

CONFIDENTIAL OFFERING CIRCULAR



## Companhia de Saneamento Básico do Estado de São Paulo—SABESP

### **US\$140,000,000 7.5% Notes due 2016**

We are offering US\$140,000,000 aggregate principal amount of 7.5% notes due 2016. Interest on the notes will accrue from November 3, 2006 at a rate of 7.5% per year and will be payable semiannually in arrears on May 3 and November 3, commencing on May 3, 2007.

The notes will mature on November 3, 2016. The notes may, at our option, be redeemed in whole or in part at 100% of their principal amount plus accrued interest and additional amounts, if any, at any time upon the occurrence of specified events relating to Brazilian tax law, as set forth in this offering circular.

The notes will be senior unsecured obligations and will rank *pari passu* with our other existing and future unsecured, unsubordinated indebtedness.

Application has been made to list the notes on the Luxembourg Stock Exchange and to trade them on the Euro MTF Market of that exchange. See "Listing and General Information." Notes that are sold to qualified institutional buyers are expected to be designated as being eligible for trading in the Private Offerings, Resales and Trading through Automatic Linkages (PORTAL<sup>SM</sup>) market.

*Investing in the notes involves risks. See "Risk Factors" beginning on page 12 to read about important factors you should consider before investing in the notes.*

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**Offering Price: 99.136% plus accrued interest from the issue date, if any**

**The notes have not been registered under the U.S. Securities Act of 1933, as amended, or the Securities Act, and are being offered only to (1) qualified institutional buyers under Rule 144A under the Securities Act and (2) non-U.S. persons outside the United States in compliance with Regulation S under the Securities Act. For more information about restrictions on transfer of the notes, see "Transfer Restrictions" beginning on page 150. To the extent that the offering of the notes is made to persons within the European Economic Area, it shall exclusively be made to "qualified investors" within the meaning of EU Directive 2003/71/EC, or the Prospectus Directive, and shall therefore be exempt from the requirement to publish a prospectus compliant with the Prospectus Directive.**

The notes will be delivered to purchasers in book-entry form through The Depository Trust Company, or DTC, and its direct and indirect participants, including Clearstream Banking, S.A. Luxembourg, or Clearstream, and Euroclear Bank S.A./N.V., as operator of the Euroclear System, or Euroclear, on or about November 3, 2006.

## **Deutsche Bank Securities**

The date of this offering circular is October 20, 2006.



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In this offering circular, 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. References to the “initial purchaser” are to Deutsche Bank Securities Inc. “Brazil” refers to the Federative Republic of Brazil and “State” refers to the State of São Paulo, which is also our controlling shareholder. The phrases “Federal Government” and “Brazilian government” refer to the federal government of the Federative Republic of Brazil and “State government” refers to the state government of the State of São Paulo. The term “Central Bank” refers to the *Banco Central do Brasil*, or the Central Bank of Brazil.

You should rely only on the information contained in this offering circular. We have not authorized anyone to provide you with different information. Neither we nor the initial purchaser are making an offer of the notes in any jurisdiction where the offer is not permitted.

We, having made all reasonable inquiries, confirm that the information contained in this offering circular with regards to us is true and accurate in all material respects, that the opinions and intentions we express in this offering circular are honestly held, and that there are no other facts the omission of which would make this offering circular as a whole or any of such information or the expression of any such opinions or intentions misleading in any material respect. We accept responsibility accordingly.

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**This offering circular does not constitute an offer to sell, or a solicitation of an offer to buy, any notes offered hereby by any person in any jurisdiction in which it is unlawful for such person to make an offer or solicitation. Neither the delivery of this offering circular nor any sale made hereunder shall, under any circumstances, imply that there has been no change in our**

**affairs or that the information set forth in this offering circular is correct as of any date subsequent to the date of this offering circular.**

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This offering circular has been prepared by us solely for use in connection with the proposed offering of the notes. This offering circular is personal to you and does not constitute an offer to any other person or to the public in general to subscribe for or otherwise acquire the notes. Distribution of this offering circular by you to any person other than those persons retained to advise you is unauthorized, and any disclosure of any of the contents of this offering circular without our prior written consent is prohibited. By accepting delivery of this offering circular, you agree to the foregoing and agree not to make photocopies of this offering circular, and, if you do not purchase the notes or the offering is terminated for any reason, you agree to return this offering circular to Deutsche Bank Securities Inc., 60 Wall Street, New York, NY 10005, Attention: Debt Capital Markets.

You must (1) comply with all applicable laws and regulations in force in any jurisdiction in connection with the possession or distribution of this offering circular and the purchase, offer or sale of the notes, and (2) obtain any required consent, approval or permission for the purchase, offer or sale by you of the notes under the laws and regulations applicable to you in force in any jurisdiction to which you are subject or in which you make such purchases, offers or sales, and neither we nor the initial purchaser or its agents have any responsibility therefor. See “Transfer Restrictions” for information concerning some of the transfer restrictions applicable to the notes.

You acknowledge that:

- you have been afforded an opportunity to request from us, and to review, all additional information considered by you to be necessary to verify the accuracy of, or to supplement, the information contained in this offering circular;
- you have not relied on the initial purchaser or its agents or any person affiliated with the initial purchaser or its agents in connection with your investigation of the accuracy of such information or your investment decision; and
- no person has been authorized to give any information or to make any representation concerning us or the notes other than those as set forth in this offering circular. If given or made, any such other information or representation should not be relied upon as having been authorized by us, the initial purchaser or its agents.

**In making an investment decision, you must rely on your own examination of our business and the terms of this offering, including the merits and risks involved. The notes have not been recommended by any federal or state securities commission or regulatory authority. Furthermore, these authorities have not confirmed the accuracy or determined the adequacy of this offering circular. Any representation to the contrary is a criminal offense.**

**This offering is being made in reliance upon an exemption from registration under the U.S. Securities Act of 1933, as amended, or the Securities Act, for an offer and sale of securities that does not involve a public offering. The notes are subject to restrictions on transferability and resale and may not be transferred or resold except as permitted under the Securities Act and applicable state securities laws, pursuant to registration or exemption therefrom. In making your purchase, you will be deemed to have made certain acknowledgements, representations and agreements set forth in this offering circular under the caption “Transfer Restrictions.” You should be aware that you may be required to bear the financial risks of this investment for an indefinite period of time.**

**This offering circular may only be used for the purpose for which it has been published. Neither the initial purchaser nor its agents are making any representation or warranty as to the accuracy or completeness of the information contained in this offering circular, and nothing contained in this offering circular is, or shall be relied upon as, a promise or representation, whether as to the past or the future. Neither the initial purchaser nor its agents have independently verified any of such information and assume no responsibility for the accuracy or completeness of the information contained in this offering circular.**

We and the initial purchaser reserve the right to reject any offer to purchase, in whole or in part, and for any reason, the notes offered by this offering circular. We and the initial purchaser also reserve the right to sell or place less than all of the notes offered by this offering circular.

Neither the U.S. Securities and Exchange Commission, or the SEC, nor any state securities commission has approved or disapproved the offering of these securities or determined if this offering circular is truthful or complete. Any representation to the contrary is a criminal offense.

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See “Risk Factors” beginning on page 12 of this offering circular for a description of certain factors relating to an investment in the notes, including information about our business. None of us, the initial purchaser nor any of our or its representatives is making any representation to you regarding the legality of an investment by you under applicable legal investment or similar laws. You should consult with your own advisors as to legal, tax, business, financial and related aspects of a purchase of the notes.

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## **NOTICE TO NEW HAMPSHIRE RESIDENTS**

**NEITHER THE FACT THAT A REGISTRATION STATEMENT, OR AN APPLICATION FOR A LICENSE, HAS BEEN FILED UNDER CHAPTER 421-B WITH THE STATE OF NEW HAMPSHIRE NOR THE FACT THAT A SECURITY IS EFFECTIVELY REGISTERED OR A PERSON IS LICENSED IN THE STATE OF NEW HAMPSHIRE CONSTITUTES A FINDING BY THE SECRETARY OF STATE OF NEW HAMPSHIRE THAT ANY DOCUMENT FILED UNDER RSA 421-B IS TRUE, COMPLETE AND NOT MISLEADING. NEITHER ANY SUCH FACT NOR THE FACT THAT AN EXEMPTION OR EXCEPTION IS AVAILABLE FOR A SECURITY OR A TRANSACTION MEANS THAT THE SECRETARY OF STATE HAS PASSED IN ANY WAY UPON THE MERITS OR QUALIFICATIONS OF, OR RECOMMENDED OR GIVEN APPROVAL TO, ANY PERSON, SECURITY OR TRANSACTION. IT IS UNLAWFUL TO MAKE, OR CAUSE TO BE MADE, TO ANY PROSPECTIVE PURCHASER, CUSTOMER, OR CLIENT ANY REPRESENTATION INCONSISTENT WITH THE PROVISIONS OF THIS PARAGRAPH.**

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## **INTERNAL REVENUE SERVICE CIRCULAR 230 DISCLOSURE**

**PURSUANT TO INTERNAL REVENUE SERVICE CIRCULAR 230, WE HEREBY INFORM YOU THAT THE DESCRIPTION SET FORTH HEREIN WITH RESPECT TO U.S. FEDERAL TAX ISSUES WAS NOT INTENDED OR WRITTEN TO BE USED, AND SUCH DESCRIPTION CANNOT BE USED, BY ANY TAXPAYER FOR THE PURPOSE OF AVOIDING ANY PENALTIES THAT MAY BE IMPOSED ON THE TAXPAYER UNDER THE U.S. INTERNAL REVENUE CODE. SUCH DESCRIPTION WAS WRITTEN TO SUPPORT THE MARKETING OF THE NOTES. THIS DESCRIPTION IS LIMITED TO THE U.S. FEDERAL TAX ISSUES DESCRIBED HEREIN. IT IS POSSIBLE THAT ADDITIONAL ISSUES MAY EXIST THAT COULD AFFECT THE U.S. FEDERAL TAX TREATMENT OF THE NOTES, OR THE MATTER THAT IS THE SUBJECT OF THE DESCRIPTION NOTED HEREIN, AND THIS DESCRIPTION DOES NOT CONSIDER OR PROVIDE ANY CONCLUSIONS WITH RESPECT TO ANY SUCH ADDITIONAL ISSUES. TAXPAYERS SHOULD SEEK ADVICE BASED ON THE TAXPAYER'S PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT TAX ADVISOR.**

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The notes will be available initially only in book-entry form. We expect that the notes will be issued in the form of one or more registered global notes. The global notes will be deposited with, or on behalf of, The Depository Trust Company, or DTC, and registered in its name or in the name of Cede & Co., its nominee. Beneficial interests in the global notes will be shown on, and transfers of beneficial interests in the global notes will be effected through, records maintained by DTC and its participants. We expect the Regulation S global notes, if any, to be deposited with the trustee as custodian for DTC, and beneficial interests in them may be held through the Euroclear, Clearstream or other participants. After the initial issuance of the global notes, certificated notes may be issued in registered form, which shall be in minimum denominations of US\$100,000 and integral multiples of US\$1,000.

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## AVAILABLE INFORMATION

We are a reporting company under Section 13 or Section 15(d) of the U.S. Securities Exchange Act of 1934, as amended, or the Exchange Act, and file periodic reports with the SEC. However, if at any time we cease to be a reporting company under Section 13 or Section 15(d) of the Exchange Act, or are not exempt from reporting pursuant to Rule 12g3-2(b) under the Exchange Act, we will be required to furnish to any holder of a note which is a "restricted security" (within the meaning of Rule 144 under the Securities Act), or to any prospective purchaser thereof designated by such a holder, upon the request of such holder or prospective purchaser, in connection with a transfer or proposed transfer of any such note pursuant to Rule 144A under the Securities Act or otherwise, the information required to be delivered pursuant to Rule 144A(d)(4) under the Securities Act. Any such request should be directed to us at Rua Costa Carvalho, 300, 05429-900, São Paulo, SP, Brazil, Attention: Chief Financial Officer and Investor Relations Officer (telephone number: +55 11 3388-8247).

We are subject to the informational requirements of the Exchange Act and, in accordance therewith, file reports, including annual reports on Form 20-F, reports on Form 6-K and other information with the SEC. As a foreign private issuer, we are exempt from the Exchange Act rules regarding the provision and control of proxy statements and regarding short-swing profit reporting and liability. Such reports and other information can be inspected and copied at the public reference facilities of the SEC at Room 1580, 100 F Street N.E., Washington, D.C. 20549. Copies of such materials can also be obtained at prescribed rates by writing to the Public Reference Section of the SEC at 100 F Street N.E., Washington, D.C. 20549. We file materials with, and furnish materials to, the SEC electronically using the EDGAR System. The SEC maintains an Internet site that contains these materials at [www.sec.gov](http://www.sec.gov). In addition, such reports and other information concerning us can be inspected at the offices of the New York Stock Exchange, Inc., 20 Broad Street, New York, New York 10005, on which our equity securities are listed.

Being a publicly traded company in Brazil, we are also subject to the information requirements of Brazilian laws and regulations, in particular those issued by the Brazilian Securities Commission (*Comissão de Valores Mobiliários*), or the CVM, which include the filing of annual and quarterly reports with the CVM (which are available to the public generally in Portuguese), as well as the publication of notices to investors (*atos relevantes*) in accordance with applicable regulations (including, without limitation, CVM Instruction No. 358, dated January 3, 2002).

We will furnish to Deutsche Bank Trust Company Americas, as trustee, copies in English of our audited annual financial statements as of and for the years ended December 31, 2003, 2004 and 2005 and our unaudited interim financial statements as of and for the six months ended June 30, 2005 and 2006. Upon receipt thereof, the trustee will promptly mail to you copies of such financial statements.

The Luxembourg paying agent will furnish you with copies of documents referred to in this offering circular. You should contact the Luxembourg paying agent, Deutsche Bank Luxembourg, at 2 Boulevard Konrad Adenauer, Luxembourg, Luxembourg.

## CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This offering circular includes forward-looking statements. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends affecting our business. These forward-looking statements are subject to risks, uncertainties and assumptions, including, among other things:

- the interests of our controlling shareholder, the State of São Paulo;
- our ability to collect amounts owed to us by our controlling shareholder and by municipalities;
- existing and future governmental regulation, including taxes on, and charges to, us;
- our lack of formal concessions for the City of São Paulo and other municipalities, including the cities comprising the São Paulo Metropolitan Region (as defined below);
- municipalities' power to terminate our existing concessions;
- our ability to obtain additional concessions and to renew current concessions when they become due;
- our ability to achieve plans to increase Water Coverage Ratio and Sewage Coverage Ratio and water and sewage connections;
- our ability to maintain Water Coverage Ratio of 100% in the municipalities to which we provide water services;
- our ability to again access attractive financing in the future;
- limitations on our ability to increase and readjust tariffs;
- our capital expenditure program and other liquidity and capital resources requirements;
- our level of indebtedness and limitations on our ability to incur additional indebtedness;
- droughts, water shortages and climate events;
- 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;
- general economic, political and other conditions in Brazil and in other emerging market countries;
- inflation and currency devaluation in Brazil;
- changes to tax laws in Brazil;
- power shortages or rationing in energy supply or significant changes in energy tariffs;
- our management's expectations and estimates concerning our future financial performance; and



- the size and growth of our customer base.

This list of factors is not exhaustive, and other risks and uncertainties may cause actual results to differ materially from those in the forward-looking statements. Various risks, uncertainties and other important factors have been identified under the caption “Risk Factors.”

The words “believe,” “may,” “will,” “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 offering circular 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 neither we nor the initial purchaser undertake the obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, unless required by law. Any such forward-looking statements are not guarantees of future performance and involve risks. As a result, you should not make an investment decision solely based on the forward-looking statements contained in this offering circular.

