de Paula	49	Alternate Fiscal Council Member	April 29, 2010
Joaldir Reynaldo Machado	61	Alternate Fiscal Council Member	April 29, 2010

## Audit Committee

Our by-laws provide for an audit committee to be comprised of three board members, who shall cumulatively comply with the requirements of (i) independence, (ii) technical expertise, and (iii) availability and/or applicable exemptions in accordance with the Securities and Exchange Commission, or SEC, rules. The members are appointed by the board of directors.

The audit committee is responsible for assisting and advising the board of directors in its responsibilities to ensure the quality, transparency and integrity of the Company's published financial information. To this end, the audit committee supervises all matters relating to accounting, internal controls and the internal and independent audit functions. The audit committee and its members have no decision making powers or executive functions.

The minimum availability required from each member of the audit committee is thirty hours per month. Under our by-laws, the members shall exercise their roles for the same period as their corresponding term of office, or until otherwise resolved by the general shareholders' meeting or by resolution of the board of directors.

The table below sets forth the members of the board of directors appointed to serve on our audit committee:

<b>Director</b>	<b>Position</b>	<b>Date Elected</b>
Jerônimo Antunes	Coordinator and Financial Expert	May 13, 2010
Reinaldo Guerreiro	Member	May 13, 2010

## Corporate Governance Practices

The significant differences between our corporate governance practices and the New York Stock Exchange, or NYSE, standards can be found on our website, [www.sabesp.com.br](http://www.sabesp.com.br), at the following location: Investors Relations Corporate Governance SABESP and NYSE Standards. The information found at this website is not incorporated by reference into this document.

### 6.D. Employees

As of December 31, 2009, we had 15,103 full time employees, respectively. In 2009, we had an average of 931 trainees and 468 apprentices (*aprendizes*), as defined by federal Law No. 10,097, dated December 19, 2000.

The following table sets forth the number of our full time employees by main category of activity and geographic location as of the dates indicated:

	<b>As of December 31,</b>		
	<b>2007</b>	<b>2008</b>	<b>2009</b>
Total number of employees	16,850	16,649	15,103
Number of employees by category of activity:			
Projects and operations	11,130	10,932	9,763
Administration	2,794	2,819	2,574
Finance	564	522	490
Marketing	2,362	2,376	2,276
Number of employees by corporate division:			
Head office	1,618	1,623	1,541
São Paulo metropolitan region	8,004	7,884	7,055
Regional Systems	7,228	7,142	6,507

The average tenure of our employees is approximately 18 years. We also outsource certain services such as maintenance, delivery of water and sewage bills, meter reading, catering and security. We believe that our relations with our employees are generally satisfactory.

Approximately 70% of all our employees are members of unions. The four main unions that represent our employees are the *Sindicato dos Trabalhadores em Água, Esgoto e Meio Ambiente de São Paulo*, or SINTAEMA, *Sindicato dos Trabalhadores da Região Urbana de Santos, São Vicente, Santos metropolitan region, Litoral Sul e Vale Ribeira*, or SINTIUS, the *Sindicato dos Engenheiros do Estado de São Paulo*, or SEESP and the *Sindicato dos Advogados de São Paulo*, or SASP. Our most recent collective bargaining agreements expired on April 30, 2010. We are currently negotiating a new collective bargaining agreements with the unions.

We have experienced the following strikes in the last five years, none of which interrupted the essential services that we provide: a two day strike in June 2005, a one day strike in May 2006, a four day strike in June 2008, a three day strike in May 2009 and a seven day strike in May 2010. In 2007 there were no strikes. Under Brazilian law, our non administrative employees are considered essential employees and, therefore, are limited in their right to strike.

#### **6.E. Share Ownership**

As of May 31, 2010, the members of the board of directors and the executive officers owned an aggregate of 5,210 common shares. The members of our board of directors and our executive officers, on an individual basis and as a group, beneficially own less than 0.1% of our common shares. See *Item 7A. Major Shareholders and Related Party Transactions Major Shareholder* for more information. As of the same date, none of our directors and executive officers owned any stock option plans.

## **ITEM 7. Major Shareholders and Related Party Transactions**

## 7.A. Major Shareholder

Our outstanding capital stock as of May 31, 2010 consisted of 227,836,623 common shares, without par value. Under our by laws and the State laws, the State is required to own at least one half plus one of our outstanding common shares. All of our shareholders, including the State, have the same voting rights.

The following table sets forth ownership information for each of our shareholders that beneficially owned 5.0% or more of our common shares and for our officers and directors, individually and as a group, as of May 31, 2010.

	Common shares	
	Shares	%
State of São Paulo	114,508,623	50.3%
Directors and executive officers of SABESP <sup>(1)</sup>	5,210	0.0%
Others	113,323,330	49.7%
<b>Total<sup>(2)</sup></b>	<b>227,836,623</b>	<b>100%</b>

(1) Our directors and executive officers collectively own less than 0.1% of our outstanding common shares.

(2) As of May 31, 2010, 49.7% of our outstanding common shares were held by 2,865 registered shareholders in Brazil.

## **7.B. Related Party Transactions**

### **Transactions with the State of São Paulo**

We have entered into extensive transactions with the State, which is our controlling shareholder, and we expect to continue to do so. The State is our largest customer. It owns some of the facilities that we use in our business, it is one of the governmental entities that regulates our business, and it has assisted us in obtaining financing on favorable terms.

Many of our transactions with the State reflect policies of the State that depend on decisions of elected officials or public servants, and are accordingly subject to change. Among the practices that could change are those described below concerning the provision of State guarantees, and the terms on which we use State owned reservoirs.

#### ***Provision of Services***

We provide water and sewage services to the federal government, state and municipal governments and government entities in the ordinary course of our business. Sales of water and sewage services to the State, including State entities, totaled R\$358.3 million in 2009 and R\$343.6 million in 2008. Our accounts receivable from the State for water supply and sewage services totaled R\$234.3 million and R\$169.5 million, as of December 31, 2008 and 2009, respectively. In addition, as required by law, we invest our cash and cash equivalents with government financial institutions in short term securities.

#### ***Payment of Pensions***

Pursuant to a law enacted by the State, certain former employees of some State owned companies that provided services to us in the past and later merged to form SABESP acquired a legal right to receive supplemental pension benefit payments. These rights are referred to as Plan G0. These amounts are paid by us, on behalf of the State, and are claimed by us as reimbursements from the State, as primary obligor. In 2008 and 2009, we made payments to former employees of R\$107.1 million and R\$108.0 million, respectively, in respect of Plan G0. The State made reimbursements in 2008 and 2009 in the amount of R\$3.8 million and R\$102.8 million, respectively.

#### ***Agreements with the State***

In September 1997, we and the State entered into a memorandum of understanding providing that we would, in effect, apply dividends we declared that were otherwise payable to the State to offset accounts receivable in connection with the provision of water and sewage services to the State and its controlled entities. In 1998, 2000 and 2001, we applied dividends, in the form of interest on shareholders' equity due to the State in respect of its shareholding in us to settle a portion of the unpaid accounts receivable from the State. In 1999, we did not pay dividends or other distributions to our shareholders.

On December 11, 2001, we entered into an agreement with the State and the DAEE. Pursuant to this agreement, the State acknowledged and agreed, subject to an audit by a State appointed auditor, to pay us amounts it owed to us in respect of:

- water and sewage services we provided to governmental agencies, State owned autonomous entities and foundations through December 1, 2001, and that was not offset in accordance with the September 1997 memorandum of understanding, in the total amount of R\$358.2 million; and
- supplemental retirement and pension benefits we paid from March 1986 to November 2001 on behalf of the State to former employees of the State owned companies which merged to form SABESP; as we did not reach an agreement regarding these amounts, a joint inquiry has commenced in order to ensure agreement between us and the State, in the total amount of R\$320.6 million.

The agreement provided that the DAEE would transfer to us ownership of the Taiacupeba, Jundiá, Biritiba, Paraitinga and Ponte Nova reservoirs (herein after referred to as the reservoirs ), which form the Alto Tietê system, and that the fair value of these assets would reduce the amounts owed to us by the State.

Under the December 2001 agreement, in 2002, a State owned construction company (*Companhia Paulista de Obras e Serviços*), or the CPOS, on behalf of the State, and an independent appraisal firm (*Engenharia de Avaliações*), or the ENGEVAL, on our behalf, presented their valuation reports relating to the reservoirs. Under the agreement, the arithmetic average of these appraisals is deemed the fair value of the reservoirs. The appraisals contained in these reports were in the amounts of R\$335.8 million and R\$341.2 million, respectively. Because we had already made investments in these reservoirs by then, the arithmetic average of the appraisals submitted to our board of directors by August 2002, R\$300.9 million, was net of a percentage corresponding to these investments. Our board of directors approved the valuation reports.

Under the December 2001 agreement, for amounts due in excess of the fair value of the reservoirs, the State is to make payments in 114 consecutive monthly installments. The nominal amount owed by the State would not be indexed to inflation or earn interest if there was a delay in concluding the appraisal of fair value. The installments will be indexed on a monthly basis by the IGP M index, plus 6.0% per year, starting on the date the first installment becomes due.

On October 29, 2003, the Public Prosecution Office of the State of São Paulo (*Ministério Público do Estado de São Paulo*), on behalf of the people of the State, brought a civil public action in a Trial Court of the State of São Paulo (*12a Vara da Fazenda Pública do Estado de São Paulo*) alleging that a transfer to us of ownership of the Alto Tietê system reservoirs from the DAEE would be illegal. An injunction against the transfer of ownership of such reservoirs was granted but was later reversed. However, in October 2004, the court ruled in favor of the Public Prosecution Office, which ruling we believe relates only to the illegality of the transfer of the reservoirs. In response, we filed an appeal which is pending final decision and the State successfully filed an action suspending the trial court's decision until final judgment is reached by the Court of Justice of the State of São Paulo. We are unable to predict whether we will succeed in appealing such decision. However, we currently do not expect that an eventual unfavorable decision would have a material adverse effect on our business and financial condition.

The December 2001 agreement also provided that the legal advisors of the State would carry out specific analyses, which have commenced, to ensure agreement among the parties as to the methodology employed in determining the amount of reimbursement for pension benefits owed to us by the State. The commencement of payments with respect to pension amounts owed to us by the State has been postponed until these analyses are completed, the appraisal report is approved and the credit assignments relating to the transfer of the reservoirs are formalized. In addition, the transfer of these reservoirs is currently being disputed and we are not certain whether such transfer will be legally allowed. Under the December 2001 agreement, the first payment was to be made in July 2002.

On March 22, 2004, we and the State entered into a first amendment to the December 2001 agreement. Under this amendment, the State acknowledged that it owed R\$581.8 million to us relating to unpaid accounts receivable from the State until February 29, 2004, and we acknowledged that we owed an aggregate amount of R\$518.7 million to the State as dividends, in the form of interest on shareholders' equity. Accordingly, we and the State agreed to offset each other's credit up to the limit of R\$404.9 million, which was an amount adjusted up to February 2004. The outstanding balance of R\$176.9 million (as of February 29, 2004) of the State's consolidated debt will be paid in consecutive monthly installments from May 2005 until April 2009. These installments will be indexed according to the IPCA index, plus an interest rate of 0.5% per month. Upon the execution of the first amendment, we were able to reconcile the offsetting of part of the debt that the State owed to us for the use of water and sewage services until February 2004 with the debt that we owed to the State as dividends, in the form of interest on shareholders' equity. The outstanding

balance of R\$113.8 million as dividends in the form of interest on shareholders' equity that we owed to the State was netted against accounts overdue after February 2004. The first amendment did not amend the provisions of the December 2001 agreement regarding the supplemental retirement and pension benefits we paid from March 1986 to November 2001 on behalf of the State to former employees of the State-owned companies.

On December 28, 2007, we and the State entered into a second amendment to the December 2001 agreement, pursuant to which the State agreed to pay (a) the outstanding balance under the first amendment, in the amount of R\$133.7 million (as of November 30, 2007), in 60 consecutive monthly installments, beginning on January 2, 2008, and (b) 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. As part of this amendment, we agreed to pay 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, which we paid as agreed. In addition, pursuant to the second amendment, we and the State agreed on complying with certain mutual obligations relating to the improvement of payment processes and budget management procedures, the rationalization of the use of water and the amount of water and sewage bills under the responsibility of the State, the recording of governmental entities with accounts overdue in a delinquency system or reference file and the possibility of interrupting water supply to these entities in case of non-payment of water and sewage bills. We have not made any provisions for amounts due to us by the State because we expect to recover these amounts and we do not consider net losses probable. Finally, this second amendment did not amend the provisions of the December 2001 agreement regarding the supplemental retirement and pension benefits we paid from March 1986 through November 2001 on behalf of the State to former employees of the State-owned companies.

In 2007, we received payment installments from the State in the amount of R\$326.0 million. As of December 31, 2007, our dividends payable to the State, due from 2004 through 2007, were in the amount of R\$552.0 million. We are currently unable to determine the amount, if any, of the declared dividends that the State will apply to current and future accounts receivable owed to us by the State or its entities. The second amendment no longer requires that dividends be applied to offset accounts receivable from the State.

On March 26, 2008, we entered into a commitment agreement (*termo de compromisso*) with the State with the purpose of finding an alternate solution to the deadlock related to the amount owned by the State to us in connection to the supplemental retirement and pension benefits we paid from March 1986 to November 2001 on behalf of the State to former employees of the State-owned companies which merged to form SABESP. In this agreement, we committed ourselves to hire specialized companies to carry out new valuations of the amounts owned to us by the State and of the reservoirs. An independent consulting firm, FIPECAFI, has been retained to resolve the disagreement and validate the Disputed Reimbursement Amount. In addition, FIPECAFI is performing, together with another independent consulting firm, a new evaluation of the reservoirs that might be transferred to us as amortization of the reimbursement payable by the State to us.

On November 17, 2008, we, the State and DAEE entered into a third amendment to the December 2001 agreement, pursuant to which the State recognized a debt balance payable to SABESP totaling R\$915.3 million, referred to as the Undisputed Reimbursement Amount, as adjusted based on the IPCA. SABESP accepted on a provisional basis the reservoirs as part of the payment of the Undisputed Reimbursement Amount and offered to the State a provisional settlement, recognizing a credit totaling R\$696.3 million, corresponding to the value of the reservoirs located in the Upper Tietê region. We and the State have agreed that the final offset will only be recorded when the effective transfer of the Alto Tietê system is recorded at the Real Estate Registry. The Company did not recognize the reimbursement receivable related to the other reservoirs, as it is not virtually certain that will be transferred by the State. The outstanding balance of Undisputed Reimbursement Amount, amounting to R\$219.0 million, is being paid by the State in 114 consecutive monthly installments, as adjusted by the annual IPCA variation, plus interest accruing at the annual rate of 6%. The first installment was paid in November 2008.