## PRESENTATION OF FINANCIAL AND OTHER INFORMATION

In this offering circular, 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 dollars. Solely for the convenience of the reader, we have translated some of the *real* amounts contained in this offering circular into U.S. dollars at a rate equal (unless otherwise indicated) to R\$2.1643 to US\$1.00, the commercial selling rate on June 30, 2006, as reported by the Central Bank. As a result of the recent fluctuations in the *real*/U.S. dollar exchange rate, the commercial selling rate may not be indicative of current or future exchange rates. Therefore, you should not read these translations as representations that any such amounts have been, could have been or could be converted into U.S. dollars at that or at any other exchange rate. See “Exchange Rates” for information regarding exchange rates allocable to the Brazilian currency since January 1, 2001.

Our audited annual financial statements as of and for the years ended December 31, 2003, 2004 and 2005, included elsewhere in this offering circular, have been audited by Deloitte Touche Tohmatsu Auditores Independentes, an independent registered public accounting firm, as stated in their report herein. Our unaudited interim financial statements as of and for the six months ended June 30, 2005 and 2006, are included elsewhere in this offering circular.

Our primary annual and interim quarterly financial statements, as required to be filed periodically with the CVM, are presented in *reais* and are prepared and presented in accordance with the Brazilian Corporate Law Method, which is based on Brazilian Corporate Law (Law No. 6,404/76, as amended), the rules and regulations issued by the CVM and the accounting standards issued by the Brazilian Institute of Independent Auditors (*Instituto dos Auditores Independentes do Brasil*), or IBRACON, hereinafter referred to as the “Brazilian Corporate Law Method.” Unless otherwise indicated, our financial statements and all financial data included in this offering circular have been prepared in accordance with the Brazilian Corporate Law Method.

Like other Brazilian companies, for purposes of filing our Annual Report on Form 20-F with the SEC, we prepare and present annual financial statements on the basis of accounting principles established in accordance with the Brazilian Corporate Law Method with a reconciliation to accounting principles generally accepted in the United States of America, or U.S. GAAP. In addition, certain terminology changes have been made and, in certain cases, the notes to the financial statements have been expanded to conform them to reporting requirements of the SEC and reporting practices prevailing in the United States of America.

The Brazilian Corporate Law Method differs in significant respects from U.S. GAAP. Note 22 to our audited annual financial statements, included elsewhere in this offering circular, provides a description of the significant differences between the Brazilian Corporate Law Method and U.S. GAAP as they relate to our annual financial statements and a reconciliation from the Brazilian Corporate Law Method to U.S. GAAP of our net income and shareholders’ equity for the periods presented therein. Certain significant differences between the Brazilian Corporate Law Method and U.S. GAAP described in Note 22 to our audited annual financial statements are relevant to the financial information presented herein. Further, investors should also consider the following relevant aspects with respect to the description of the differences between the Brazilian Corporate Law Method and U.S. GAAP contained in Note 22:

- Future differences between the Brazilian Corporate Law Method and U.S. GAAP resulting from changes in accounting standards or from transactions or events that may occur in the future have not been taken into account in the description contained in Note 22 and we have not attempted to identify them.
- Ongoing proposals of the regulatory bodies that promulgate the Brazilian Corporate Law Method and U.S. GAAP can affect future comparisons between the Brazilian Corporate Law Method and U.S. GAAP such as the description contained in Note 22.

- In making an investment decision, potential holders of notes must rely upon their own examination of our business, the terms of the notes and the offering and the financial and other information set forth in this offering circular. Potential holders of notes should consult with their own professional advisors for an understanding of the differences between the Brazilian Corporate Law Method and U.S. GAAP and how these differences might affect the financial information contained in this offering circular.

We do not have any subsidiaries.

### **Market Share and Other Information**

We make statements in this offering circular about our market share in the industry in which we operate in Brazil. We have made these statements on the basis of information obtained from third-party sources that we believe are reliable. We derive information regarding our competitive position in the industry in which we operate and other information from third-party sources and reports that we believe are reasonably reliable. Although we have no reason to believe that any of this information is inaccurate in any material respect, neither we nor the initial purchaser have independently verified the capacity, market share, market size or similar data provided by third parties or derived from industry or general publications.

References to “Water Coverage Ratio” in this offering circular mean the ratio between the number of residences to which we provide water services divided by the number of urban residences in a certain area. References to “Sewage Coverage Ratio” mean the ratio between (i) the number of residences to which we provide sewage collection services divided by the number of urban residences in a certain area.

### **Rounding**

We have made rounding adjustments to reach some of the figures included in this offering circular. As a result, numerical figures shown as totals in this offering circular may not be an arithmetic aggregation of the figures that preceded them.

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## SUMMARY

*You should read the following summary together with the more detailed information regarding us and our financial statements and related notes appearing elsewhere in this offering circular.*

### Our Business

We believe we are one of the largest water and sewage service providers in the world based on population served in 2005. We operate water and sewage systems in the State of São Paulo, in which the City of São Paulo, Brazil's largest city, is located. According to the Brazilian Institute of Geography and Statistics (*Instituto Brasileiro de Geografia e Estatística*), or IBGE, the State of São Paulo is Brazil's most populous and economically productive state. We are authorized to provide water and sewage services outside the State of São Paulo, including in other countries, either directly or through national or international consortia. We serve a broad range of residential, commercial, industrial and governmental customers in the area we refer to as the São Paulo Metropolitan Region, comprising 38 municipalities, and in the area we refer to as the Regional Systems, comprising 329 municipalities in the interior and coastline regions of the State of São Paulo, for a total of 367 of the 645 municipalities in the State of São Paulo as of the date of this offering circular. We also supply water on a wholesale basis to six municipalities in the São Paulo Metropolitan Region in which we do not operate water systems. For the six months ended June 30, 2006, the São Paulo Metropolitan Region (including the municipalities to which we provide water on a wholesale basis) and the Regional Systems accounted for 75.6% and 24.4%, respectively, of our gross revenue from sales and services. For the year ended December 31, 2005, the São Paulo Metropolitan Region (including the municipalities to which we provide water on a wholesale basis) and the Regional Systems accounted for 75.5% and 24.5%, respectively, of our gross revenue from sales and services.

As of June 30, 2006, we provided water services to approximately 22.6 million people, approximately 60% of the urban population of the State of São Paulo, with a Water Coverage Ratio of 100%, through approximately 59,480 kilometers of water pipes and mains to more than 6.5 million water connections. As of June 30, 2006, we provided sewage services to approximately 18.4 million people, with a Sewage Coverage Ratio of 78%, through 38,669 kilometers of sewer lines to approximately 4.9 million sewage connections. In addition, we sold water on a wholesale basis to six municipalities with a total estimated population of approximately 3.2 million.

For the six months ended June 30, 2006, we recorded net revenue from sales and services of R\$2,658.0 million (US\$1,228.1 million) and net income of R\$503.5 million (US\$232.6 million). For the same period in 2005, we recorded net revenue from sales and services of R\$2,390.0 million (US\$1,104.3 million) and net income of R\$487.1 million (US\$225.1 million). Our Adjusted EBITDA increased to R\$1,286.5 million (US\$594.4 million) for the six months ended June 30, 2006 from R\$1,119.4 million (US\$517.2 million) for the same period in 2005. As of June 30, 2006 and 2005, we had total assets of R\$17,716.2 million (US\$8,185.6 million) and R\$17,787.1 million (US\$8,218.4 million), respectively, and shareholders' equity of R\$8,878.4 million (US\$4,102.2 million) and R\$8,341.2 million (US\$3,854.0 million), respectively. For the years ended December 31, 2005, 2004 and 2003, we recorded net revenue from sales and services of R\$4,953.4 million (US\$2,288.7 million), R\$4,397.1 million (US\$2,031.6 million) and R\$4,130.8 million (US\$1,908.6 million), respectively, and net income of R\$865.6 million (US\$399.9 million), R\$513.0 million (US\$237.0 million) and R\$833.3 million (US\$385.0 million), respectively. Our Adjusted EBITDA also increased to R\$2,285.6 million in the year ended December 31, 2005 from R\$2,076.5 million in the year ended December 31, 2003. For a reconciliation between our net income and Adjusted EBITDA, see "—Summary Financial and Operating Information" and "Selected Financial and Operating Data." As of December 31, 2005, 2004 and 2003, we had total assets of R\$17,435.2 million (US\$8,055.8 million), R\$16,783.8 million (US\$7,754.8 million) and R\$16,590.1 million (US\$7,665.3 million), respectively, and shareholders' equity of R\$8,482.5 million (US\$3,919.3 million), R\$7,951.6 million (US\$3,674.0 million) and R\$7,576.9 million (US\$3,500.9 million), respectively.

We have the power to adjust our tariffs and, historically, we have done it once a year, usually in the month of August, for a period of at least 12 months. We increased our tariffs for water and sewage services by 9.0% on August 31, 2005 and by 6.71% on August 31, 2006.

The State of São Paulo, our controlling shareholder, is required by our by-laws and State law to own at least 50% plus one of our common (voting) shares. As of June 30, 2006, the State of São Paulo owned 50.3% of our outstanding common shares.

## **Our Strengths**

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

*Well-established business with significant size and scale.* We believe we are one of the largest water and sewage service providers in the world based on population served in 2005. We are the sole provider of water and/or sewage services in our areas of operation. We provide water services directly and through other public companies to approximately 25.8 million people (including the municipalities to which we provide water services on a wholesale basis), having a Water Coverage Ratio of 100% as of June 30, 2006, and sewage services to approximately 18.4 million people, having a Sewage Coverage Ratio of 78% as of June 30, 2006. From 2003 to 2005, our net revenue from sales and services has increased by an average of 19.9% per year and our net income has increased by an average of 3.9% per year. During the six months ended June 30, 2006, our net revenue from sales and services increased by 11.2% as compared to the six months ended June 30, 2005, and our net income increased by 3.4%.

*Operations in Brazil's most populous and wealthy state.* The State of São Paulo, part of the most developed and economically active region of Brazil, is the most populous state in Brazil, with an estimated population of 40.5 million as of June 30, 2006. The City of São Paulo had an estimated population of 10.8 million as of June 30, 2006, with 19.4 million inhabitants in the São Paulo Metropolitan Region. Based on its gross domestic product, or 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\$494.8 billion in 2003, representing approximately 32% of Brazil's total GDP. The State of São Paulo generates more revenues from water and sewage services than any other Brazilian state.

*High-quality operations.* We believe that we adhere to high standards of service and utilize the best available technology in the sanitation business. Five of our water quality laboratories in the São Paulo Metropolitan Region and all of our ten laboratories in the Regional Systems have received ISO 9001/2000 certification and three in the Regional Systems have received ISO 17025 certification with respect to the quality of our management systems to respond to client needs and the technical ability of our laboratories to produce results. We believe our technology enhances the efficiency and quality of our operations.

*Access to low-cost and diverse sources of financing.* Strong cash flow generation from our operations and compliance with financial covenants place us in a privileged position in our industry to obtain low cost, long-term financing from Brazilian and international multilateral agencies and development banks. In addition, we are not dependent upon one or few sources of financing. We benefit from various alternatives of funding available in the Brazilian and international markets for our working capital needs and our capital expenditure programs.

*Strong corporate governance practices.* In 2002, we joined the *Novo Mercado*, the highest corporate governance listing segment of the São Paulo Stock Exchange (*Bolsa de Valores de São Paulo – BOVESPA*). We are committed to maintaining certain corporate governance practices and disclosure requirements in addition to those already required under Brazilian law. These corporate governance practices require us to increase shareholders' rights and to enhance the quality of information provided to our shareholders.

*Expansion opportunities.* We had a Sewage Coverage Ratio of 78% as of June 30, 2006, and plan to increase this level to 86% by 2010 by adding over 1,080,000 sewage connections. Since January 1, 1997, we have obtained concessions for 33 additional municipalities (representing a total population of 2.2 million). In addition, there are municipalities in the State of São Paulo in which we currently do not operate water or sewage concessions or to which we currently supply water solely on a wholesale basis, which represent a total population of approximately 15.6 million. Our strong presence in the State and experience in providing water and sewage services place us in a privileged position to expand our Sewage Coverage Ratio in municipalities where we only provide water services and to expand our water and sewage services to municipalities where we are not yet operating, not only in the State of São Paulo but also in other states of Brazil and abroad.

## **Our Strategy**

Our mission is to make public sanitation services universally available in the State of São Paulo and to provide quality services in both the national and international markets. To this end, our strategic objectives are based upon the guiding principles of growth, quality, universalization of water services, social, economic and environmental sustainability, as well as our political and institutional relationships. We seek to implement these guiding principles through the following strategies:

*Continue to reduce operating costs and increase productivity and profitability.* We intend to continue our efforts to reduce operating costs and increase productivity and profitability. To this end, we plan to improve the management of our assets, as well as continue reducing our total salary and payroll expenses by decreasing the number of our employees, automating some of our operations, streamlining operational processes, implementing integrated planning and further investing in internal technological research and development. We are also continuing our efforts to improve our collection of overdue accounts receivable from municipalities to which we provide water on a wholesale basis, from the State and from other governmental entities. We are actively pursuing the overdue amounts and in some cases exploring opportunities to swap these amounts for rights and infrastructure to operate water and sewage systems.

*Ensure the quality and availability of our services in our existing service area.* Our goal is to maintain universal coverage of water services with a high standard of quality and availability. We intend to continue providing universal water services and meet population growth by adding 845,000 water connections by 2010 and to increase our Sewage Coverage Ratio to 86% by 2010. To ensure the quality and availability of our services, we also intend to improve customer relations by shortening response times for customer installations as well as through a focused public relations program to enhance our image. In addition, we are also developing short, medium and long-term marketing strategies, such as client segmentation and tailor-made solutions for each type of client, which we believe will help us increase our customer base.

*Maintain our existing concession base.* We intend to renew all of our existing concessions as they expire and have put together a task force to address concession expiration in a timely and effective manner. To this end, we are also seeking to develop closer relationships with the municipal governments that we serve to increase customer loyalty and thereby increase our revenues.

*Continue to expand our existing service area and obtain additional concessions.* Our goal is to expand sewage collection and treatment services. A significant portion of our capital expenditure program, which will require total expenditures of approximately R\$4.8 billion between 2006 and 2010, is designed to achieve this goal. We also regularly explore the possibility of obtaining additional water and sewage concessions in municipalities in the State of São Paulo in which we currently have no operations or to which we currently supply water solely on a wholesale basis, representing a total population of approximately 15.6 million. We evaluate possible expansion opportunities in terms of proximity to our existing service areas to maximize return on investment and improve our financial performance. We also intend to study, and take advantage of,

opportunities in other Brazilian states and in other countries to expand our services and increase our market share.

*Set our tariffs to cover our costs of operations and to provide a return on investment.* We intend to continue periodically adjusting our tariffs for water and sewage services using a transparent formula which covers our operating costs and other expenses, accounts for inflation, and provides for return on investment. We generally adjust our tariffs once a year, usually in the month of August, for a period of at least 12 months. We increased our tariffs by 9.0% on August 31, 2005 and by 6.71% on August 31, 2006. To ensure proper adjustment of our tariffs and higher return on investment, we intend to restructure our tariff structure to apply a formula which takes into account economic efficiency, future costs of operations and payment capacity of low-income families. We have also prepared a marketing strategy for the segmentation of our clients and of the market, taking into account specific characteristics and commercial potential, as well as proposals for improvement of our ability to segment our market and set appropriate tariffs for each segment.