In addition to the Undisputed Reimbursement Amount, there is an outstanding balance relating to the supplemental retirement and pension benefits we paid from March 1986 through November 2001 on behalf of the State to former employees that the State has not yet agreed to reimburse us. This amount, referred to as the Disputed Reimbursement

Amount, was recorded for losses due to the current stage of the negotiations with the State and the uncertainty regarding its recovery. We understand that as of December 31, 2009, the State owed us R\$1,394.7 million with respect to pension payments on behalf of the State, of which R\$1,167.9 million was not recorded because such amount is not considered virtually certain that it will be reimbursed by the State. We and the State have agreed that the dispute relating to the Disputed Reimbursement Amount will not prevent us from carrying out the commitments made in the December 2001 agreement.

We are working with the State government to obtain legislative authorization to transfer the reservoirs to SABESP, overcoming the uncertainties arising from the public lawsuit challenging the absence of specific legislative authorization for the transfer of the property of the reservoirs. The reservoirs will be transferred to us after the publication of a legislative authorization.

In addition, the third amendment to the December 2001 provides for the regularization of the monthly flow of benefits. While we are liable for the flow of monthly payment of benefits, the State shall reimburse us based on criteria identical to those applied when determining the Undisputed Reimbursement Amount. Should there be no preventive court decision, the State will assume the flow of monthly payment of benefits portion deemed as undisputed.

Finally, the third amendment to the December 2001 agreement established that the Public Attorney's Office of the State of São Paulo (the Public Attorney's Office) would issue a revised interpretation of the calculation and eligibility criteria applicable to the Disputed Reimbursement Amount. At that time, we believed that the Public Attorney's Office would issue a revised interpretation which would have helped us bring the negotiations with the State to a conclusion. However, the Public Attorney's Office recent interpretation of the calculation and eligibility criteria applicable to the Disputed Reimbursement Amount did not conform to our expectations, refuting the reimbursement of the largest portion of this amount.

Even though the negotiations with the State are still progressing, it is not possible to assure that we will recover the receivables related to the Disputed Reimbursement Amount without conflict. As of December 31, 2009, the Disputed Reimbursement Amount amounted to R\$ 471.6 million. See Note 9 to our consolidated financial statements regarding the Disputed Reimbursement Amount.

We will not waive the receivables from the State to which we consider ourselves to be legally entitled. Accordingly, we will take all possible actions to resolve the issue at all administrative and court levels. Should this conflict persist, we will take all the necessary actions to protect our interests. On March 24, 2010, we reported to the controlling shareholder the official letter approved by our executive committee, proposing that the matter be discussed at the São Paulo Stock Exchange (BM&FBovespa) Arbitration Chamber.

Our management decided not to recognize State reimbursements which were not considered virtually certain. As of December 31, 2009 and 2008, the amounts not recorded by us, related to the pension benefits paid on behalf of the State by us, totaled R\$1,167.9 million, R\$1,105.4 million, respectively, including R\$696.3 million related to the transfer of the reservoirs in the Upper Tietê region. As a result, we also recognized the obligation related to the pension benefit obligations maintained with the beneficiaries and pensioners of Plan G0, whose right it is to be paid by us and is not considered virtually certain that we will be reimbursed by the State. As of December 31, 2009 and 2008 the pension benefit obligations of Plan G0 totaled R\$1,299.8 million and R\$1,271.4 million, respectively. For a detailed explanation on the pension benefit obligations refer to Note 17 of our consolidated financial statements.

## **Agreement with the State and the city of São Paulo**

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 that will be responsible for planning the water and sewage services and for reviewing our investment plans. The management committee is composed of six members appointed for renewable two year terms. The State and the city of São Paulo has 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*). See Item 4.B. Business Overview Our Operation Operations in the city of São Paulo and certain Metropolitan Regions.

## Dividends

We regularly pay dividends to our shareholders, including the State of São Paulo. In the past, we have withheld part of the dividends to which the State was entitled in order to offset it against our pending receivables from the State.

In accordance with our agreements with the State, we do not anticipate that we will withhold dividends to which the State was entitled in order to offset it against our pending receivables from the State in the near future. For more information regarding our dividend policy, see *Item 8.A Financial Information Consolidated Statements and Other Financial Information Dividends and Dividend Policy*.

## Cash and Cash Equivalents

Our cash and cash equivalents invested with State financial institutions in short term securities amounted to R\$579.8 million and R\$722.2 million, as of December 31, 2008 and 2009, respectively. Interest income from these investments totaled R\$62.2 million in 2008 and R\$73.9 million in 2009.

## Government Guarantees of Financing

In some situations, the federal government, the State or government agencies guarantee our performance under debt and project related agreements.

The State has also guaranteed a portion of our repayment obligations under loan agreements that we entered into with the federal government in 1994 through its financial agent, Banco do Brasil S.A. which totaled R\$1,416.0 million as of December 31, 2009. Furthermore, the federal government has guaranteed, and the State has provided a counter guarantee, in respect of the financial agreement we entered into with the IDB in 2000 for the total aggregate amount of US\$200.0 million related to the financing of the Tietê River recovery project to reduce pollution.

On August 6, 2004, we entered into a credit agreement with the JICA for the financing of the Environmental Recovery Program for the Baixada Santista metropolitan region (*Programa Onda Limpa*), which was guaranteed by the federal government, with counter guarantee from the State of São Paulo, for an aggregate principal amount of R\$337.7 million.

In addition, we are currently negotiating with BNDES and Caixa for additional loans to finance portions of our capital expenditure program.

## Use of State Owned Reservoirs

We currently use the Guarapiranga and Billings reservoirs which are owned by another company controlled by the State, based on a grant issued by the DAEE. We do not pay any fees with respect to the use of these reservoirs. We are, however, responsible for maintaining them and funding their operating costs. The State incurs no operating costs on our behalf. If these facilities were not available for our use, we would have to obtain water from more distant sources, which would be more costly.

## **Agreements with Reduced Tariffs**

We have entered into agreements with public entities, including State entities and municipalities, which manage approximately 6,803 properties under which we provide these entities with a 25.0% tariff reduction for the water and sewage services we provide if such entities implement our program for the rational use of water, which includes a reduction of at least 10.0% in water consumption. These agreements are valid for a 12 month term with automatic renewal for equal periods. Pursuant to the terms of these agreements, if these entities fail to make any payment on a timely basis to us, we have the right to cancel the agreement, thereby revoking the 25.0% tariff reduction.

## **Personnel Assignment Agreement Among Entities Related to the State Government**

We have personnel assignment agreements with entities related to the State Government, under which the expenses are fully passed on and monetarily reimbursed. The expenses related to personnel assigned by us to other state government entities in 2008 and 2009 amounted to R\$5.5 million and R\$5.4 million, respectively.

The expenses related to personnel assigned by other entities to us totaled R\$1.3 million and R\$ 0.3 million in 2008 and 2009, respectively.

## **Services Obtained from State Government Entities**

As of December 31, 2009, we had an outstanding amount payable of R\$10.4 million for services rendered by São Paulo state government entities, including the supply of electric power by CESP. As of December 31, 2009, the amount payable for expenses related to construction works performed by DAEE totaled R\$11.1 million.

## **Non operating Assets**

We lend land, free of charge, to associations, support entities, non governmental organizations and to DAEE, among others. Such non operating assets totaled R\$15.9 million as of December 31, 2008 and 2009, of which R\$2.3 million was lent to DAEE, as of December 31, 2008 and 2009, respectively.

## **Transactions with SABESPREV Pension Fund**

SABESPREV is the funded pension plan that we established to provide our employees with retirement and pension benefits. The assets of SABESPREV are independently held, but we nominate 50.0% of the directors of SABESPREV, including the chairman of the board, who has the deciding vote pursuant to the applicable legislation. Both we and our employees make contributions to the pension plan. We contributed R\$12.5 million and R\$12.9 million in 2008 and 2009, respectively. On May 29, 2001, a federal law was enacted which, among other provisions, limits the amount mixed capital companies, like us, may contribute to their pension plans. Specifically, the ordinary contributions made by us to our pension plans may not exceed the contributions made by the beneficiaries of these plans. Studies have been undertaken in order to cure the deficit with respect to the current plan and transform it into a defined contribution plan.

## **Compensation of Management Key Personnel**

The compensation paid by us to the members of our board of directors and officers amounted to R\$2.4 million in 2008 and R\$2.6 million in 2009. An additional amount of R\$0.9 million, related to the bonus program, was accrued in 2008 and 2009.

## **ITEM 8. Financial Information**

## 8.A. Consolidated Statements and Other Financial Information

See *Item 3. Key Information Selected Financial Data* and *Item 18. Financial Statements*.

### Legal Proceedings

In the ordinary course of our business, we are a party to judicial and administrative proceedings relating to civil, environmental, labor and tax matters. As of December 31, 2009, we estimated that these legal proceedings totaled approximately R\$3,418.6 million (excluding the amount of R\$100.3 million related to court deposits). This amount was based on probable and possible losses and on the value attributed to the lawsuit by the plaintiffs in some cases and on the economic value of the lawsuits in others. Out of the total amount of contingencies as of December 31, 2009, approximately R\$1,543.7 million relate to tariff related legal proceedings and consumers claims, approximately R\$843.0 million relate to contractors claims, approximately R\$309.4 million relate to tax proceedings, approximately R\$201.8 million relate to labor proceedings, approximately R\$102.8 million relate to civil public actions related to environmental matters and approximately R\$418.0 million relate to other civil matters. As of December 31, 2009, the provisions for legal contingencies totaled R\$1,468.8 million (excluding the amount of R\$88.8 million related to court deposits), of which R\$783.6 million relate to tariff-related legal proceedings and consumers claims, R\$341.5 million relate to contractors claims, R\$28.7 million relate to tax proceedings, R\$101.5 million relate to labor proceedings, R\$58.5 million relate to civil public actions related to environmental matters and R\$155.0 million relate to other civil matters.

The difference between the provisioned amount and the total amount of the contingencies derives from the methodology for establishing our provisions. This methodology takes into account: (i) the probability of loss of each lawsuit, based on the alleged facts, the claim based on the factual circumstances vis à vis the law, as well as prevailing precedents in similar cases; and (ii) the calculation of the provisioned amounts, which requires significant judgment and in certain circumstances, given the nature of the claim, we are unable to estimate with accuracy our liability exposure. In these cases, we have taken into account the value attributed to the lawsuits by the plaintiff and legal opinions of counsel in charge of each lawsuit. Once the methodology is applied, as a general rule, we make the provisions only for the lawsuits that are considered as probable losses.

We cannot give any assurances either as to the sufficiency of the provisioned amount to cover the contingencies or as to the total amount of potential liabilities that we may incur or penalties that may be imposed. We may not obtain a favorable outcome in the administrative or court proceedings to which we are a party. In addition, the total amount of the contingencies, based on the value attributed to the lawsuit by the plaintiff, may not correspond to the economic value of the lawsuits, which may be substantially higher than the total estimated amount of contingencies. If the economic outcome of these lawsuits is higher than the amount attributed to the lawsuit by the plaintiff or, in the event the total amount of our provisions are not sufficient to pay the contingencies due, we could incur greater costs than those that were originally estimated. If these costs are significant, our results of operations and financial condition could be negatively affected. See *Item 3.D. Risk Factors Risks Relating to Our Business Any substantial monetary judgment against us in legal proceedings may have a material adverse effect on us.*

### ***Civil Public Actions Related to Environmental Matters***

We are a party to civil public actions brought by municipalities that seek to cease to pay us fees relating to sewage services, alleging that we do not treat the sewage in these municipalities and that we failed to make certain investments in sewage treatment facilities as provided in the relevant concession agreements.

In addition, we are being sued by the Public Prosecution Office of the State of São Paulo (*Ministério Público do Estado de São Paulo*), by some municipalities as well as some non-governmental organizations through a number of environmental civil public actions: (i) aiming that we cease releasing raw sewage into certain local water courses; (ii) in some cases seeking remedies for environmental damages, which have not yet been specified and evaluated by technical experts of the courts; and (iii) aiming to require us to install and operate sewage treatment facilities in those locations. In each case, we are subject to daily fines for non-compliance therewith. In our response to these lawsuits we emphasize that the installation and operation of sewage treatment facilities in those locations is included in our investment plan and that the immediate cessation of the release of raw sewage into the relevant local water courses would hinder us from collecting sewage—a primary necessity—in those locations, causing even more damage against the environment and public health. There have already been unfavorable judicial decisions against us. These effects may include: (i) investment in works or services not considered by the long-term investment plan, (ii) anticipation of works or services that were considered for execution in future years in the long-term investment plan, (iii) payments related to environmental indemnification; and (iv) a negative impact of our image in national and international markets and in public bodies.

Although we are not able to predict the final outcome of these lawsuits, we believe that the outcome, if unfavorable to us, may have a material adverse effect on us.

The civil public lawsuits related to environmental matters to which we are party include the following:

- The Public Prosecution Office of the State of São Paulo has brought a civil public action requesting remedies

due to environmental damage caused by the release of sludge from the Rio Grande water treatment facilities into certain receiving waters and in the Billings reservoir, seeking the immediate cessation of this activity and the implementation of an environmental recovery project. The Trial Court ruled in our favor and there was a subsequent appeal against this decision. On May 2006, the appellate court ruled against us and ordered the release of sludge to cease within a year from the final ruling. The court also determined that the environmental recovery must be carried out within two years of the date mentioned above, under the penalty of a daily fine of R\$10,000 to compensate for environmental damage. The appellate court decision is not final and we are awaiting a decision from the superior courts. Our legal counsel assessed the risk of loss as probable and we have provisioned the amount of R\$182,063 for this lawsuit, as of December 31, 2009.