*Continue to diversify sources of financing and reduce levels of indebtedness.* Our goal is to continue to secure funding from both public and private sources, in the Brazilian and international markets, and to restructure and refinance our indebtedness in order to reduce and diversify our debt exposure. In the six months ended June 30, 2006, we reduced our total indebtedness by 14.0%, to R\$6,420.5 million from R\$7,462.2 million during the same period in 2005 mainly through the repayment of the outstanding amounts relating to our US\$275.0 million notes due 2005. In the same period, there was also a significant reduction in our foreign currency indebtedness of 36.2%, to R\$1,471.9 million from R\$2,307.0 million during the same period in 2005.

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

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

#### **Planned Tender Offer for 12.0% Notes due 2008**

We have commenced a tender offer and related consent solicitation, or the Tender Offer, to acquire up to all of our 12.0% notes due 2008 in conjunction with this offering. As of the date of this offering circular, US\$225 million in principal amount of our 12.0% notes due 2008 are outstanding. The successful completion of this offering of notes is conditioned upon the Tender Offer.



We are a mixed capital company (*sociedade de economia mista*), a corporation organized under the laws of Brazil of which a majority of the voting capital must be owned by the State of São Paulo. Our principal executive offices are located at Rua Costa Carvalho, 300, 05429-900, São Paulo, SP, Brazil and our telephone number is (55-11) 3388-8000. Our website address is [www.sabesp.com.br](http://www.sabesp.com.br). The information on our website is not incorporated by reference in this offering circular and does not constitute a part of this offering circular.

## The Offering

*This summary highlights information presented in greater detail elsewhere in this offering circular. This summary is not complete and does not contain all the information you should consider before investing in the notes. You should carefully read this entire offering circular before investing in the notes, including “Risk Factors” and our financial statements.*

<b>Issuer</b> .....	Companhia de Saneamento Básico do Estado de São Paulo – SABESP.
<b>Notes offered</b> .....	US\$140,000,000 aggregate principal amount of 7.5% notes due 2016.
<b>Issue price</b> .....	99.136%
<b>Maturity date</b> .....	November 3, 2016
<b>Interest payment dates</b> .....	Payable semiannually in arrears on May 3 and November 3, commencing on May 3, 2007.
<b>Interest</b> .....	7.5% per annum.
<b>Ranking</b> .....	The notes will be our senior unsecured obligations, ranking <i>pari passu</i> with our other existing and future unsecured, unsubordinated indebtedness.
<b>Tax redemption</b> .....	We may redeem the notes, in whole but not in part, at 100% of their principal amount plus accrued interest and additional amounts, if any, upon the occurrence of specified events relating to Brazilian tax law. See “Description of the Notes—Redemption—Redemption at the Option of the Company for Changes in Brazilian Withholding Tax.”
<b>Additional amounts</b> .....	Payments of interest on the notes will be made after withholding and deduction for any Brazilian taxes as set forth under “Taxation.” We will pay such additional amounts as will result in receipt by the holders of notes of such amounts as would have been received by them had no such withholding or deduction for Brazilian taxes been required, subject to certain exceptions set forth under “Description of the Notes—Additional Amounts.”
<b>Covenants</b> .....	The indenture will contain covenants restricting our ability to: <ul style="list-style-type: none"> <li>• create liens;</li> <li>• incur additional indebtedness;</li> </ul>

- engage in sale-leaseback transactions;
- enter into certain transactions with affiliates; and
- engage in a merger, sale or consolidation transaction.

However, these restrictions are subject to a number of important exceptions. See “Description of the Notes—Certain Covenants.”

<b>Events of default .....</b>	The indenture will set forth the events of default applicable to the notes, including an event of default triggered by acceleration of other indebtedness in an amount of US\$25 million or more.
<b>Use of proceeds .....</b>	We will use the gross proceeds from the issuance of the notes, approximately US\$ 138.8 million, towards the repurchase of the 12.0% notes due 2008 submitted pursuant to the Tender Offer. In addition, we will apply certain available cash to pay accrued interest and expenses related to this offering and the Tender Offer.
<b>Form and denomination; settlement .....</b>	<p>The notes will be issued in the form of global notes in fully registered form without interest coupons, as described under “Description of the Notes.” The global notes will be exchangeable or transferable, as the case may be, for definitive certificated notes in fully registered form without interest coupons only in limited circumstances. The notes will be issued in registered form in denominations of US\$100,000 and integral multiples of US\$1,000 in excess thereof. See “Description of the Notes—Book Entry; Delivery and Form.”</p> <p>The notes will be delivered in book-entry form through the facilities of DTC for the accounts of its participants, including Euroclear Bank S.A./N.V., as operator of the Euroclear, and Clearstream Luxembourg, and will trade in DTC’s Same-Day Funds Settlement System.</p>
<b>Transfer restrictions .....</b>	The notes have not been registered under the Securities Act and are subject to limitations on transfers, as described under the caption “Transfer Restrictions.”
<b>Listing of the notes .....</b>	Application has been made to list the notes on the Official List of the Luxembourg Stock Exchange and to trade them on the Euro MTF Market of that exchange. We cannot assure you, however, that

this application will be accepted.

If the listing of the notes on the Luxembourg Stock Exchange would, in the future, require us to publish financial information either more regularly than we otherwise would be required to, or according to accounting principles which are materially different from the accounting principles which we would otherwise use to prepare our published financial information, we may seek an alternative admission to listing, trading and/or quotation for the notes by another listing authority, stock exchange and/or quotation system.

We expect that the notes will be designated as eligible for trading in the PORTAL<sup>SM</sup> Market.

<b>Governing law .....</b>	The indenture and the notes will be governed by, and construed in accordance with, the laws of the State of New York.
<b>Trustee, registrar and transfer agent .....</b>	Deutsche Bank Trust Company Americas
<b>Principal paying agent .....</b>	Deutsche Bank Trust Company Americas
<b>Luxembourg paying agent and transfer agent....</b>	Deutsche Bank Trust Luxembourg
<b>Luxembourg Listing Agent .....</b>	Deutsche Bank Trust Luxembourg

## Summary Financial and Operating Information

The following summary of financial and operating information should be read in conjunction with our audited annual financial statements as of and for the years ended December 31, 2003, 2004 and 2005 and our unaudited interim financial statements as of and for the six months ended June 30, 2005 and 2006, included elsewhere in this offering circular and information under the captions "Presentation of Financial and Other Information," "Exchange Rates," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Selected Financial and Operating Data." Our financial statements have been prepared in accordance with the Brazilian Corporate Law Method, which differs in significant respects from U.S. GAAP. Note 22 to our audited annual financial statements, included elsewhere in this offering circular, provides for a description of the significant differences between the Brazilian Corporate Law Method and U.S. GAAP as they relate to our annual financial statements and a reconciliation from the Brazilian Corporate Law Method to U.S. GAAP of our net income and shareholders' equity for the periods presented therein. Solely for the convenience of the reader, *real* amounts as of and for the year ended December 31, 2005 and as of and for the six months ended June 30, 2006 have been translated into U.S. dollars at the commercial selling rate as of June 30, 2006 of R\$2.1643 per US\$1.00.

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

	As of and for the year ended December 31,				As of and for the six months ended June 30,		
	2003	2004	2005		2005	2006	
	(in millions, except per share and per ADS data)						
	R\$	R\$	R\$	US\$	R\$	R\$	US\$
<b>Brazilian Corporate Law Method</b>							
<b>Statement of Operations:</b>							
Net revenue from sales and services .....	4,130.8	4,397.1	4,953.4	2,288.7	2,390.0	2,658.0	1,228.1
Cost of sales and services .....	(2,067.1)	(2,253.4)	(2,390.4)	(1,104.5)	(1,152.1)	(1,266.1)	(585.0)
Gross profit .....	2,063.6	2,143.7	2,563.0	1,184.2	1,237.9	1,391.9	643.1
Selling expenses .....	(297.5)	(502.5)	(537.9)	(248.5)	(244.6)	(267.9)	(123.8)
Administrative expenses .....	(254.1)	(313.6)	(335.5)	(155.0)	(168.9)	(135.3)	(62.5)
Financial income (expenses), net .....	(346.5)	(503.7)	(447.0)	(206.6)	(98.7)	(238.2)	(110.1)
Income from operations <sup>(1)</sup> .....	1,165.5	823.9	1,242.6	574.1	725.7	750.5	346.7
Non-operating income (expenses) .....	(54.5)	(33.9)	(25.4)	(11.7)	0.9	0.1	—
Income before taxes on income .....	1,111.1	790.0	1,217.2	562.4	726.6	750.6	346.7
Income tax and social contribution tax .....	(242.6)	(241.9)	(316.5)	(146.3)	(221.9)	(229.5)	(106.0)
Extraordinary item, net of income and social contribution taxes <sup>(2)</sup> .....	(35.1)	(35.1)	(35.1)	(16.2)	(17.6)	(17.6)	(8.1)
Net income .....	833.3	513.0	865.6	399.9	487.1	503.5	232.6
Net income per 1,000 common shares .....	29.26	18.01	30.39	14.04	17.10	17.68	8.17
Net income per ADS .....	7.32	4.50	7.60	3.51	4.28	4.42	2.04
Dividends and interest on shareholders' equity per 1,000 common shares .....	17.70	5.37	12.23	5.65	3.69	4.55	2.10
Number of common shares outstanding at year end (in thousands of shares) .....	28,479,578	28,479,578	28,479,578	28,479,578	28,479,578	28,479,578	28,479,578
<b>Balance Sheet:</b>							
Cash and cash equivalents .....	281.0	105.6	280.1	129.4	877.9	336.0	155.2
Customer accounts receivable, net .....	1,056.2	1,227.9	1,458.6	673.9	1,394.1	1,511.9	698.6
Reimbursement for pension benefits paid .....	491.0	576.3	672.7	310.8	619.8	719.0	332.2
Short and long-term receivables from shareholders, net <sup>(3)</sup> .....	164.2	245.6	294.2	135.9	312.6	330.2	152.6
Property, plant and equipment, net .....	13,376.6	13,523.5	13,613.6	6,290.1	13,472.2	13,666.4	6,314.5

	As of and for the year ended December 31,				As of and for the six months ended June 30,		
	2003	2004	2005		2005	2006	
	(in millions, except per share and per ADS data)						
	R\$	R\$	R\$	US\$	R\$	R\$	US\$
Concession assets acquired, net ...	686.6	517.4	502.5	232.2	509.0	499.3	230.7
Total assets .....	16,590.1	16,783.8	17,435.2	8,055.8	17,787.1	17,716.2	8,185.6
Total short-term loans and financing .....	997.0	1,496.8	759.0	350.7	1,420.2	642.4	296.9
Total long-term loans and financing .....	6,267.3	5,553.8	5,905.2	2,728.5	6,042.0	5,778.1	2,669.7
Total liabilities .....	9,013.2	8,832.2	8,952.6	4,136.5	9,455.8	8,837.8	4,083.4
Shareholders' equity .....	7,576.9	7,951.6	8,482.5	3,919.3	8,341.2	8,878.4	4,102.2
<b>Other Financial Information:</b>							
Cash provided by operating activities <sup>(4)</sup> .....	1,655.3	1,436.1	1,754.8	810.8	723.5	1,061.8	490.6
Cash used in investing activities <sup>(4)</sup> .....	(650.8)	(670.5)	(660.5)	(305.2)	(240.7)	(329.4)	(152.2)
Cash used in financing activities <sup>(4)</sup> .....	(1,138.2)	(941.1)	(919.7)	(424.9)	289.6	(676.6)	(312.6)
Adjusted EBITDA <sup>(5)</sup> .....	2,076.5	1,926.5	2,285.6	1,056.1	1,119.4	1,286.5	594.4
Capital expenditures <sup>(4)</sup> .....	641.3	670.3	660.4	305.1	240.7	331.5	153.2
Depreciation and amortization .....	564.5	598.9	596.0	275.4	295.0	297.8	137.6

- (1) Includes financial expenses, net.
- (2) The extraordinary item charged to income in the years ended December 31, 2003, 2004 and 2005 as well as in the six months ended June 30, 2005 and 2006 relates to the amortization (over a five-year period) of the actuarial liability recorded on December 31, 2001 upon first-time recognition of the defined benefits pension plan. The presentation of the charge as an extraordinary item is consistent with the CVM regulations and the Brazilian Corporate Law Method. For purposes of U.S. GAAP, the pension expense has been treated as a payroll expense from the first year presented.
- (3) Short- and long-term receivables from shareholders, net represent amounts due from the State for water and sewage services. See Note 6 to our audited annual financial statements and Note 5 to our unaudited interim financial statements, included elsewhere in this offering circular.
- (4) Based upon the statements of cash flows included in Note 24 to our audited annual financial statements for the years ended December 31, 2003, 2004 and 2005 and included in Note 19 to our unaudited interim financial statements for the six months ended June 30, 2005 and 2006, included elsewhere in this offering circular.
- (5) The inclusion of Adjusted EBITDA information aims at presenting a measure for our economic operating performance. Our Adjusted EBITDA means net income before financial expenses, net, income tax and social contribution tax (federal taxes on income), depreciation and amortization, non-operating income (expenses) and extraordinary item, net of income tax and social contribution. Adjusted EBITDA is not a measure of financial performance recognized under the Brazilian Corporate Law Method, and should not be considered individually or as an alternative for net income, as a measure of operating performance, or alternative for operating cash flows, or as a measure of liquidity. Our definition of Adjusted EBITDA or EBITDA may not be comparable with the definition of Adjusted EBITDA or EBITDA used by other companies. In our operations, we relate our Adjusted EBITDA to our operating cash flows. We do not include in the calculation of Adjusted EBITDA expenses with interest, taxes, depreciation and amortization, therefore, our Adjusted EBITDA works as a general indicator of economic performance and it is not affected by debt restructurings, interest rate fluctuations, changes in tax burden or in depreciation and amortization levels. Consequently, we believe that Adjusted EBITDA works as an adequate tool to regularly compare our operating performance. Additionally, Adjusted EBITDA is used in covenants related to some of our financial commitments. We believe that Adjusted EBITDA allows a better understanding not only of our financial performance but also of our capacity to satisfy our liabilities and to raise funds for our capital expenditures and working capital. Adjusted EBITDA, however, has limitations that prevent it from being used as a measure of our profitability because it does not take into consideration other costs resulting from our business or certain other costs, which could significantly affect our profits, such as financial expenses, taxes, depreciation, capital expenses and other related charges. Adjusted EBITDA calculation presented herein is in accordance with the rules issued by the Brazilian regulatory authorities, which set forth the Brazilian Corporate Law Method. The table below sets forth, for the periods indicated, the reconciliation between our net income with Adjusted EBITDA:

	As of and for the year ended December 31,			
	2003	2004	2005	
	(in millions, except per share and per ADS data)			
	R\$	R\$	R\$	US\$
<b>U.S. GAAP</b>				
<b>Statement of Operations:</b>				
Net revenue from sales and services .....	4,130.8	4,397.1	4,953.4	2,288.7
Gross profit .....	1,853.3	1,953.1	2,369.1	1,094.6
Selling expenses .....	(323.4)	(521.5)	(555.5)	(256.7)
Administrative expenses .....	(276.3)	(324.1)	(336.1)	(155.3)
Income from operations <sup>(6)</sup> .....	1,136.5	1,073.0	1,470.2	679.3
Financial income (expenses), net .....	(329.4)	(479.2)	(401.9)	(185.7)
Net income .....	642.6	417.5	791.2	365.6
Net income per 1,000 common shares- basic and diluted .....	22.56	14.66	27.78	12.84

	As of and for the year ended December 31,			
	2003	2004	2005	
	(in millions, except per share and per ADS data)			
	R\$	R\$	R\$	US\$
<b>U.S. GAAP</b>				
Net income per ADS-basic and diluted .....	5.64	3.67	6.95	3.21
Weighted average number of common shares outstanding (in thousands of shares) .....	28,479,578	28,479,578	28,479,578	28,479,578