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- Public civil action filed by the Public Prosecution Office of the State of São Paulo against us and the Cotia Mayor's Office seeking individual and joint adverse judgments against the defendants requesting: (i) the permanent cessation of the release of untreated water effluents into the Cotia River or its tributaries, subject to a daily fine in the case of non-compliance; (ii) the treatment of sewage prior to its release into the Cotia River, under the penalty of a daily fine in the event of non-compliance; (iii) the full restoration of soil, of surface and underground water bodies and of vegetation to their original condition, under the penalty of a daily fine in the event of non-compliance; (iv) the payment of compensation for environmental damage caused to soil, to water sources and to underground and surface water bodies that cannot be recovered. The appellate court rendered favorable decisions to us with respect to items (i), (iii) and (iv) mentioned above. According to evaluations by the court's technical expert, compensation for environmental damages was R\$5.8 million as of October 17, 2006. This amount is under discussion and its approval is subject to a final decision by the appellate court. Our legal counsel assessed the risk of loss as probable. In December 2009, the court's technical expert's evaluation for the compensation was adjusted to R\$7.5 million. The lawsuit is currently being enforced against us. We are in negotiation with the Public Prosecution Office of the State of São Paulo to settle this lawsuit.
- In 2003, a public civil action filed by the Piracicaba Civil Entities Coordination Board against us, the Agência Nacional de Águas – the ANA and the Government of the State of São Paulo seeking remedy for damages caused by the use of the Piracicaba, Jundiá and Capivari rivers' basin to supply the São Paulo metropolitan region through the Cantareira Water System for nearly 30 years. The value attributed to the claim was R\$11.4 billion on December 10, 2003, and later adjusted to R\$16.8 billion as of December 31, 2009. This lawsuit is in its initial stage and is pending judgment from the trial court. So far no value has been set for the damages alleged. Our legal counsel assessed the risk of loss as remote. No provision was made for this lawsuit.
- The Public Prosecution Office of the State of São Paulo has filed a public civil action against us, AES Eletropaulo, DAEE, CETESB and the State Secretariat of Treasury seeking a joint condemnation for alleged environmental damage caused by the reversal of the Pinheiros River into the Billings Dam. A Trial Court found the defendants guilty and, based on an expert's report which estimated the amount of damages, condemned the defendants to jointly pay R\$284.5 million in damages. As of December 31, 2009, the amount monetarily adjusted of damages totaled R\$548.9 million. We, DAEE, AES Eletropaulo, CETESB and the State Treasury Department have filed an appeal against the ruling at the appellate court. The appellate court ruled in our favor. Our legal counsel assessed the risk of loss as remote. No provision was made for this lawsuit.
- On December 11, 2007, the Public Prosecution Office of the State of São Paulo filed a civil public action against us seeking that we (i) cease releasing untreated sewage in receiving waters and in the soil, (ii) implement a sewage system in the municipality of Vargem Grande Paulista and the necessary infrastructure for the sewage treatment, and (iii) indemnification for irreversible damages caused to the environment and public health, subject to daily fines. The trial court ruled partially against us and we have appealed the decision. Our legal counsel assessed the risk of loss as probable. The value attributed to the lawsuit was R\$3.0 million as of November 20, 2007, and later adjusted to R\$3.3 million as of December 31, 2009.
- The Public Prosecution Office of the State of São Paulo filed a civil public action against us and the Piracaiá Mayor's Office seeking that we cease to release untreated residential sewage in the Atibaia River. The value attributed to the lawsuit was R\$3.5 million as of July 11, 1996, and later adjusted to R\$9.0 million as of December 31, 2009. This lawsuit was in its initial stage, pending judgment from the trial court. Our legal counsel assessed the risk of loss as possible.



- The Public Prosecution Office of the State of São Paulo filed a civil public action against us seeking that we (i) cease releasing sewage in the Cascavel River or any other body of water in the municipality of Echaporã, subject to a daily fine and an indemnification for the damages caused to the environment in an amount to be determined by an expert. The Trial Court ruled against us, compelling us to cease to release sewage in the Cascavel River or any other body of water in the municipality of Echaporã for a period of six months, under the daily penalty of 10 times minimum wage (equivalent to R\$4,600 on May 12, 2009). The court also compelled us to pay an indemnification for the damages caused to the environment in the amount of R\$352.0 thousand with interest in June 2000. The trial court's ruling was upheld in appellate court and we are awaiting a decision from the superior court. Our legal counsel assessed the risk of loss as probable and we have provisioned the amount of R\$12.2 million for this lawsuit related to expert examination work and penalty fine, as of December 31, 2009.
- The Public Prosecution Office of the State of São Paulo filed a civil public action against us seeking that we (i) cease to release untreated sewage effluents in the Capivari river in the municipality of Campos do Jordão within 540 days from the filing of this lawsuit, subject to a daily fine of R\$100.0, (ii) fully restore the environmental damage or indemnify the State for such damages if restoration is not viable. The trial court ruled against us. The appellate court also ruled against us, but reduced the daily fine to R\$10.0. We have appealed the appellate court's ruling and are currently waiting for a ruling on our appeal. Our legal counsel assessed the risk of loss as probable. As of December 31, 2009, the fine due was R\$10.3 million and we have provisioned this amount.
- On April 12, 2005, the Federal Public Prosecution Office and the Federal Government sued us and the Santos Mayor's Office requesting: (i) the full restoration of the area where the emissary was built to its original condition and the conservation of the remaining vegetation; (ii) the maintenance of the area in a condition that is adequate for its use for the population; and (iii) that an environmental license is obtained before any change in the pipes of the emissary. The Trial Court ruled in our favor and there was a subsequent appeal against this decision. We are currently waiting for a ruling on the plaintiffs' appeal. Our legal counsel assessed the risk of loss as possible. The value attributed to the lawsuit was R\$3.1 million as of December 31, 2009. We have not provisioned this amount.
- On October 19, 2009, the Public Prosecution Office of the State of São Paulo filed a civil public action against us and the municipality of Itatiba seeking that we (i) cease releasing untreated sewage in Itatiba; (ii) fully restore the soil, of surface and underground water bodies and of vegetation to their original condition, under the penalty of a daily fine in the event of non-compliance; (iii) indemnify the State for damages when restoration is not viable; and (iv) indemnify the State for moral damages. This lawsuit is in its initial stage and is pending judgment from the trial court. Our legal counsel assessed the risk of loss as possible. The value attributed to the lawsuit was R\$20 million as of December 31, 2009 and we have not provisioned this amount.

We are currently involved in other environmental lawsuits and administrative proceedings against the release of untreated sewage in the municipalities, which have been evaluated as probable and possible losses. The amounts provisioned that not always represent the final amount to be paid as compensation for the alleged damages in view of the current status of the lawsuits and since Management is precluded from reasonably estimating the amounts of future disbursements. As of December 31, 2009, the total amount provisioned was R\$58.5 million.

## ***Labor Proceedings***

We are party to labor proceedings, mainly regarding unpaid overtime, health and safety conditions in the workplace,

among others. We make provisions for part or the entire amounts involved in the proceedings. For those cases in which the probability of loss is assessed as probable, we provision the full amounts being discussed.

As of December 31, 2009, we are party to approximately 3,989 labor proceedings and one public civil action filed by some of our current and former employees. These lawsuits seek to negotiate certain benefits granted by Law No. 4,819 of August 26, 1958. Approximately 40 plaintiffs are claiming the same benefits in the civil court and in these cases. Our position in these lawsuits is that the State government, and not us, should be responsible for the payments due to the plaintiffs. In the public civil action filed against us and the State Treasury, a temporary injunction was granted in the trial court requiring us to pay the benefits set forth in Law No. 4,819/58 to all the plaintiffs. A trial court decision was rendered on April 5, 2005, granting the relief sought under this proceeding and confirming the temporary injunction to require us to continue to pay the benefits. We have appealed this decision. There are currently other pending individual lawsuits discussing the same claims, and up to the date of this report neither Sabesp nor the State government had reached an agreement as to the indemnification amounts related to these proceedings.

As of December 31, 2009, the total amount discussed in the labor proceedings was R\$201.8 million for risks considered as probable and possible losses. We have established a provision of R\$101.5 million as of December 31, 2009 for these contingencies, including the lawsuits described in the preceding paragraphs, based on calculations made by our legal and human resources departments.