**Balance Sheet:**

Property, plant and equipment, net .....	15,268.9	15,347.2	15,393.9	7,112.6
Concession assets acquired, net .....	686.6	517.4	502.5	232.2
Total assets .....	17,630.4	17,704.5	18,213.9	8,415.6
Short-term loan financing .....	997.0	1,496.8	759.0	350.7
Long-term loan financing .....	6,267.3	5,553.8	5,905.2	2,728.5
Total liabilities .....	11,604.3	11,339.7	11,392.5	5,263.8
Shareholders' equity .....	6,085.6	6,364.8	6,821.4	3,151.8

	As of and for the year ended December 31,			As of and for the six months ended June 30,	
	2003	2004	2005	2005	2006
<b>Operating Data (at period end):</b>					
Number of water connections (in thousands) .....	6,044	6,358	6,489	6,431	6,538
Number of sewage connections (in thousands) .....	4,462	4,747	4,878	4,817	4,938
Percentage of population with water connections (%) .....	100	100	100	100	100
Percentage of population with sewage connections (%) .....	78	78	78	78	78
Volume of water billed during period (in millions of cubic meters) .....	1,765	1,692	1,759	873.2	901.0
Water loss percentage during period (average)(%) <sup>(7)</sup> .....	33.0	34.0	32.4	33.4	32.0
Water loss per connection (average) <sup>(8)</sup> .....	563	547	520	537	513
Number of employees .....	18,546	17,735	17,448	17,577	17,289

	For the year ended December 31,				For the six months ended June 30,		
	2003	2004	2005		2005	2006	
			(in millions)				
	R\$	R\$	R\$	US\$	R\$	R\$	US\$
<b>Brazilian Corporate Law Method:</b>							
Net income .....	833.3	513.0	865.6	399.9	487.1	503.5	232.6
<b>Add:</b>							
Financial expenses (income), net .....	346.5	503.7	447.0	206.6	98.7	238.2	110.1
Income and social contribution tax .....	242.6	241.9	316.5	146.3	221.9	229.5	106.0
Depreciation and amortization .....	564.5	598.9	596.0	275.4	295.0	297.8	137.6
Non-operating income (expenses), net .....	54.5	33.9	25.4	11.7	(0.9)	(0.1)	
Extraordinary item, net of income and social contribution taxes .....	35.1	35.1	35.1	16.2	17.6	17.6	8.1
Adjusted EBITDA .....	2,076.5	1,926.5	2,285.6	1,056.1	1,119.4	1,286.5	594.4

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

## RISK FACTORS

*An investment in the notes involves a high degree of risk. You should carefully consider the risks described below before making an investment decision. Our business, financial condition and results of operations could be materially and adversely affected by any of these risks. The trading price of the notes could decline due to any of these risks or other factors, and you may lose all or part of your investment. The risks described below are those that we currently believe may materially affect us.*

### 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 the notes.***

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 the notes, may be adversely affected by changes in public policy at federal, state and municipal levels with respect to public tariffs and exchange controls, as well as other factors, such as:

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

Uncertainty over whether the Brazilian government will implement changes in policies or regulations affecting these or other factors may contribute to economic uncertainty in Brazil and to heightened volatility in the Brazilian securities markets and securities issued by Brazilian issuers. These uncertainties may have a material adverse effect on us and may also adversely affect the market price of the notes.

Additionally, in recent months, members of the Brazilian government's executive and legislative branches, as well as other related persons, have been investigated for alleged illicit or unethical behavior. It is impossible to foresee the outcome of these investigations and whether it could adversely affect Brazil's economy. The resulting uncertainty, and any further allegations of unethical or illegal political conduct, may adversely affect the market price of the notes.

The presidential elections in Brazil held on October 1, 2006 resulted in the need for a further run-off election. This second presidential run-off election in Brazil will take place in late October 2006. The President of Brazil has considerable power in determining governmental policies and actions that relate to the Brazilian economy and, consequently, affect the operations and financial performance of businesses,



such as us. The run up to the presidential election may result in changes in existing governmental policies, and the post-election administration – even if President Luiz Inácio Lula da Silva is re-elected – may seek to implement new policies. We cannot predict what policies will be adopted by the Brazilian government and whether these policies will negatively affect the economy or our business or financial performance.

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

Brazil has in the past experienced extremely high rates of inflation. Inflation and the Brazilian government's measures to fight inflation have had significant negative effects on the Brazilian economy, contributing to economic uncertainty and heightened volatility in the Brazilian securities markets. The Brazilian government's measures to control inflation have often included maintaining a tight monetary policy with high interest rates, thereby restricting the availability of credit and reducing economic growth. The official interest rate in Brazil, the SELIC, which is the interest rate of the Special Clearing and Settlement System (*Sistema Especial de Liquidação e Custódia*), at the end of 2001, 2002, 2003, 2004 and 2005 was 19.0%, 25.0%, 16.5%, 17.75% and 18.75%, respectively. On June 30, 2006, the official interest rate in Brazil was 15.25% and on August 30, 2006, it was reduced to 14.25%.

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 20.1% in 1999 to 1.2% in 2005. However, Brazilian governmental actions, including interest rate decreases, intervention in the foreign exchange market and actions to adjust or fix the value of the *real*, may trigger increases in inflation. If Brazil again experiences high inflation, our costs and expenses may rise, we may be unable to increase our tariffs to counter the effects of inflation, and our overall financial performance may be adversely affected. In addition, a substantial increase in inflation may weaken investor's confidence in Brazil, causing the decline in the market value of the notes.

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 also could have a material adverse effect on us and may also adversely affect the market value of the notes.

***Exchange rate instability may adversely affect us and the market price of the notes.***

The Brazilian currency has experienced frequent and substantial devaluations in relation to the U.S. dollar and other foreign currencies during the last decades. Throughout this period, the Brazilian government has implemented various economic plans and utilized a number of exchange rate policies, including sudden devaluations, periodic mini-devaluations during which the frequency of adjustments has ranged from daily to monthly, floating exchange rate systems, exchange controls and dual exchange rate markets. From time to time, there have been significant fluctuations in the exchange rate between the Brazilian *real* and the U.S. dollar and other currencies. For example, the *real* depreciated against the U.S. dollar by 9.3% in 2000, 18.7% in 2001 and 34.3% in 2002. Although the *real* appreciated 22.3%, 8.8% and 13.4% against the U.S. dollar in 2003, 2004 and 2005, respectively, no assurance can be given that the *real* will not depreciate against the U.S. dollar again. On June 30, 2006, the exchange rate was R\$2.1643 per US\$1.00 and, on October 20, 2006, it was R\$2.1457 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 substantial foreign currency-denominated indebtedness, any significant devaluation of the *real* during a financial period will increase our financial expenses as a result of foreign exchange losses that we must record. We had total foreign currency-denominated indebtedness of R\$1,576.0 million as of December 31, 2005 and of R\$1,471.9 million as of June 30, 2006, and we anticipate that we may incur substantial amounts of foreign currency-denominated indebtedness in the future. Our overall results of operations were positively affected by the 13.4% appreciation of the *real* against the U.S. dollar in 2005, which amounted to R\$312.1 million. We do not currently have any hedging instruments in place

to protect us against a devaluation of the *real* in relation to any foreign currency. A devaluation of the *real* may adversely affect us and the market price of the notes.

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

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

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

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

The State of São Paulo, through its ownership of our common shares, has the ability to determine our operating policies and strategy, to authorize tariff adjustments, to control the election of a majority of the members of our board of directors and to appoint our senior management. As of June 30, 2006, the State owned 50.3% of our outstanding common shares.

The State has from time to time in the past, and may in the future, through its control of our board of directors, set our tariffs and direct that we engage in certain business activities and make certain expenditures that promote political, economic or social goals but that do not necessarily also enhance our business and results of operations. See "Management's Discussion and Analysis of Financial Condition and Results of Operations—Factors Affecting Our Results of Operations."

Newly elected Governors of the State typically make significant changes in our board of directors and senior management and, historically, the chairman of our board of directors has been the Secretary of the Energy, Water Resources and Sanitation Secretariat of the State (*Secretaria Estadual de Energia, Recursos Hídricos e Saneamento*). In October 2006, there will be elections for the State government and changes in government or government policy could lead to changes in our board of directors and senior management.

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

Historically, the State and some State entities have had substantial overdue accounts payable to us relating to (1) the provision of water and sewage services and (2) State-mandated special retirement and pension payments that we make to some of our former employees for which the State is required to reimburse us. As of June 30, 2006, the amounts owed to us by the State for the provision of water and sewage services totaled R\$330.2 million and, with respect to payment of pensions on behalf of the State, the State owed us R\$719.0 million. We expect amounts owed to us by the State for water and sewage services and reimbursements for pensions paid to increase in the future.

We have entered into agreements with the State to settle these overdue amounts payable to us. For a detailed discussion of these agreements, see "Related Party Transactions." Pursuant to these agreements, the amounts due with respect to water and sewage services may be settled through the application of dividends payable by us to the State. Since the State entered into these agreements in 1997, we have applied the dividends payable to the State to the repayment of amounts owed to us. However, the agreements do not require application of all dividends payable to the State to the

repayment of amounts owed to us. Furthermore, there can be no assurance as to whether and to what extent we will continue to record sufficient profits to pay dividends.

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

We cannot assure you as to when or if the State will pay overdue amounts owed to us. Due to the State’s history of not making timely payments to us in respect of services and of not reimbursing us in a timely manner for the payments of pensions on behalf of the State, we cannot assure you that the amount of accounts receivable owed to us by the State and some State entities will not significantly increase in the future. In addition, we have not established any provisions for any amounts due to us by the State, as we do not expect to incur any significant losses relating to these amounts. If the State does not pay the amount it owes to us, we will be adversely affected.

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

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

## **Risks Relating to Our Business**

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

At the present time, there is no specific regulation related to sanitation services in Brazil. The Brazilian Federal Congress has, from time to time, discussed proposals for regulation to establish directives for basic sanitation services. Both the House of Representatives and the Senate in Brazil have agreed upon the creation of a joint committee (*comissão mista*) that will be responsible for the organization and systemization of the proposed regulation for water and sewage services in Brazil. Several bills are under debate at the Brazilian Federal Congress. As of the date of this offering circular, the joint committee has agreed on the proposed federal regulation No. 219, which has already been approved by the Brazilian Senate and is under discussion at the Brazilian House of Representatives. There can be no assurance that this regulation will be turned into a law or approved by the Brazilian House of Representatives. For more information, see “Government Regulation—Pending Legislation.”

Any proposed regulation, when and if approved, could establish a new municipal regulatory authority for our industry that may, in part, preempt the existing State regulatory authorities under which we operate in all metropolitan regions. In addition, a new regulation could modify the way we charge commercial and industrial customers for our water and sewage services, as well as our capital expenditure program. Any of these changes and any other unforeseen changes could have a material

adverse effect on our revenue by causing us to lose concessions we currently hold, or on our operating margins by limiting our ability to pass our costs on to our customers.

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

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

- we may become subject to substantial water-related and sewage-related charges imposed by governmental water agencies of the State and of the Federal Government related to the abstraction of water from, or dumping of sewage into, water resources controlled by these agencies, which we may not be able to pass on to our customers. See “Government Regulation—Water Usage;”
- in some cases, we are required to continue providing services to certain municipalities to which we provide water on a wholesale basis that have overdue amounts owed to us and are not paying us on a regular basis and we cannot assure you as to when or whether these municipalities will pay us;
- we may be unable to increase our tariffs in line with increases in inflation and operating expenses, including taxes, or to increase them in a timely manner, due to political and legal constraints that may hinder us from passing on to our customers increases in our cost structure. Also, we are highly dependent upon our ability to timely set and collect adequate tariffs for our water and sewage services to fund our capital expenditure program and financing activities and to meet our debt service requirements. For a detailed discussion of the effect of tariff increases, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Factors Affecting Our Results of Operations—Effects of Tariff Increases;”
- we are exposed to droughts that may adversely affect our water supply systems, resulting in a decrease in the volume of water distributed and billed as well as in the revenue from water supply; and
- we are dependent upon energy to conduct our operations and shortages or rationing of energy may prevent us from providing water and sewage services and may also cause material damages to our water and sewage systems when we resume operations. Also, we may not be able to pass on to customers significant increases in energy tariffs.

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

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

We do not hold formal concessions in the City of São Paulo, which, on June 30, 2006, accounted for 56.6% of our sales and services rendered, and in 40 other municipalities in the State of São Paulo. Because we do not hold concessions or formal contract rights to provide services in these municipalities, we may not be able to effectively enforce our right to continue to provide services or to be paid for the services we provide. In the future, our rights in respect of the City of São Paulo and these other municipalities could be modified or adversely affected by Brazilian federal, state or local governmental actions or other factors.

From time to time, mayors of the City of São Paulo have initiated or proposed discussions with the State regarding entering into a formal concession contract with us to provide water and sewage

services in the City of São Paulo. For a detailed discussion of these initiatives, see “Government Regulation—Concessions Laws.” To date, there has been no change to the conditions under which we provide services to the City of São Paulo. We cannot assure you when or if there will be changes to these conditions and we cannot anticipate their effects for the provision of our services in the City of São Paulo and in these other municipalities.

***Our concessions may not be renewed and we may face difficulties in renewing our concessions or obtaining new concessions due to competition.***

We provide water and sewage services in 325 municipalities in the State of São Paulo pursuant to concessions granted by the municipalities. Substantially all of these concessions have 30-year terms. As of June 30, 2006, 48 of our concessions have expired, all of which are under negotiation. From July 2006 through December 2006, 78 concessions will expire. During 2007, 28 concessions will expire, and from 2008 through 2010, 96 of our concessions will expire. The rest of our concessions will expire between 2011 and 2034.

If certain municipalities choose not to renew their concessions, we could be adversely affected. Even if they choose to renew these concessions, we cannot assure you that we will obtain the same terms under which we currently provide services to these municipalities. See “Business—Our Operations” and “Government Regulation—Public Consortia Law.”

We may also face difficulties in renewing and obtaining concessions because of increased competition. If we are required to participate in public bidding processes in order to renew our existing concessions or to obtain new ones, our failure to outbid our competitors for our existing concessions, or our inability to renew our concessions or obtain new concessions at favorable terms, may adversely affect us.

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

The concessions we hold are subject to early termination by the municipalities under certain circumstances. Municipalities may terminate our concessions if we fail to comply with our obligations under the relevant concession contract and applicable law, or if the municipality determines, based on authorization by municipal law, through an expropriation proceeding, that terminating our concession prior to the contractual expiration date is in the public interest. If any municipality terminates our concession, we are entitled to be indemnified for the unamortized portion of our investments, but the compensation may not be sufficient for us to recover the full value of our investments. Further, under the terms of the Constitution of the State of São Paulo, we may receive the compensation over a term of 25 years. The early termination by municipalities of any of our concession contracts, or our inability to receive adequate compensation for the investments we made, or if compensation is paid over a term of 25 years, would have a material adverse effect on us.

In 1997, the municipality of Santos enacted a law expropriating our water and sewage systems in Santos. In 1995, the municipality of Diadema terminated the concession agreement that had been entered into with us prior to the expiration of the agreement. There are pending legal proceedings discussing both the expropriation carried out by the municipality of Santos and early termination by the municipality of Diadema. We continue to provide water and sewage services to Santos and Diadema. For further information on these lawsuits, see “Business—Legal Proceedings.”

We cannot assure you that other municipalities will not seek to terminate their concessions before the contractual expiration date. Exercise of concession termination rights by substantial numbers of municipalities could have a material adverse effect on us.