## ***Tax Proceedings***

Our tax proceedings and our contingency reserves for tax proceedings refer mainly to tax collection suits resulting from different interpretations by us and the competent government authority with respect to the applicable law. The tax proceedings to which we are party include the following:

- We are challenging in court the taxation, by the city of São Paulo, for the use of public areas for the installation of water and sewage mains for the provision of public sanitation services. The tax was originally established by the municipal decree No. 38,139/99 and later replaced by the municipal decree No. 40,532/2001 and finally by the municipal Law No. 13,614/2003. On February 22, 2000, filed a writ of mandamus requesting an injunction to challenge this tax. This first lawsuit covers the taxation before the enactment of the municipal Law No. 13,614/2003. The trial court found in our favor and the appellate court confirmed that the tax was not due. The city of São Paulo appealed from this decision and a final decision is pending. On April 20, 2004, we filed a writ of mandamus challenging the Law No. 13,614/2003. We requested a temporary injunction against the collection of this tax, which was granted by the trial court. The São Paulo city government appealed from this decision and an appellate court decision is still pending. We cannot estimate the potential increase to our expenses should we have to pay this tax for the use of public areas for the installation of water and should we be required to pay such tax since 1999. Until present, no provision for any type of potential expense deriving from this municipal tax had been recorded.
- We filed a writ of mandamus challenging the municipal law 13,476/2002. Before the enactment of this law, we were exempted from the payment of the Brazilian Service Tax (*Imposto Sobre Serviço*), or ISS. The trial court originally granted a preliminary injunction in our favor, suspending the levy of the tax, but later ruled against us. In July 2005, we filed an appeal to maintain the injunction previously granted. The final ruling has not yet been issued, but we believe that the outcome will be favorable to us.

- With respect to the ISS, the Secretariat of Treasury of the city of São Paulo drew up collection assessment notices on September 18, 2006, and we filed an administrative objection in reply. Our administrative objection was denied. As a result, we file a lawsuit requesting an injunction to annul the assessment notices. The amount involved was estimated in R\$70.0 million, and later adjusted to R\$158.8 million, as of December 31, 2009. Based on the opinion of our legal counsel, our risk of loss is possible.
- We proposed to carry over losses from previous years to offset an income tax liability of approximately R\$56.1 million and a social contribution tax liability of approximately R\$8.7 million. These amounts refer to the period between January and April 2003. In 2005, the Federal Revenue Service denied the compensation of approximately R\$11.2 million related to income tax liability and R\$0.7 million related to social contribution tax liability, totaling R\$11.9 million (R\$25.3 million as of December 31, 2009), and allowed us to compensate the remainder portion. We appealed from this decision and our request was partially granted. As of December 31, 2009, we recorded R\$6.0 million as possible loss and R\$1.0 million as probable loss.
- In 2006, the Federal Revenue Service concluded that, for the year 2001, we have an income tax liability and social contribution tax liability totaling R\$277.0 million (R\$341.1 million, as adjusted as of December 31, 2009) and initiated administrative collection proceedings against us. We filed an administrative objection to this collection proceeding. Based on the opinion of our legal counsel, we have a risk of remote loss of approximately 90% of this amount and a risk of possible loss of the remaining 10%.
- In 2008, the Federal Revenue Service denied six requests for compensation to offset income tax and social contribution tax liabilities. We proposed to offset income tax and social contribution tax paid in excess against our tax liability. The amount involved in these proceedings was R\$37.9 million as of December 31, 2009. Based on the opinion of our internal legal counsel, we have a risk of possible loss.
- In November 2004, we filed a writ of mandamus against the municipality of Bragança Paulista regarding the imposition of a new tax for the use of public areas for the installation of water and sewage mains for the provision of public sanitation services. On February 16, 2005, we were granted a temporary injunction suspending the imposition of this tax and preventing the municipality from collecting any current or future amounts due in respect of this tax until a ruling is rendered by the trial court. In June 2005, the trial court ruled in our favor by confirming the injunction. In July 2005, the municipality of Bragança Paulista filed an appeal to the São Paulo appellate court, which has not yet rendered a ruling on the appeal. We have not made any provisions for this proceeding.

We cannot predict the outcome of any of these lawsuits nor can we assure you that, in the event of an adverse decision, we will be able to pass on to our customers any increase in our deductions from gross revenue, operating expenses or other expenses. See *Item 3.D. Risk Factors Risks Relating to Our Business Any substantial monetary judgment against us in legal proceedings may have a material adverse effect on us.*

### **Condemnation Proceedings**

We are party to a significant number of condemnation proceedings arising from the partial or total expropriation or use of private property for water mains, sewer lines and facilities. Under Brazilian law, the State or the relevant municipality is entitled to condemn private property to the extent required for the construction, development or improvement of water and sewage systems operated by us. However, we are required to provide compensation to affected property owners based upon appraised fair market values. Although we generally provide compensation to property owners on the basis of negotiated settlements, we are a party to many lawsuits related to compensation awards.

On December 31, 2009, the future disbursement was estimated at R\$526.0 million, as to all proceedings regarding expropriation and easements. These payments are made over the year, according to each court order or settlement. After making each payment, we will obtain the title to the respective real property which will be recorded as an asset belonging to us after being expropriated. We have not provisioned any amounts with regards to these proceedings.

### **Concession Related Legal Proceedings**

In December 1997, the municipality of Santos enacted a statute expropriating our water and sewage systems located in Santos. We filed a writ of mandamus requesting a temporary injunction against the expropriation which was denied by the trial court. This decision was subsequently reversed by the appellate court, which then issued a temporary injunction suspending the effectiveness of the statute. By August 2, 2002, both the trial and appellate courts had ruled in our favor, but we are currently waiting for a final decision. We continue to render the water and sewage collection services in the municipality of Santos.

On March 25, 2005, the municipality of Itapira approved a decree revoking the concession contract. In addition, a municipal law was enacted revoking an earlier law authorizing the municipality to enter into the contract with us. The municipality of Itapira has further filed a repossession lawsuit seeking to repossess all of the reversible assets, rights, and privileges transferred in connection with the water and sewage collection services, and has obtained an injunction which was later confirmed by an appellate court decision. We appealed from this decision but later we decided to waive this appeal and file a compensation lawsuit against the municipality of Itapira.

The municipality of Tuiuti has filed a lawsuit seeking to recognize the inexistence of any judicial or legal grounds for us to provide water and sewage collection services in the municipality of Tuiuti, and to confirm the legality of the expropriation of these services by the municipality. We filed an answer to the lawsuit requesting that the trial court (i) confirm the existence of a legal relationship between us and the municipality of Tuiuti and (ii) award damages for the expropriation of our assets. The trial court ruled against us but awarded us an indemnification of R\$541.0, to be updated since March 2006. Both parties appealed from this decision and we are currently waiting for an appellate court decision. We are not operating in the municipality of Tuiuti.

The municipality of Cajobi has filed a repossession lawsuit. This lawsuit requests the repossession of water and sewage collection services due to the termination of the concession agreement on November 13, 2006, and an indemnification for all amounts paid to us for water and sewage collection services after November 2006, as well as payments for the use of all the reversible assets, rights and privileges transferred to us in the concession agreement. The municipality has been rendering the water and sewage collection services since May 29, 2007, based on an injunction granted by the trial court. The amounts involved in this lawsuit are still being evaluated by an independent appraisal firm.

The municipality of Monte Alto has filed a repossession lawsuit. This lawsuit requests the repossession of water and sewage collection services due to the termination of the concession agreement entered into with us and an indemnification for all amounts paid to us for water and sewage collection services after the termination, as well as payments for the use of all the reversible assets, rights and privileges transferred to us in the concession agreement. We reassumed the water and sewage collection services in this municipality in June 2008, following an agreement with the municipality.

The municipality of Araçoiaba da Serra has filed a repossession lawsuit requesting the repossession of water and sewage collection services due to the termination of the concession entered into with us and an indemnification for all amounts paid to us for water and sewage collection services after the termination on September 23, 2006, as well as payment for the use of all the reversible assets, rights and privileges transferred to us in the concession agreement. A temporary injunction was granted by the appellate court in favor of the municipality of Araçoiaba da Serra and confirmed by the superior courts. The lawsuit is currently in the discovery phase.