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

Our capital expenditure program requires substantial liquidity and capital resources of approximately R\$4.8 billion in the period from 2006 through 2010, including approximately R\$960.0 million in 2006 and R\$960.0 million in 2007.

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

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

We are also subject to financial covenants limiting our ability to incur additional indebtedness, whether denominated in *reais* or foreign currency. Under these covenants, we would have been able to borrow up to an additional R\$2,260.1 million as of June 30, 2006. These contractual limitations may prevent us from completing our capital expenditure program, which could have a material adverse effect on us.

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

Our facilities are subject to extensive Brazilian federal, state and local laws and regulations relating to the protection of human health and the environment. These laws and regulations limit or prohibit emissions or spills of effluents and toxic substances, such as untreated sewage, produced in connection with our operations. Current and past disposal and emissions practices may result in the need for us to clean up or retrofit our facilities at substantial costs and could result in substantial liabilities.

We could be subject to civil public actions and criminal, administrative and other civil proceedings for non-compliance with environmental laws and regulations, which could expose us to civil penalties and criminal sanctions, such as fines, closure orders and significant indemnification obligations. Since environmental laws and their enforcement by Brazilian authorities are becoming more stringent, our capital expenditures and expenses for environmental compliance may increase substantially. Expenditures required for compliance with environmental laws and regulations may result in reductions in other strategic investments that we have planned, which could negatively affect us.

We are a party to several civil public actions related to environmental matters, with regard to which we are unable to calculate our estimated amount of potential liability, especially fines, and have not provisioned any amounts. In addition, due to more stringent enforcement of environmental laws by Brazilian courts, we may be required to pay substantial fines and indemnifications in amounts that may vary widely from those currently anticipated. Any unfavorable judgment in relation to these proceedings or any material unforeseen environmental liabilities may have a material adverse effect on us.

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

We are a party to a number of legal proceedings involving significant monetary claims. These legal proceedings include, among others, tax, labor, condemnation and other proceedings. A substantial monetary judgment against us in one or more of these legal proceedings may have a material adverse effect on us. Based on advice from our lawyers, we have provisioned a total aggregate amount of R\$628.3 million as of June 30, 2006 to cover probable losses related to legal proceedings. However, this provision does not cover all legal proceedings involving monetary claims filed against us and it may be insufficient to cover our liabilities related to these claims. Any unfavorable judgment in relation to these proceedings may have an adverse effect on us. For more information, see “Business—Legal Proceedings.”

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

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

#### **Risks Relating to the Notes**

***Payments on the notes will be junior to our secured debt obligations and to some Brazilian statutory obligations, and a substantial portion of our assets may not be used to secure a judgment.***

The notes will constitute our senior unsecured obligations and will rank equal in right of payment with all of our other existing and future unsecured indebtedness. Although the holders of the notes will have a direct, but unsecured, claim on our assets and property, payment on the notes will be subordinated to our secured debt to the extent of the assets and property securing the secured debt. Holders of the notes may not be able to enforce a judgment against our assets because a substantial portion of our assets is used in the provision of essential public services and, under Brazilian law, would not be subject to attachment or any other legal process. Similarly, if we were declared bankrupt, a significant portion of our assets would not be available for liquidation.

In addition, under Brazilian bankruptcy law, our obligations under the notes are subordinated to certain statutory preferences, including claims for salaries, wages, secured obligations, social security, taxes and court fees and expenses. In the event of our liquidation, the statutory preferences will have preference over other claims, including claims by any holder of the notes.

As of June 30, 2006, we have R\$4,076.1 million of secured debt obligations.

***We cannot assure you that an active trading market for the notes will develop.***

The notes constitute a new issue of securities, for which there is no existing market. Although we have applied to list the notes on the Luxembourg Stock Exchange and trade on the Euro MTF, we cannot provide you with any assurances that the application will be accepted. Furthermore, no assurance can be provided regarding the future development of a market for the notes, the ability of holders of the notes to sell their notes, or the price at which the holders may be able to sell their notes. If such a market were to develop, the notes could trade at prices that may be higher or lower than the initial offering price depending on many factors, including prevailing interest rates, our results of operations and financial condition, prospects for other companies in our industry, political and economic developments in and affecting Brazil, risks associated with Brazilian issuers of these types of securities and the market for

similar securities. If an active market for the notes does not develop or is interrupted, the market price and liquidity of the notes may be adversely affected.

***Judgments of Brazilian courts enforcing the Company's obligations under the notes would be payable only in reais.***

If proceedings were brought in the courts of Brazil seeking to enforce obligations of the Company under the notes, the Company would not be required to discharge such obligations in a currency other than *reais*. Any judgment obtained against the Company in Brazilian courts in respect of any payment obligations under the notes will be expressed in *reais* equivalent to the U.S. dollar amount at the exchange rate published by the Central Bank of Brazil on the date on which such judgment is rendered. We cannot assure you that this exchange rate will afford you full compensation of the amount invested in the notes.



## **USE OF PROCEEDS**

We will use the gross proceeds from the issuance of the notes, approximately US\$138.8 million, towards the repurchase of our 12.0% notes due 2008 submitted pursuant to the Tender Offer. In addition, we will apply available cash to pay certain accrued interest and expenses related to this offering and the Tender Offer.

## CAPITALIZATION

The following table sets forth our financial debt and capitalization as of June 30, 2006, based on our unaudited interim financial statements prepared in accordance with the Brazilian Corporate Law Method, included elsewhere in this offering circular:

- on an actual basis;
- as adjusted to give effect to (i) the issuance and sale of the notes in this offering, (ii) the repurchase of US\$126.9 million in principal amount of our 12.0% notes due 2008, and (iii) the payment of US\$12.9 million in consideration pursuant to the Tender Offer, but excluding accrued interest on the tendered notes and expenses associated with the Tender Offer and this offering. See “Use of Proceeds.”

There has been no material change in our capitalization since June 30, 2006.

This table should be read in conjunction with our unaudited interim financial statements, including the notes thereto, included elsewhere in this offering circular.

	As of June 30, 2006			
	Actual (in millions of <i>reais</i> )	As adjusted <sup>(1)</sup>	Actual (in millions of US\$)	As adjusted <sup>(1)</sup>
Cash and Cash equivalents .....	336.0	332.4	155.2	153.6
<b>Short-term debt<sup>(2)</sup></b>				
<b>Debentures</b> .....	<b>95.0</b>	<b>95.0</b>	<b>43.9</b>	<b>43.9</b>
<b>Other real-denominated debt</b> .....	<b>325.7</b>	<b>325.7</b>	<b>150.5</b>	<b>150.5</b>
<b>Foreign currency-denominated debt</b> .....	<b>108.2</b>	<b>108.2</b>	<b>50.0</b>	<b>50.0</b>
<b>Interest</b> .....	<b>113.5</b>	<b>113.5</b>	<b>52.5</b>	<b>52.5</b>
Total short-term debt .....	642.4	642.4	296.9	296.9
<b>Long-term debt</b>				
<b>12% notes due 2008</b> .....	<b>487.0</b>	<b>212.3</b>	<b>225.0</b>	<b>98.1</b>
<b>Notes issued hereunder</b> .....	<b>-</b>	<b>303.0</b>	<b>-</b>	<b>140.0</b>
<b>Debentures</b> .....	<b>1,622.9</b>	<b>1,622.9</b>	<b>749.8</b>	<b>749.8</b>
<b>Other real-denominated debt</b> .....	<b>2,803.0</b>	<b>2,803.0</b>	<b>1,295.1</b>	<b>1,295.1</b>
<b>Other foreign currency-denominated debt</b> .....	<b>865.2</b>	<b>865.2</b>	<b>399.8</b>	<b>399.8</b>
Total long-term debt .....	5,778.1	5,806.4	2,669.7	2,682.8
<b>Shareholders' equity</b>				
<b>Capital stock</b> .....	<b>3,403.7</b>	<b>3,403.7</b>	<b>1,572.7</b>	<b>1,572.7</b>
<b>Capital reserves</b> .....	<b>100.7</b>	<b>100.7</b>	<b>46.5</b>	<b>46.5</b>
<b>Revaluation reserves</b> .....	<b>2,483.6</b>	<b>2,483.6</b>	<b>1,147.5</b>	<b>1,147.5</b>
<b>Income reserves</b> .....	<b>2,255.0</b>	<b>2,255.0</b>	<b>1,041.9</b>	<b>1,041.9</b>
<b>Legal reserves</b> .....	<b>215.3</b>	<b>215.3</b>	<b>99.5</b>	<b>99.5</b>
<b>Retained earnings</b> .....	<b>420.1</b>	<b>420.1</b>	<b>194.1</b>	<b>194.1</b>
Total shareholders' equity .....	8,878.4	8,878.4	4,102.2	4,102.2
<b>Total capitalization (long-term debt plus shareholders' equity) .....</b>	<b>14,656.5</b>	<b>14,684.8</b>	<b>6,771.9</b>	<b>6,685.0</b>

(1) Excludes (i) expenses associated with the Tender Offer and this offering and (ii) accrued interest payable in connection with the Tender Offer.

(2) Includes current portion of long-term debt (R\$642.4 million as of June 30, 2006).

## EXCHANGE RATES

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

- the commercial rate exchange market, dedicated principally to foreign trade transactions and transactions that generally required prior approval from Brazilian monetary authorities, such as the buying and selling of registered investments by foreign entities, the purchase or sale of shares, or the payment of dividends or interest with respect to shares; and
- the floating rate exchange market, generally used for specific transactions that required prior Central Bank approval and were not conducted through the commercial rate exchange market.

On March 4, 2005, the CMN enacted Resolution No. 3,265, pursuant to which the commercial rate exchange market and the floating rate exchange market were unified in a single exchange market, effective as of March 14, 2005. The new regulation allows, subject to certain procedures and specific regulatory provisions, the purchase and sale of foreign currency and the international transfer of *reais* by a foreign person or legal entity, without limitation as to amount. However, the underlying transaction must be valid. Foreign currencies may be purchased through financial institutions domiciled in Brazil and authorized to operate in the exchange market. The purchase and sale of foreign currency in Brazil has to be carried out through these institutions.

Additionally, on March 9, 2005, the Central Bank enacted Circular No. 3,280, containing the regulations for the foreign exchange market and for international investments, which governs the Brazilian foreign exchange market, Brazilian investments abroad and foreign investments in Brazil.

As of June 30, 2006, the commercial selling rate was R\$2.1643 to US\$1.00. The Central Bank has intervened occasionally to control unstable movements in the foreign exchange rate. However, the exchange market may continue to be volatile and the *real* may depreciate or appreciate substantially in value in relation to the U.S. dollar in the future. We cannot predict whether the Central Bank or the Brazilian government will continue to let the *real* float freely or will intervene in the exchange rate market through a currency band system or otherwise.

The following tables set forth the commercial selling rate, expressed in *reais* per U.S. dollar (R\$/US\$) for the periods indicated, as reported by the Central Bank.

	Period-end	Average for Period <sup>(1)</sup>	Low	High
		(R\$ per US\$1.00)		
<b>Year Ended December 31,</b>				
2001 .....	2.3204	2.3522	1.9353	2.8007
2002 .....	3.5333	2.9309	2.2709	3.9552
2003 .....	2.8892	3.0715	2.8219	3.6623
2004 .....	2.6544	2.9257	2.6544	3.2051
2005 .....	2.3407	2.4341	2.1633	2.7621

Source: Central Bank

(1) Represents the average of the month-end exchange rates during the relevant period.

	Period-end	Average for Period <sup>(1)</sup> (R\$ per US\$1.00)	Low	High
<b>Month</b>				
March 2006 .....	2.1724	2.1520	2.1067	2.2238
April 2006 .....	2.0892	2.1293	2.0892	2.1542
May 2006 .....	2.3005	2.1781	2.0586	2.3711
June 2006 .....	2.1643	2.2483	2.1643	2.3018
July 2006 .....	2.1762	2.1893	2.1646	2.2130
August 2006 .....	2.1388	2.1559	2.1329	2.1905
September 2006 .....	2.1742	2.1687	2.1282	2.2188
October 2006 (through October 20) .....	2.1457	2.1510	2.1331	2.1676

Source: Central Bank

(1) Average of the lowest and highest rates in the period.

Exchange rate fluctuations may adversely affect our financial condition and the market price of the notes. See “Risk Factors—Risks Relating to Brazil—Exchange rate instability may adversely affect us and the market price of the notes.”

## SELECTED FINANCIAL AND OPERATING DATA

The selected financial data as of and for the years ended December 31, 2003, 2004 and 2005 is derived from our annual financial statements audited by Deloitte Touche Tohmatsu Auditores Independentes, included elsewhere in this offering circular. The selected financial data as of and for the six months ended June 30, 2005 and 2006 is derived from our unaudited interim financial statements, included elsewhere in this offering circular.

Our financial statements have been prepared in accordance with the Brazilian Corporate Law Method, which differs in significant respects from U.S. GAAP. Note 22 to our audited annual financial statements, included elsewhere in this offering circular, provides for a description of the significant differences between the Brazilian Corporate Law Method and U.S. GAAP as they relate to our annual financial statements and a reconciliation from the Brazilian Corporate Law Method to U.S. GAAP of our net income and shareholders' equity for the periods presented therein.

You should read this selected financial data in conjunction with our financial statements and the related notes thereto, included elsewhere in this offering circular, and also with the information under the captions "Summary Financial and Operating Information," "Presentation of Financial and Other Information" and "Management's Discussion and Analysis of Financial Condition and Results of Operations." Solely for the convenience of the reader, *real* amounts as of and for the year ended December 31, 2005 and as of and for the six months ended June 30, 2006 have been translated into U.S. dollars at the commercial selling rate as of June 30, 2006 of R\$2.1643 per US\$1.00.

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

	As of and for the year ended December 31,				As of and for the six months ended June 30,		
	2003	2004	2005		2005	2006	
	(in millions, except per share and per ADS data)						
	R\$	R\$	R\$	US\$	R\$	R\$	US\$
Brazilian Corporate Law Method							
Statement of Operations:							
Net revenue from sales and services .....	4,130.8	4,397.1	4,953.4	2,288.7	2,390.0	2,658.0	1,228.1
Cost of sales and services .....	(2,067.1)	(2,253.4)	(2,390.4)	(1,104.5)	(1,152.1)	(1,266.1)	(585.0)
Gross profit .....	2,063.6	2,143.7	2,563.0	1,184.2	1,237.9	1,391.9	643.1
Selling expenses .....	(297.5)	(502.5)	(537.9)	(248.5)	(244.6)	(267.9)	(123.8)
Administrative expenses .....	(254.1)	(313.6)	(335.5)	(155.0)	(168.9)	(135.3)	(62.5)
Financial income (expenses), net .....	(346.5)	(503.7)	(447.0)	(206.6)	(98.7)	(238.2)	(110.1)
Income from operations <sup>(1)</sup> .....	1,165.5	823.9	1,242.6	574.1	725.7	750.5	346.7
Non-operating income (expenses).....	(54.5)	(33.9)	(25.4)	(11.7)	0.9	0.1	-
Income before taxes on income .....	1,111.1	790.0	1,217.2	562.4	726.6	750.6	346.7
Income tax and social contribution tax .....	(242.6)	(241.9)	(316.5)	(146.3)	(221.9)	(229.5)	(106.0)
Extraordinary item, net of income and social contribution taxes <sup>(2)</sup> .....	(35.1)	(35.1)	(35.1)	(16.2)	(17.6)	(17.6)	(8.1)
Net income .....	833.3	513.0	865.6	399.9	487.1	503.5	232.6
Net income per 1,000 common shares .....	29.26	18.01	30.39	14.04	17.10	17.68	8.17
Net income per ADS .....	7.32	4.50	7.60	3.51	4.28	4.42	2.04
Dividends and interest on shareholders' equity per 1,000 common shares .....	17.70	5.37	12.23	5.65	3.69	4.55	2.10
Number of common shares outstanding at year end (in thousands of shares) .....	28,479,578	28,479,578	28,479,578	28,479,578	28,479,578	28,479,578	28,479,578

**Balance Sheet:**

Cash and cash equivalents .....	281.0	1056	280.1	1294	877.9	3360	1552
Customer accounts receivable, net .....	1,056.2	1,227.9	1,458.6	673.9	1,394.1	1,511.9	698.6
Reimbursement for pension benefits paid .....	491.0	576.3	672.7	310.8	619.8	719.0	332.2
Short and long-term receivables from shareholders, net <sup>(3)</sup> .....	164.2	245.6	294.2	135.9	312.6	330.2	152.6

	As of and for the year ended December 31,				As of and for the six months ended June 30,		
	2003	2004	2005		2005	2006	
	(in millions, except per share and per ADS data)						
	R\$	R\$	R\$	US\$	R\$	R\$	US\$
Property, plant and equipment, net.....	13,376.6	13,523.5	13,613.6	6,290.1	13,472.2	13,666.4	6,314.5
Concession assets acquired, net.....	686.6	517.4	502.5	232.2	509.0	499.3	230.7
Total assets.....	16,590.1	16,783.8	17,435.2	8,055.8	17,787.1	17,716.2	8,185.6
Total short-term loans and financing .....	997.0	1,496.8	759.0	350.7	1,420.2	642.4	296.9
Total long-term loans and financing.....	6,267.3	5,553.8	5,905.2	2,728.5	6,042.0	5,778.1	2,669.7
Total liabilities.....	9,013.2	8,832.2	8,952.6	4,136.5	9,455.8	8,837.8	4,083.4
Shareholders' equity.....	7,576.9	7,951.6	8,482.5	3,919.3	8,341.2	8,878.4	4,102.2

**Other Financial Information:**

Cash provided by operating activities <sup>(4)</sup> .....	1,655.3	1,436.1	1,754.8	810.8	723.5	1,061.8	490.6
Cash used in investing activities <sup>(4)</sup> .....	(650.8)	(670.5)	(660.5)	(305.2)	(240.7)	(329.4)	(152.2)
Cash used in financing activities <sup>(4)</sup> .....	(1,138.2)	(941.1)	(919.7)	(424.9)	289.6	(676.6)	(312.6)
Adjusted EBITDA <sup>(5)</sup> .....	2,076.5	1,926.5	2,285.6	1,056.1	1,119.4	1,286.5	594.4
Capital expenditures <sup>(4)</sup> .....	641.3	670.3	660.4	305.1	240.7	331.5	153.2
Depreciation and amortization .....	564.5	598.9	596.0	275.4	295.0	297.8	137.6

**U.S. GAAP****Statement of Operations:**

	As of and for the year ended December 31,			
	2003	2004	2005	
	(in millions, except per share and per ADS data)			
	R\$	R\$	R\$	US\$
Net revenue from sales and services .....	4,130.8	4,397.1	4,953.4	2,288.7
Gross profit .....	1,853.3	1,953.1	2,369.1	1,094.6
Selling expenses .....	(323.4)	(521.5)	(555.5)	(256.7)
Administrative expenses .....	(276.3)	(324.1)	(336.1)	(155.3)
Income from operations <sup>(6)</sup> .....	1,136.5	1,073.0	1,470.2	679.3
Financial income (expenses), net .....	(329.4)	(479.2)	(401.9)	(185.7)
Net income .....	642.6	417.5	791.2	365.6

**Balance Sheet:**

Property, plant and equipment, net .....	15,268.9	15,347.2	15,393.9	7,112.6
Concession assets acquired, net .....	686.6	517.4	502.5	232.2
Total assets .....	17,630.4	17,704.5	18,213.9	8,415.6
Short-term loan financing .....	997.0	1,496.8	759.0	350.7
Long-term loan financing .....	6,267.3	5,553.8	5,905.2	2,728.5
Total liabilities .....	11,604.3	11,339.7	11,392.5	5,263.8
Shareholders' equity .....	6,085.6	6,364.8	6,821.4	3,151.8

	As of and for the year ended December 31,			As of and for the six months ended June 30,	
	2003	2004	2005	2005	2006
<b>Operating Data (at period end):</b>					
Number of water connections (in thousands) .....	6,044	6,358	6,489	6,431	6,538
Number of sewage connections (in thousands) .....	4,462	4,747	4,878	4,817	4,938
Percentage of population with water connections (%) .....	100	100	100	100	100
Percentage of population with sewer connections (%) .....	78	78	78	78	78
Volume of water billed during period (in millions of cubic meters) .....	1,765	1,692	1,759	873.2	901.0
Water loss percentage during period (average)(%) <sup>(7)</sup> .....	33.0	34.0	32.4	33.4	32.0
Water loss per connection (average) <sup>(8)</sup> .....	563	547	520	537	513
Number of employees .....	18,546	17,735	17,448	17,577	17,289

(1) Includes financial expenses, net.

- (2) The extraordinary item charged to income in the years ended December 31, 2003, 2004 and 2005 as well as in the six months ended June 30, 2005 and 2006 relates to the amortization (over a five-year period) of the actuarial liability recorded on December 31, 2001 upon first time recognition of the defined benefits pension plan. The presentation of the charge as an extraordinary item is consistent with the instructions of the CVM and the Brazilian Corporate Law Method. For purposes of U.S. GAAP, the pension expense has been treated as a payroll expense from the first year presented.
- (3) Short- and long-term receivables from shareholders, net represent amounts due from the State for water and sewage services. See Note 6 to our audited annual financial statements and Note 5 to our unaudited interim financial statements, included elsewhere in this offering circular.
- (4) Based upon the statements of cash flows included in Note 24 to our audited annual financial statements for the years ended December 31, 2003, 2004 and 2005 and included in Note 19 to our unaudited interim financial statements for the six months ended June 30, 2005 and 2006, included elsewhere in this offering circular.
- (5) The inclusion of Adjusted EBITDA information aims at presenting a measure for our economic operating performance. Our Adjusted EBITDA means net income before financial expenses, net, income tax and social contribution tax (federal taxes on income), depreciation and amortization, non-operating income (expenses) and extraordinary item, net of income tax and social contribution. Adjusted EBITDA is not a measure of financial performance recognized under Brazilian Corporate Law Method, and should not be considered individually or as an alternative for net income, as a measure of operating performance, or alternative for operating cash flows, or as a measure of liquidity. Our definition of Adjusted EBITDA or EBITDA may not be comparable with EBITDA as defined by other companies. In our operations, we relate our Adjusted EBITDA to our operating cash flows. We do not include in the calculation of Adjusted EBITDA expenses with interest, taxes, depreciation and amortization, therefore, our Adjusted EBITDA works as a general indicator of economic performance and it is not affected by debt restructurings, interest rate fluctuations, changes in tax burden or in depreciation and amortization levels. Consequently, we believe that Adjusted EBITDA works as an adequate tool to regularly compare our operating performance. Additionally, Adjusted EBITDA is used in covenants related to some of our financial commitments. We believe that Adjusted EBITDA allows a better understanding not only of our financial performance but also of our capacity to satisfy our liabilities and to raise funds for our capital expenditures and working capital. Adjusted EBITDA, however, has limitations that prevent it from being used as a measure of our profitability because it does not take into consideration other costs resulting from our business or certain other costs, which could significantly affect our profits, such as financial expenses, taxes, depreciation, capital expenses and other related charges. Adjusted EBITDA calculation presented herein is in accordance with the applicable rules issued by the Brazilian regulatory authorities, which set forth the Brazilian Corporate Law Method. The table below sets forth, for the periods indicated, the reconciliation between our net income with Adjusted EBITDA:

	For the year ended December 31,				For the six months ended June 30,		
	2003	2004	2005		2005	2006	
	R\$	R\$	R\$	(in millions) US\$	R\$	R\$	US\$
Brazilian Corporate Law Method:							
<b>Net income</b> .....	<b>833.3</b>	<b>513.0</b>	<b>865.6</b>	<b>399.9</b>	<b>487.1</b>	<b>503.5</b>	<b>232.6</b>
Add:							
Financial expenses (income), net.	346.5	503.7	447.0	206.6	98.7	238.2	110.1
Income and social contribution tax	242.6	241.9	316.5	146.3	221.9	229.5	106.0
Depreciation and amortization .....	564.5	598.9	596.0	275.4	295.0	297.8	137.6
Non-operating income (expenses), net	54.5	33.9	25.4	11.7	(0.9)	(0.1)	0
Extraordinary item, net of income and social contribution taxes .....	35.1	35.1	35.1	16.2	17.6	17.6	8.1
<b>Adjusted EBITDA</b> .....	<b>2,076.5</b>	<b>1,926.5</b>	<b>2,285.6</b>	<b>1,056.1</b>	<b>1,119.4</b>	<b>1,286.5</b>	<b>594.4</b>

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

## **MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following management's discussion and analysis of financial condition and results of operations should be read in conjunction with our audited annual financial statements as of and for the years ended December 31, 2003, 2004 and 2005 and our unaudited interim financial statements as of and for the six months ended June 30, 2005 and 2006, included elsewhere in this offering circular. This offering circular 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 under the caption "Risk Factors."*

*The financial statements in this offering circular have been prepared in accordance with the Brazilian Corporate Law Method, which differs in certain significant respects from U.S. GAAP. For additional information regarding some differences between the Brazilian Corporate Law Method and U.S. GAAP, see Note 22 to our audited annual financial statements, included elsewhere in this offering circular, which provides for a description of the significant differences between the Brazilian Corporate Law Method and U.S. GAAP as they relate to our annual financial statements and a reconciliation from the Brazilian Corporate Law Method to U.S. GAAP of our net income and shareholders' equity for the periods presented therein.*

*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.*

### **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 more than one-half of the other municipalities in the State of São Paulo. We also make wholesale sales of water 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 territory. With a population of approximately 19.4 million, the São Paulo Metropolitan Region (including the municipalities to which we provide water on a wholesale basis) accounted for approximately 75.9%, 74.5% and 75.5% of our gross revenue from sales and services in the years ended December 31, 2003, 2004 and 2005, respectively, and approximately 75.0% and 75.6% of our gross revenue from sales and services in the six months ended June 30, 2005 and 2006, respectively. Approximately 72.9% of the property, plant and equipment reflected on our balance sheet as of June 30, 2006 is 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 dedicated 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 meteorological conditions. In 2004, results of operations and financial condition were also significantly affected by an increase in bad debt expenses net of recoveries, increases in energy costs and increases in payments for outsourced services. In 2005, hydrological conditions improved and with the increase in efficiencies in our system, we were able to increase capacity and production. We were therefore able to increase revenues reflecting both operational improvement and greater demand arising from the end of our water usage reduction bonus program. In the six months ended June 30, 2006, our revenues increased due to expansion of demand for water supply and sewage services.



## Effects of Tariff Increases

Our results of operations and financial condition are highly dependent upon our ability to set and collect adequate tariffs for our water and sewage services. Although we generally have broad power to establish tariffs within our service territories, this power is, in practice, subject to limits due to, among other factors, the following:

- political considerations arising from our status as a State-controlled company;
- anti-inflation measures promulgated by the Federal Government from time to time; and
- federal laws that in some circumstances limit to 12.0% per year the return on the assets of some of our concessions.

Tariffs have often failed to keep up with inflation during periods of high inflation in the past. During the past few years, we generally have been able to raise tariffs in line with increases in cost of sales and services and operating expenses and to support our liquidity and capital resource requirements. In 2000, we did not raise tariffs due to the State policy for that year of not increasing tariffs for many public services. In June 2001, however, we increased our average tariff by approximately 13.1%, which was broadly in line with prevailing inflation rates in Brazil since mid-1999 as measured by the Extended Consumer Price Index (*Índice de Preços ao Consumidor Ampliado*), or IPCA index, and in August 2002, we increased our tariffs by 8.2%. In August 2003, we increased our tariffs for water and sewage services by 18.9%, in August 2004 we raised our tariffs for water and sewage services by 6.8%, and in August 2005 we raised our tariffs for water and sewage services by 9.0%. In August 2006, we increased our tariffs by 6.71%.

Since August 2003, our tariffs have been determined using a transparent formula which accounts for inflation, covers our operating costs and other expenses and provides for a return on investment. Tariffs have historically been adjusted once a year and for periods of at least 12 months. We are currently evaluating a potential revision of our tariff structure in order to improve our return on investment. We concluded a study on this topic in January 2006 and delivered it to our board of executive officers and board of directors. The resulting recommendations are currently being discussed for implementation. The following table sets forth, for the periods indicated, the percentage increase of our tariffs, as compared to three inflation indices:

	Year ended December 31,			Six months ended June 30,	
	2003	2004	2005	2005	2006
Increase in Average Tariff <sup>(1)(2)</sup> .....	18.9%	6.8%	9.0%	6.8% <sup>(3)</sup>	9.0% <sup>(4)</sup>
Inflation – <i>Índice de Preços ao Consumidor – IPC – FIPE</i> (Consumer Price Index) .....	8.2%	6.6%	4.5%	2.7%	0.1%
Inflation – <i>Índice de Preços ao Consumidor Ampliado – IPCA</i> (Extended Consumer Price Index) .....	9.3%	7.6%	5.7%	3.1%	1.5%
Inflation – <i>Índice Geral de Preços do Mercado IGP-M</i> (General Market Price Index) .....	8.7%	12.4%	1.2%	1.8%	1.4%

(1) Tariff increase effective August 29, 2003 for all categories except *residencial social* (residences of low-income families that live in sub-standard conditions, residences of persons unemployed for up to 12 months and collective living residences) and *favela* (shantytown).

(2) Tariff increases, if any, for each year took effect in August of such year.

(3) Tariff increase effective August 2004. On August 2005, there was a 9.0% tariff increase.

(4) Tariff increase effective August 2005. On August 2006, there was a 6.7% tariff increase.

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 currency exchange rate movements, 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.* In 2002, several negative economic factors adversely affected consumer confidence levels in Brazil. Prior to and subsequent to the presidential elections in November 2002, there was substantial uncertainty relating to Brazil's own political and economic future.

In 2003, the new administration largely continued the macroeconomic policies of the previous administration. The *real* appreciated by 22.3% against the U.S. dollar in 2003 to R\$2.8892 per US\$1.00 as of December 31, 2003. Inflation for 2003, as measured by the IGP-M index, was 8.7%. However, gross domestic product decreased by 0.2% during 2003 largely because the very high interest rates that prevailed at the beginning of 2003 also constrained economic growth. The Brazilian economy showed signs of improvement in the third and fourth quarters of 2003 that continued through 2004. During 2004 gross domestic product grew by 5.2%, inflation was 12.4%, as measured by the IGP-M index, and the *real* appreciated 8.8% against the U.S. dollar as the *real*/U.S. dollar exchange rate decreased to R\$2.6544 as of December 31, 2004.

The principal events affecting the Brazilian economy in 2005 were the corruption allegations against government officials and Brazilian congressmen of the current President's support base, and the Central Bank's efforts to meet the goal of 5.1% annual inflation, which resulted in the maintenance of high levels of interest rates. However, with the slow down of the economy and the consequent reduction of inflation rates, starting from November 2005, the Central Bank began a process of reducing the official interest rate in order to encourage economic growth. On December 31, 2005, the official interest rate was 18.75%.