We filed a lawsuit to collect indemnifications from the municipalities of Diadema e Mauá. These indemnifications result from the unilateral termination by these municipalities of the concession agreements entered with us in 1995. We have invested in the construction of water and sewage collection systems in these municipalities to render the contracted services. As a result of the termination of these concession agreements, the municipalities started to directly render water and sewage collection services.

With respect to the collection suit against the municipality of Diadema, in December 2007, the trial court rendered a decision confirming our claim. The municipality appealed from the decision to the appellate court, which has not yet rendered ruling on the matter. In December 2008, we entered into an agreement with the municipality of Diadema to negotiate the repossession of the water and sewage collection services by us and to also negotiate the indemnification being disputed before the courts.

With respect to the collection suit against the municipality of Mauá, a decision favorable to us was rendered by the trial court in the lawsuit filed against the municipality of Mauá, ordering the municipality to pay us R\$153.2 million as compensation for our losses. The municipality appealed this decision to the appellate court, which upheld the trial court's decision in August 2008. This decision is not yet final as the municipality has the right to appeal.

We have recorded the indemnifications to be received from the municipalities of Diadema and Mauá as non-current assets representing long-term receivables. As of December 31, 2009, this amount totaled R\$146.2 million.

### ***Tariff Related Legal Proceedings and Consumers Claims***

Approximately 1,344 lawsuits have been brought by our commercial customers that claim that their tariff rates should be equal to those of another category of customers and, consequently, seek the reimbursement of the difference between the amounts we collected and those tariffs. We have obtained final decisions both in favor and against us in many of these lawsuits, and have provisioned R\$783.6 million as of December 31, 2009 for the lawsuits for which we have determined that the risk of loss is probable.

The Association of Distinguished Bars and Restaurants (*Associação de Bares e Restaurantes Diferenciados*) has initiated several lawsuits to challenge the 10.0% penalty fee we charge on late water and sewage payments. In several of these cases, trial courts have dismissed the lawsuits based on the lack of standing by the plaintiff to initiate such a lawsuit. In other cases, the lawsuits were dismissed because a civil public action with respect to the same matter was already being heard at the civil courts of the State of São Paulo. In this civil public action, a decision against us was rendered and we have appealed the decision and a decision from the appellate court is still pending. Notwithstanding these legal proceedings, we have reduced to 2.0% the penalty fee we charge all of our customers on late bill payments.

### **Contractors Claims**

Certain contractors have filed claims against us alleging damages and underpayment of inflation indexation adjustments, monetary losses incurred in connection with introduction of the *Real* and economic instability of the contract, among other claims. These suits are being handled by different courts, and we have established provisions for them when the expectation of loss is considered probable. As of December 31, 2008 and 2009, we have recorded a provision of R\$222.4 million and R\$341.5 million, respectively.

### **Other Legal Proceedings**

We are a party to several civil lawsuits related to indemnities for property damage, pain and suffering, and loss of profits allegedly caused to third parties. As of December 31, 2008 and 2009, we have recognized a provision of R\$152.4 million and R\$155.0 million, respectively, for claims whose likelihood of loss is considered probable. There was an increase both in the number of lawsuits with probable and possible risk of loss, arising from the increase in lawsuits and the review of the expected outcomes, comprising monetary adjustment, interest and fees for the year.

The São Paulo State Public Attorney's Office has filed a public civil action against Sabesp seeking (i) to ensure water supply in the municipality of Guarujá within accepted levels of potability and in accordance with current legislation, (ii) to require us to start building water treatment station, (iii) to reimburse fees charged to consumers and (iv) to pay compensation for physical harm and pain and suffering caused by allegedly improper water consumption. A temporary injunction was granted to the São Paulo State Public Attorney's Office and we appealed such decision, which was rejected by the appellate court. We have presented an answer to the complaint and the lawsuit is currently in the discovery phase. We have not yet estimated our potential liability with respect to this lawsuit because we currently do not have sufficient information to accurately do so. We evaluated this demand as a possible loss.

On October 29, 2003, the São Paulo State Public Attorney's Office, on behalf of the people of the State of São Paulo, filed a civil public action in a trial court of the State of São Paulo alleging that a transfer to us of ownership of the Alto Tietê System reservoirs from the DAEE would be illegal. In October 2004, the court ruled in favor of the Public Prosecution Office of the State of São Paulo, with respect to the illegality of the transfer of the reservoirs. We then filed an appeal at the appellate court, which has not yet rendered a ruling on the matter. We are a party to a substantial number of other legal proceedings, in addition to the lawsuits and administrative proceedings discussed above, in the ordinary course of our business. These legal proceedings include personal injury and property damage cases, environmental proceedings, challenges to our ability to cease rendering water and sewage services upon default by our customers and a range of other matters. We have not established provisions with respect to these other legal proceedings.

## **Dividends and Dividend Policy**

### ***Amounts Available for Distribution***

At each annual shareholders meeting, the board of directors is required to recommend the allocation of net profits for the preceding fiscal year. For purposes of Brazilian Corporate Law, net profits are defined as net income after income tax and social contribution tax for such fiscal year, net of any accumulated losses from prior fiscal years and any amounts allocated to employees and management's participation in our profits. In accordance with Brazilian Corporate Law, the amounts available for dividend distribution are the amounts equal to our net profits less any amounts allocated from such net profits to:

- the legal reserve; and
- retained earnings for investment reserve.

We are required to maintain a legal reserve, to which we must allocate 5% of net profits for each fiscal year until the amount for such reserve equals 20% of our paid in capital. However, we are not required to make any allocations to our legal reserve in respect of any fiscal year in which the aggregate amount of the legal reserve plus our other established capital reserves exceeds 30% of our capital. Net losses, if any, may be offset against the legal reserve. As of December 31, 2009, the balance of our legal reserve was R\$378.5 million, which was equal to 6.1% of our capital.

Brazilian Corporate Law also provides for two discretionary allocations of net profits that are subject to approval by the shareholders at each annual shareholders meeting. First, a percentage of net profits may be allocated to a contingency reserve for anticipated losses that are deemed probable in future years. Any amount so allocated in a prior year must be either reversed in the fiscal year in which the loss was anticipated if such loss does not in fact occur, or written off in the event that the anticipated loss occurs. Second, if the mandatory distributable amount exceeds the sum of realized net profits in any given year, such excess may be allocated to an unrealized revenue reserve. Under Brazilian Corporate Law, realized net profits is defined as the amount of net profits that exceeds the net positive result of equity adjustments and profits or revenues from operations with financial results after the end of the next succeeding fiscal year.

Under Brazilian Corporate Law, any company may authorize in its by laws the creation of a discretionary reserve. By laws which authorize the allocation of a percentage of a company's net income to the discretionary reserve must also indicate the purpose, criteria for allocation and maximum amount of the reserve. We may also allocate a portion of our net profits for discretionary allocations for plan expansion and other capital investment projects, the amount of which would be based on a capital budget previously presented by management and approved by our shareholders. Under Law No. 10,313 of October 3, 2001, capital budgets for more than one year must be revised at each annual shareholders meeting. After completion of the relevant capital projects, we may retain the allocation until the shareholders vote to transfer all or a portion of the reserve to capital or retained earnings. As of December 31, 2009, we had an investment reserve of R\$1,676.1 million.

The amounts available for distribution may be further increased by a reversion of the contingency reserve for anticipated losses constituted in prior years but not realized. The amounts available for distribution are determined on the basis of financial statements prepared in accordance with Brazilian GAAP.