In 2005, the *real* appreciated 13.4% as compared to the U.S. dollar and gross domestic product grew by 2.4%. Despite the appreciation, Brazil had a commercial surplus of US\$44.8 billion, its highest commercial surplus ever. The average unemployment rate has dropped from 11.5% to 9.8% in the main metropolitan regions of the country, in accordance with unemployment estimates published by the IBGE. The inflation rate, as measured by the IGP-M index, was 1.2% in 2005.

In the six months ended June 30, 2006, the Central Bank continued to reduce the levels of interest rates. On June 30, 2006, the official interest rate was 15.25% and on August 30, 2006, it was reduced to 14.25%. In this period, inflation, as measured by the IGP-M index, was 1.4% and the gross domestic product increased by 2.2%. The *real* appreciated against the U.S. dollar by 8.2%, reaching the rate of R\$2.1643 per US\$1.00 on June 30, 2006.

*Interest Rates.* Interest rate levels in Brazil are closely linked to exchange rate movements 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 domestic capital and lending markets. As a result, we may continue to require substantial amounts of foreign currency-denominated debt in order to satisfy our liquidity and capital resource requirements, which increases our exposure to exchange rate movements, as discussed below.

The Central Bank increased the official interest rate to 26.5% on February 19, 2003 and decreased it to 16.0% on April 14, 2004. The Central Bank increased the official interest rate to 17.75% on December 15, 2004. During the first four months of 2005, the Central Bank continued to raise the official interest rate, which reached 19.5% on April 20, 2005. However, starting from November 2005, the Central Bank has begun a process of reducing the official interest rate. On December 31, 2005, the official interest rate was 18.75%. In the six months ended June 30, 2006, the Central Bank continued to reduce the official interest rate, reaching 15.25%. On August 30, 2006, it was reduced to 14.25%.

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 debt, which increases are determined by reference to the daily government interest rate (*Taxa Referencial—TR*) plus an agreed margin. We cannot assure that we will be able, in future periods, to increase tariffs 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,			Six months ended June 30,	
	2003	2004	2005	2005	2006
Inflation – Consumer Price Index (IPC-FIPE) .....	8.2%	6.6%	4.5%	2.7%	0.1%
Inflation – General Market Price Index (IGP-M).....	8.7%	12.4%	1.2%	1.8%	1.4%

Source: *Fundação Getúlio Vargas*.

**Currency Exchange Rates.** We had total foreign currency-denominated indebtedness of R\$1,576.0 million as of December 31, 2005. In the event of further 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 tariffs and other revenues 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 34.3% devaluation of the *real* in 2002 increased our financial expenses and negatively affected our overall results of operations for that year. In contrast, in 2003, the *real* appreciated 22.3% against the U.S. dollar, which resulted in a foreign exchange gain of R\$540.6 million. The 8.8% appreciation of the *real* against the U.S. dollar in 2004 led to a foreign exchange gain of R\$179.7 million. The 13.4% appreciation of the *real* against the U.S. dollar in 2005 led to a foreign exchange gain of R\$312.1 million. The 8.2% appreciation of the *real* against the U.S. dollar in the six months ended June 30, 2006 led to a foreign exchange gain of R\$78.0 million.

The following table shows the appreciation of the *real* against the U.S. dollar, the period-end exchange rates and average exchange rates for the periods indicated:

	Year ended December 31,			Six months ended June 30,	
	2003	2004	2005	2005	2006
Appreciation of the <i>real</i> versus U.S. dollar.....	22.3%	8.8%	13.4%	13.0%	8.2%
Period-end exchange rate – US\$1.00.....	R\$2.8892	R\$2.6544	R\$2.3407	R\$2.3504	R\$2.1643
Average exchange rate – US\$1.00 <sup>(1)</sup> .....	R\$3.0711	R\$2.9257	R\$2.4341	R\$2.4135	R\$2.2483

(1) Represents the month-end average for the 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 indebtedness denominated in foreign currency, taking advantage of market opportunities to improve the profile of our indebtedness and reduce our costs.

### **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. During this period, the São Paulo Metropolitan Region, in particular, faced its worst drought in 65 years. As a result, from mid-June to mid-September in 2000, we rationed water in the southern portion of the São Paulo Metropolitan Region, affecting approximately 3.5 million people, or approximately 20% of the total population of this region. Under this rationing, water was made available to our customers for only two out of every three days. During this period of rationing, we also reduced our total water production by approximately 8%. From April 2001 through January 2002, we rationed water in the western portion of the São Paulo Metropolitan

Region, affecting approximately 300,000 people. Under this rationing, water was made available to these 300,000 customers for only 40 out of every 78 hours. Throughout 2003, rain levels were below average resulting in a weak replenishment of our reservoirs, particularly in the Cantareira System, the largest water supply system in the São Paulo Metropolitan Region. From October to December 2003, we rationed water on the Western part of the São Paulo Metropolitan Region, served by the Alto Cotia System, affecting approximately 450,000 people, or approximately 2% of the region's population. Under this rationing, water was available to those people for three days, followed by two days of rationing. During this period our total water production volume was reduced by 0.8%. As a result of the drought, our revenue declined as our volume of water billed decreased, and our costs increased because of required expenditures to protect and develop water sources and to preserve water quality. The impact that droughts have may vary across our different systems, which may allow us to mitigate the effects of any particular drought. The effects of the drought continued to impact our systems through 2004. In order to minimize the effects of this drought we implemented a water usage reduction bonus program. Due to this program and the return to normal rainfall levels that occurred throughout 2004 and early 2005, the conditions of our reservoirs have improved.

### ***Effects of the Water Usage Reduction Bonus Program***

In order to encourage customers to use less water in drought conditions, in 2004 we instituted a "bonus" system, rewarding customers who reduced their water consumption by specified amounts. The "bonus" was shown on each customer's bill as a discount, and was calculated based on the customer's water usage each month, and applied to decrease the amount payable by that customer.

This water usage reduction program took effect on March 15, 2004 and ended on September 15, 2004, and had the following effects:

- customers reduced their overall water usage, leading to lower revenues from lower volumes of water and sewage services;
- we discounted the amounts payable by customers who successfully lowered their water usage; and
- many customers, by reducing their water usage, shifted their households into a lower tariff category.

Our results for 2004 reflect the impact of these effects, all of which lowered our revenue from March 15, 2004 to September 15, 2004, thus affecting bills sent out through October. In 2004, the volume of water and sewage invoiced decreased by 1.4%, and our revenue from water and sewage services provided to the São Paulo Metropolitan Region decreased by R\$74.1 million, as a result of our water reduction program. This reduction was offset in part by the positive impact of tariff readjustments.

### **Critical Accounting Policies, Practices and Estimates**

Critical accounting policies and practices are those that are both (1) important to the portrayal of our financial condition and results of operations and (2) require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. As the number of variables and assumptions affecting the possible future resolution of the uncertainties increase, those judgments become even more subjective and complex. In order to provide an understanding about how our management forms its judgments about future events, including the variables and assumptions underlying the estimates, and the sensitivity of those judgments to different circumstances, we have identified the critical accounting policies and practices discussed below.

Our management discussion and analysis of financial condition and results of operations are based upon our primary financial statements, which have been prepared in accordance with the Brazilian Corporate Law Method, which differs in significant respects from U.S. GAAP. We have included a

discussion on material differences between the Brazilian Corporate Law Method and U.S. GAAP related to each critical accounting policy in Note 22 to our audited annual financial statements.

### ***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, taking into consideration the expected recovery in different categories of customers. We record an allowance for doubtful accounts for balances receivable in the amount of R\$5,000 up to R\$30,000 and overdue for more than 360 days, and for balances receivable in excess of R\$30,000 and overdue for more than 360 days, for which we have commenced judicial collection proceedings. Accounts receivable balances under R\$5,000 and overdue for more than 180 days are written off as a direct charge to income.

Provisions for the allowance for doubtful accounts are included in selling expenses, net of recoveries. The net charge to this allowance was R\$37.6 million in 2003, R\$241.6 million in 2004 and R\$255.3 million in 2005. For the six months ended June 30, 2006 it was R\$124.1 million.

Our 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 we use are reasonable, actual results could differ from those estimates.

In addition, we have substantial receivables consisting of amounts owed by the State. These amounts consist primarily of accounts receivable for services, reimbursement for pensions paid and amounts due under our December 2001 and March 2004 agreement with the State. See "Related Party Transactions." We do not reserve against any of these amounts owed by the State due to the following factors:

- we do not expect to incur losses from these accounts receivable; and
- we entered into agreements in September 1997, December 2001 and March 2004 under which the State has committed to settle the outstanding amounts due to us described in these agreements by applying dividends declared by us to the remaining balance of the accounts receivable owed by the State or its controlled entities.

As of June 30, 2006, the amounts owed to us by the State for the provision of water and sewage services included R\$161.6 million which was considered overdue as of February 29, 2004. As of June 30, 2006 the State owed us an additional R\$168.6 million in accounts receivable related to the provision of water and sewage services rendered from February 2004. With respect to reimbursement for pensions paid on behalf of the State, the State owed to us R\$719.0 million as of June 30, 2006 (R\$320.6 million of which was acknowledged by the State in an agreement with us subject to a further audit which has not yet occurred). We have not established any provisions for any amounts due to us by the State.

For U.S. GAAP purposes, the amounts receivable from the State for pensions paid is not recorded as accounts receivable, but rather is included as part of our estimated pension and other post-retirement obligations. Only amounts effectively reimbursed by the State are presented as additional paid-in capital. No additional differences have been identified between accounting policies for accounts receivable and allowance for doubtful accounts under the Brazilian Corporate Law Method and U.S. GAAP.

### ***Indemnities Receivable***

Indemnities receivable is a long-term asset representing amounts receivable from the Municipalities of Diadema and Mauá as indemnification for the unilateral withdrawal by those authorities

of our water and sewage service concessions in 1995. As of June 30, 2006, this asset amounted to R\$148.8 million.

Under 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 Diadema and Mauá concessions, 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 to 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 the relevant authorities.

Our rights to the recovery of 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 such amounts and we continue to monitor the status of the legal proceedings. However, the ultimate amounts to be received, if any, will most likely be subject to a final court decision. As such, actual amounts received could differ from those recorded.

With respect to Mauá, a decision has been issued by the lower court requiring Mauá to pay us the amount of R\$153.2 million as compensation for the loss of profits. This decision was appealed by Mauá and is pending the decision of the court of appeals. For more information, see “Business—Legal Proceedings.”

No differences have been identified between accounting policies on compensation for concession termination adopted under the Brazilian Corporate Law Method and U.S. GAAP.

### ***Property, Plant and Equipment***

*Valuation of Long-Lived Assets.* We review long-lived assets, primarily buildings, water and sewage system assets and acquired concession assets to be held and used in our business, for the purpose of determining and measuring impairment on a recurring basis or when events or changes in circumstances indicate that the carrying value of an asset or group of assets may not be recoverable. Under the Brazilian Corporate Law Method, we evaluate possible impairment by determining whether projected future operating income is sufficient to absorb the depreciation or amortization of long-lived assets, within the context of the balance sheet as a whole.

Studies supporting the write-offs for obsolescence and abandonment of projects are conducted in the accounting period of the write-offs based on undiscounted cash flow projections, and approved by our board of directors. We monitor the carrying value of our property, plant and equipment on an on-going basis and, if applicable, adjust the net book value to assure future projected operations will be sufficient to recover the carrying value of the assets. Depreciation is provided using the straight-line method based on the estimated useful lives of the underlying assets. When applicable, depreciation rates are adjusted to take account of changes in estimated prospective depreciable lives as assets are replaced.

U.S. GAAP Statement of Financial Accounting Standards, or SFAS, No. 144, “Accounting for the Impairment of Long-lived Assets,” requires companies to periodically evaluate the carrying value of long-lived assets to be held and used, and for long-lived assets to be disposed of, when events and circumstances warrant such a review. Companies are required to identify the smallest unit, or group, of assets at which cash flows generated by the group can be measured. The projected undiscounted cash flows from each such asset group are compared to its carrying value. For those assets for which the projected cash flows are not sufficient to recover the carrying values, a loss is recognized to the extent that the carrying value exceeds the fair market value of the assets.

In evaluating impairment of our long-lived assets, we make significant assumptions and estimates regarding matters that are inherently uncertain, including projections of future operating income and cash

flows, future growth rates, and the remaining useful lives of the assets, among others. 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 we use are reasonable, the use of different assumptions could materially affect our valuations.

No adjustments have been included in the reconciliation from the Brazilian Corporate Law Method to U.S. GAAP to take account of differences between the measurement criteria because no impairment provisions were required based on our analysis of cash flows. Losses on the write-off of property, plant and equipment arose primarily from adjustments upon withdrawal of concession assets, construction-in-progress projects which were deemed no longer to be economically feasible and obsolescence write-offs.

*Depreciation of Property, Plant and Equipment.* Depreciation of our property, plant and equipment, primarily buildings, water and sewage systems and other assets acquired, is provided using the straight-line method based on the estimated useful lives of the underlying assets, which generally do not exceed the contractual terms of our concession contracts.

While we believe that our estimates of current remaining estimated lives is reasonable, the use of different assumptions and estimates and changes in future circumstances, could affect the remaining useful lives of our assets, which could have a significant impact on our results of operations in the future.

### ***Loss Contingencies***

We are a party to a number of legal proceedings involving significant monetary claims. These legal proceedings include, among others, tax, labor, civil, environmental, condemnation and other proceedings. For a more detailed discussion of these legal proceedings, see “Business—Legal Proceedings.” 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. As such, we are required to make judgments regarding future events for which we often seek the advice of legal counsel. As a result of the significant judgment required in assessing and estimating these loss contingencies, actual losses realized in future periods could differ significantly from our estimates and could exceed the amounts which we have provisioned.

No differences have been identified between accounting policies on loss contingencies adopted under the Brazilian Corporate Law Method and U.S. GAAP.

### ***Pension Plans***

*Plan G1.* We sponsor a funded defined-benefit pension and benefits fund, or Plan G1, which is operated and administered by SABESPREV—*Fundação SABESP de Seguridade Social*.

Under the Brazilian Corporate Law Method, prior to January 1, 2002, we recorded pension expense on an accrual basis based on our contributions to the plan. Effective January 1, 2002, in accordance with the issuance of a new accounting standard, we began accounting for our actuarial obligation under Plan G1. As permitted under this standard, we are amortizing the transition liability related to the actuarial value of our obligation at the date of adoption of the new standard over a period of five years, which is recorded in our statements of operations as an extraordinary item, net of the related tax effects. For 2005, pension costs charged to income totaled R\$65.7 million, of which R\$35.1 million (net of tax effects totaling R\$18.1 million) was presented as “extraordinary item net of income tax and social contribution.” The remaining R\$30.6 million was charged to cost of services rendered, general and administrative expenses and selling expenses. For the six months ended June 30, 2006, pension costs charged to income totaled R\$30.0 million, of which R\$17.6 million (net of tax effects totaling R\$9.0 million) was presented as “extraordinary item net of income tax and social contribution.” The remaining R\$4.0 million was charged to cost of services rendered, general and administrative expenses and selling expenses. Based on independent actuarial reports, as of December 31, 2005, our obligation

under Plan G1 was R\$329.8 million. See Note 12 to our audited annual financial statements and Note 11 to our unaudited interim financial statements.

Under U.S. GAAP, we had already adopted the provisions of SFAS No. 87, "Employers' Accounting for Pensions," prior to 2002, which requires that we recognize an actuarial liability for pension benefits under Plan G1. While the actuarial assumptions used for U.S. GAAP are the same as those used in determining the actuarial liability under the Brazilian Corporate Law Method, pension costs and obligations under U.S. GAAP and the Brazilian Corporate Law Method are not the same, mainly due to differences related to the first year of application, the amortization of the initial transition obligation, amortization periods for other actuarial gains and losses, and actuarial calculation methods, among others. See Note 22 to our audited annual financial statements.