The legal reserve is subject to approval by the shareholder vote at our annual shareholders meeting and may be transferred to capital but is not available for the payment of dividends in subsequent years. Our calculation of net profits and allocations to reserves for any fiscal year are determined on the basis of financial statements prepared in accordance with Brazilian GAAP.

## ***Mandatory Distribution***

Brazilian Corporate Law generally requires that the by laws of each Brazilian corporation specify a minimum percentage of the amounts available for distribution by such corporation for each fiscal year that must be distributed to shareholders as dividends, also known as the mandatory distributable amount. Under our by laws, the mandatory distributable amount has been fixed at an amount equal to not less than 25% of the amounts available for distribution, to the extent amounts are available for distribution at the end of each given fiscal year.

The mandatory distribution is based on a percentage of adjusted net income, not lower than 25%, rather than a fixed monetary amount per share. Brazilian Corporate Law, however, permits a publicly held company, such as SABESP, to suspend the mandatory distribution if the board of directors and the fiscal council report to the shareholders' meeting that the distribution would be inadvisable in view of the company's financial condition. The suspension is subject to the approval of holders of common shares. In this case, the board of directors must file a justification for such suspension with the CVM. Profits not distributed by virtue of the suspension mentioned above shall be attributed to a special reserve and, if not absorbed by subsequent losses, must be paid as dividends as soon as the financial condition of such company permits such payments.

### *Payment of Dividends*

We are required by Brazilian Corporate Law and by our by laws to hold an annual shareholders meeting by the fourth month after the end of each fiscal year at which, among other things, the shareholders have to decide on the payment of an annual dividend. The payment of annual dividends is based on the financial statements prepared for the relevant fiscal year. Under Brazilian Corporate Law, dividends generally are required to be paid within 60 days following the date the dividend was declared, unless a shareholders equity resolution sets forth another date for payment, which, in either case, must occur prior to the end of the fiscal year in which the dividend was declared. A shareholder has a three year period from the dividend payment date to claim dividends (or interest payments on shareholders equity as described under Record of Dividend Payments and Interest on Shareholders Equity ) distributed on his or her shares, after which the amount of the unclaimed dividends reverts to us. The depositary will set the currency exchange date to be used for payments to ADS holders as soon as practicable upon receipt of those payments from SABESP.

Our by laws do not permit us to pay interim dividends out of preexisting and accumulated profits for the preceding fiscal year or semester.

In general, shareholders who are not residents of Brazil must register with the Central Bank to have dividends, sales proceeds or other amounts with respect to their shares eligible to be remitted outside of Brazil. The common shares underlying our ADSs are held in Brazil by *Banco Itaú S.A.*, as the custodian and agent for the depositary, which is the registered owner of the common shares underlying the ADSs. Our current registrar is *Banco Itaú S.A.* The depositary electronically registers the common shares underlying the ADSs with the Central Bank and, therefore, is able to have dividends, sales proceeds or other amounts with respect to these shares eligible to be remitted outside Brazil. See *Item 10.D. Additional Information Exchange Controls.*

Payments of cash dividends and distributions, if any, will be made in Brazilian reais to the custodian on behalf of the depositary, which will then convert such proceeds into U.S. dollars and will cause such U.S. dollars to be delivered to the depositary for distribution to holders of ADSs. See *Item 10.D. Additional Information Exchange Controls.* Under current Brazilian law, dividends generally paid to shareholders who are not Brazilian residents, including holders of ADSs, will not be subject to Brazilian withholding income tax, except for dividends declared based on profits generated prior to December 31, 1995. See *Item 10.E. Additional Information Taxation.*

## **Record of Dividend Payments and Interest on Shareholders Equity**

Brazilian corporations are permitted to distribute dividends in the form of a tax deductible notional interest expense on shareholders equity in accordance with Law No. 9,249 of December 26, 1995, as amended. The rate at which tax deductible interest may be paid is limited to the product of the average TJLP and shareholders equity during the relevant period and cannot exceed the greater of:

- 50% of net income (before taking into account such distribution and any deductions for income taxes and after taking into account any deductions for social contributions on net profits) for the period in respect of which the payment is made;
- 50% of retained earnings; and
- Any payment of interest on shareholders' equity to holders of ADSs or common shares, whether or not they are Brazilian residents, is subject to Brazilian withholding income tax at the rate of 15% or 25% if the beneficiary is resident in a tax haven. See *Item 10.E. Additional Information Taxation*. The amount paid to shareholders as interest on shareholders' equity, net of any withholding tax, may be included as part of any mandatory distributable amount. Under Brazilian law, we are obligated to distribute to shareholders an amount sufficient to ensure that the net amount received by them, after payment by us of applicable Brazilian withholding taxes in respect of the distribution of interest on shareholders' equity, is at least equal to the mandatory distributable amount. When we distribute interest on shareholders' equity, and that distribution is not accounted for as part of the mandatory distribution, Brazilian withholding tax will apply. All payments to date were accounted for as part of the mandatory distribution.

***Distributions of dividends***

The following table sets forth the distributions of dividends that we made to our shareholders in respect of our 2007, 2008 and 2009 earnings. All these amounts distributed or to be distributed were or will be in the form of interest on shareholders' equity.

<b>Year ended December 31,</b>	<b>Aggregate amount distributed</b> (in millions of reais)	<b>Payment Dates</b>	<b>Payment per share</b>	<b>Payment per ADS</b> (in reais)	
2007	300.7	June 27, 2008		1.32	2.64
2008	296.2	June 26, 2009		1.30	2.60
2009	394.2	June 28, 2010		1.73	3.46

***Dividend Policy***

We intend to declare and pay dividends and/or interest on shareholders' equity, as required by Brazilian Corporate Law and our by-laws. Our board of directors may approve the distribution of interest on shareholders' equity, calculated based on our semiannual or quarterly financial statements. The declaration of dividends is annual, including dividends in excess of the mandatory distribution, and requires approval by the vote of the majority of the holders of our common shares. The amount of any distributions will depend on many factors, such as our results of operations, financial condition, cash requirements, prospects and other factors deemed relevant by our board of directors and shareholders. Within the context of our tax planning, we may in the future continue to determine that it is in our best interest to distribute interest on shareholders' equity.

**8.B. Significant Changes**

We are not aware of any significant changes bearing upon our financial condition since the date of the consolidated financial statements included in this annual report.

**ITEM 9. The Offer and Listing****9.A. Offer and Listing Details****Market Price of Common Shares**

Our common shares have been listed on the BM&FBOVESPA under the symbol SBSP3 since June 4, 1997 and, starting on April 24, 2002, have been included in the *Novo Mercado* segment of that exchange. As of December 31, 2009, we had 3,484 registered holders of common shares.

On April 30, 2007, our shareholders approved a reverse stock split of 125 common shares into one common share. IFRS requires the retroactive restatement of earnings per share computations for stock dividends, stock splits, and reverse splits.

The table below sets forth, for the periods indicated, the reported high and low closing sale prices in *reais* for common shares on the BM&FBOVESPA. The table also sets forth prices per ADS assuming that ADSs had been outstanding on all such dates and translated into U.S. dollars at the commercial market rate for the sale of U.S. dollars for each of the respective dates of such quotations. In addition, the table sets forth the average daily trading volume for our common shares.

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	<i>Reais per 1,000 common shares</i>		<i>U.S. dollar equivalent per ADS <sup>(1)</sup></i>		<i>Average daily trading volume (in lots of 1,000 common shares)</i>
	<b>Low</b>	<b>High</b>	<b>Low</b>	<b>High</b>	
<b>2004:</b>		115.82	182.00	10.10	16.24
<b>2005:</b>		121.41			51,359