We are currently evaluating the possible introduction of a defined contribution plan for new employees and providing exiting employees an option to switch to this new plan from Plan G1.

*Plan G0.* Pursuant to a law enacted by the State, some of its employees who provided service to us prior to May 1974 and retired as employees of ours acquired a legal right to receive supplemental pension payments, which rights are referred to as "Plan G0." These amounts are paid by us on behalf of the State and are claimed as reimbursement from the State. As such, no pension expense related to Plan G0 is recorded and no future obligations are recorded under the Brazilian Corporate Law Method.

Consistent with the guidance in SEC Staff Accounting Bulletin Topic 5-T ("SAB No. 5-T"), under U.S. GAAP, we recognize the costs and obligations associated with Plan G0 supplemental pension benefits on a "push-down basis," as we are the recipients of the benefits of the employee service for which the supplemental pension benefits are paid. The Plan G0 benefit obligation and expenses are accounted for in accordance with SFAS No. 87. Eventual amounts received as reimbursement from the State, if any, are treated as additional paid-in-capital. As such, Plan G0 is considered unfunded for purposes of U.S. GAAP. See Note 22 to our audited annual financial statements.

*Assumptions.* Accounting for these pension benefits under the Brazilian Corporate Law Method and U.S. GAAP requires an extensive use of assumptions, including those related to the inflation adjusted discount rate, expected return on plan assets, the expected rate of future compensation increases received by our employees, mortality rates and turnover. We review each assumption annually, with the assistance of our actuarial consultant who provides guidance in establishing the assumptions. The assumptions are selected to represent the weighted average expected experience over time and may differ in any one year from actual experience due to changes in the capital markets and the overall economy, regulatory events, judicial rulings, and higher or lower actual rates of withdrawal, turnover or mortality among our participating employees. While we believe that the assumptions used are appropriate, differences in actual experience or changes in assumptions could affect the amount of pension expense that we recognize.

The present value of our pension obligations was based on a discount rate of 12.32% for 2003, 2004 and 2005. Our pension obligation and expense increases as the discount rate is reduced.

Our expected return on assets for Plan G1 is determined by evaluating the asset class return expectations with our advisors, as well as actual, long-term historical results of our asset returns. For 2005, we used an expected rate of return on assets assumption of 12.06%, which is expected to remain the same for 2006. The expected return on assets assumption is based on a targeted allocation of investments in accordance with the investment strategies of the plans. We believe that this targeted allocation will, on average, approximate actual long-term asset allocation.

### ***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 Sabesp. These amounts are expected to be reimbursed to us by the State, as primary obligor. However, these amounts have been outstanding for a long period. We account for these as long-term assets, and we do not reserve against such accounts receivable as we expect to recover these amounts and loss is not considered probable.

*Accounts Receivable from the State for Water and Sewage Services 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 "Related Party Transactions."

*Use of Certain Assets Owned by the State.* We currently use certain reservoirs in the Alto Tietê system and 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 not to pay any fees to the State for the use of certain reservoirs of the Alto Tietê system is addressed by a number of formal agreements first entered into on March 31, 1992 and on April 24, 1997 and later amended on March 16, 2000 and on November 21, 2001, respectively. As part of the arrangement, we agreed to fund 100.0% of the estimated costs of the 1992 agreement (equal to R\$27.8 million) and 75.0% of the 1997 agreement (equal to R\$63.4 million) which was already disbursed, and the Government of the State of São Paulo, through the State Department of Water and Energy, agreed to fund approximately 25.0% of the estimated costs of the 1997 agreement (equal to R\$21.1 million), to construct ducts, tunnels and other facilities to interconnect the Tietê River with the Biritiba and Jundiaí reservoirs and other bodies of water in exchange for our use of the reservoirs during a 30-year period. The amendments to the 1997 agreement increased our obligations under the agreement by R\$5.9 million.

We have the right to draw water from and release emissions into the reservoirs in the Alto Tietê system during a 30-year period which began in 1997. We capitalize our expenditures on the facilities we construct. The project subject to the 1992 agreement was concluded and the assets entered operations in 1994. The project subject to the 1997 agreement became operational in 2002 and is being depreciated on a straight-line basis through 2027.

The arrangement for use of the Billings and Guarapiranga reservoirs is provided for through a grant issued by the State Department of Water and Energy. 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,			Six months ended June 30,	
	2003	2004	2005	2005	2006
Net revenue from sales and services.....	100%	100%	100%	100%	100%
Cost of sales and services.....	(50.0)	(51.2)	(48.3)	(48.2)	(47.6)
Gross profit .....	50.0	48.8	51.7	51.8	52.4
Selling expenses.....	(7.2)	(11.4)	(10.9)	(10.2)	(10.1)
Administrative expenses.....	(6.2)	(7.1)	(6.7)	(7.1)	(5.1)
Financial expenses, net.....	(8.4)	(11.5)	(9.0)	(4.1)	(9.0)
Income from operations .....	28.2	18.8	25.1	30.4	28.2
Non-operating expenses, net.....	(1.3)	(0.8)	(0.5)	-	-
Income before taxes on income.....	26.9	18.0	24.6	30.4	28.2
Income tax and social contribution tax.....	(5.9)	(5.5)	(6.4)	(9.3)	(8.6)
Extraordinary item, net of income tax and social contribution tax.....	(0.8)	(0.8)	(0.7)	(0.7)	(0.7)
Net income.....	20.2	11.7	17.5	20.4	18.9

## Six Months Ended June 30, 2006 Compared to Six Months Ended June 30, 2005

### *Net Revenue from Sales and Services*

Net revenue from sales and services increased by R\$268.0 million, or 11.2%, to R\$2,658.0 million for the six months ended June 30, 2006, from R\$2,390.0 million for the same period in 2005.

Net revenue from sales and services relating to water services for the six months ended June 30, 2006 increased by R\$170.0 million, or 11.4%, to R\$1,652.2 million, from R\$1,482.2 million for the same period in 2005. This increase was principally due to:

- the 9.0% tariff readjustment effected in August 2005; and
- a 3.1% increase in the volume of water distributed and invoiced in the six months ended June 30, 2006.

Net revenue from sales and services relating to sewage services for the six months ended June 30, 2006 increased by R\$126.6 million, or 11.5%, to R\$1,226.6 million, from R\$1,100.0 million for the same period in 2005. Volumes of sewage increased by 3.9%, while tariffs increased by 9.0%.

### *Cost of Sales and Services*

The cost of sales and services increased by R\$114.0 million, or 9.9%, to R\$1,266.1 million for the six months ended June 30, 2006, from R\$1,152.1 million for the same period in 2005. As a percentage of net revenue from sales and services, cost of sales and services decreased to 47.6% for the six months ended June 30, 2006, from 48.2% for the same period in 2005.

The increase in overall costs was principally due to the following factors:

- an increase of R\$68.6 million, or 16.7%, in payroll expenses and related charges, primarily due to annual salary adjustments of 7.9% in May 2005 and of 4.63% in May 2006. In addition, the increase was due to the provision of a performance-related bonus in the aggregate amount of R\$30.7 million, which is a non-recurrent provision;

- an increase of R\$8.7 million, or 6.7%, in outsourced services, mainly resulting from: (1) an increase of R\$3.1 million related to hiring additional security companies and renegotiation of existing contracts, (2) an increase of R\$2.4 million related to maintenance of operating systems, (3) R\$1.4 million in research expenses for the control of water losses in the São Paulo Metropolitan Region and (4) an increase of R\$1.1 million related to closing and re-opening water connections;
- an increase of R\$8.0 million, or 3.9%, in energy costs relating to a 1.53% increase in consumption and the corresponding increased water production volume and the average increase of 6.26% in energy tariffs;
- an increase of R\$6.4 million, or 13.5%, in materials, principally due to (1) an increase of R\$2.0 million reflecting higher prevailing market prices for fuel, (2) an increase of R\$0.7 million in maintenance of vehicles, (3) an increase of R\$1.5 million in distribution and collections network maintenance and (4) an increase of R\$0.5 million in domestic connection maintenance; and
- payment of charges related to the use of water resources from the Capivari, Piracicaba and Jundiá basins in the amount of R\$3.3 million (for more information on these charges, see “Government Regulation—Water Usage”).

### **Gross Profit**

As a result of the factors discussed above, gross profit for the six months ended June 30, 2006 increased by R\$154.0 million, or 12.4%, to R\$1,391.9 million for the six months ended June 30, 2006, from R\$1,237.9 million for the same period in 2005. As a percentage of net revenue from sales and services, gross profit increased to 52.4% for the six months ended June 30, 2006, from 51.8% for the same period in 2005.

### **Selling Expenses**

Selling expenses for the six months ended June 30, 2006 increased by R\$23.3 million, or 9.5%, to R\$267.9 million for the six months ended June 30, 2006, from R\$244.6 million for the same period in 2005. As a percentage of net revenue from sales and services, selling expenses decreased to 10.1% for the six months ended June 30, 2006, from 10.2% for the same period in 2005.

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

- an increase of R\$17.9 million, or 16.8%, in bad debt expenses, net of recoveries, to R\$124.2 million for the six months ended June 30, 2006, from R\$106.3 million for the same period in 2005. This increase was mainly due to the increase in receivables following the end of the water usage reduction bonus program. The increase was also related to the tariff adjustment of 9.0% in August 2005; and
- an increase of R\$10.1 million, or 14.6%, in payroll expenses and related charges, primarily due to annual salary adjustments of 7.9% in May 2005 and of 4.63% in May 2006. In addition, the increase was due to the non-recurring provision of a performance-related bonus in the aggregate amount of R\$5.5 million.

These increases were partially offset by:

- a decrease of R\$3.6 million, or 8.9%, in outsourced services, principally due to services related to the preparation of the study on tariffs in 2005.

### **Administrative Expenses**

Administrative expenses for the six months ended June 30, 2006 decreased by R\$33.6 million, or 19.9%, to R\$135.3 million for the six months ended June 30, 2006, from R\$168.9 million for the same period in 2005. As a percentage of net revenue from sales and services, administrative expenses decreased to 5.1% for the six months ended June 30, 2006, from 7.1% for the same period in 2005.

The decrease in administrative expenses primarily reflected:

- a decrease of R\$37.1 million, or 84.4%, in expenses related to judicial proceedings due to the decrease in provisions for in new civil and environmental proceedings; and
- a decrease of R\$10.5 million, or 22.2%, in services expenses, principally in outsourced services, which decreased by R\$12.6 million, especially in expenses related to the structuring of our issuance of securities in June 2005.

These decreases were partially offset by:

- an increase of R\$10.4 million, or 19.5%, in payroll expenses and related charges, primarily due to annual salary adjustments of 7.9% in May 2005 and of 4.63% in May 2006 in the amount of R\$2.7 million. In addition, the increase was due to the provision of a performance-related bonus in the aggregate amount of R\$4.6 million, which is a non-recurrent provision; and
- an increase of R\$3.5 million, or 25.8%, in fiscal expenses, principally in the Temporary Contribution on Financial Transactions (*Contribuição Provisória sobre Movimentações Financeiras*), or CPMF, which increased by R\$2.1 million due to the repayment of outstanding amounts related to the debentures issued under the 5<sup>th</sup> issuance and other repayments of indebtedness. This increase was also due to other federal taxes with a R\$1.0 million increase related to the income tax on remittances abroad and taxes on importation of goods and services.

### **Financial Expenses, Net**

Financial expenses, net consist primarily of interest on our indebtedness, foreign exchange losses (or gains) in respect of our indebtedness, offset partially by interest income on financial investment and time deposits and inflation-based indexation accruals, mainly relating to agreements entered into with some customers to settle overdue accounts receivable.

Financial expenses, net for the six months ended June 30, 2006 increased by R\$139.5 million, or 141.3%, to R\$238.2 million for the six months ended June 30, 2006, from R\$98.7 million for the same period in 2005. As a percentage of net revenue from sales and services, financial expenses, net increased to 9.0% for the six months ended June 30, 2006, from 4.1% for the same period in 2005.

The increase in financial expense, net was primarily due to:

- an increase in interest expenses related to our *real*-denominated loans and financings in the amount of R\$26.7 million, to R\$269.5 million for the six months ended June 30, 2006 from R\$242.8 million for the same period in 2005, principally relating to the 8<sup>th</sup> issuance of debentures in June 2005 and to the recording of interest expense on our debt obligations to holders of interests in the securitization fund of our receivables (*Fundo de Investimento em Direitos Creditórios*) in March 2006. See “—Liquidity and Capital Resources”;

- a decrease in the interest rates of our foreign currency-denominated loans and financings in the amount of R\$39.6 million due to the amortization of the Eurobonds transaction with maturity date in July 2005;
- a decrease of R\$29.9 million in provisions related to interest and monetary adjustment on legal contingencies due to the decrease in the amounts provisioned as a result of the reversion of the provisions relating to: (i) settlement under some legal proceedings and consequent payment of amounts due, which were less than the amount provisioned, and (ii) change in the likelihood of loss of some legal proceedings based on our counsel's opinion from probable loss to possible loss.
- an increase of R\$204.7 million in monetary adjustments mainly due to the lower appreciation of the *real* in relation to the U.S. dollar and the variation of a basket of currencies. For the six months ended June 30, 2006, we recorded foreign exchange gains in the amount of R\$39.2 million resulting from the 8.2% appreciation of the *real* in relation to the U.S. dollar. In the same period in 2005, foreign exchange gains amounted to R\$243.9 million, resulting from the 13.0% appreciation of the *real* in relation to the U.S. dollar.

Financial income increased by R\$19.6 million, or 58.3%, to R\$53.2 million for the six months ended June 30, 2006, from R\$33.6 million for the same period in 2005, mainly due to interest rates on agreements entered into with customers in default and financial gains.

As of June 30, 2006, 77.0% of our debt was denominated in *reais* and 23.0% was denominated in foreign currency.

### ***Income from Operations***

As a result of the factors discussed above, income from operations for the six months ended June 30, 2006 increased by R\$24.8 million, or 3.4%, to R\$750.5 million for the six months ended June 30, 2006, from R\$725.7 million for the same period in 2005.

### ***Non-Operating Expenses***

Non-operating expenses for the six months ended June 30, 2006 decreased by R\$0.8 million, or 88.9%, to R\$0.1 million for the six months ended June 30, 2006, from R\$0.9 million for the same period in 2005.

### ***Income Tax and Social Contribution Tax***

Income tax and social contribution tax (including deferred taxes) for the six months ended June 30, 2006 increased by R\$7.6 million, or 3.4%, to R\$229.5 million for the six months ended June 30, 2006, from R\$221.9 million for the same period in 2005. This increase was primarily due to the increase in taxable income, which was R\$750.6 for the six months ended June 30, 2006, compared to R\$726.6 million for the same period in 2005.

### ***Extraordinary Item***

In accordance with the requirements of the CVM, we have elected to recognize the actuarial transition liability of R\$266.1 million calculated as of December 31, 2001 with respect to our defined-benefit pension plan (Plan G1) on a straight-line basis against earnings over the five-year period ending December 31, 2006. Accordingly, this expense is recorded as an extraordinary item of R\$17.6 million, net of income tax, for the six-month periods ended June 30, 2006 and 2005.

### ***Net Income***

As a result of the factors discussed above, net income increased by R\$503.5 million, or 3.4%, for the six months ended June 30, 2006, from R\$487.1 million for the same period in 2005. This increase was primarily due to increased results of operations, which recorded a significant growth of 19.9% for the six months ended June 30, 2006 as compared to the same period in 2005. Our net income for the six months ended June 30, 2006 was not affected by foreign exchange gains as much as it was in the year ended December 31, 2005.

### **Year Ended December 31, 2005 Compared to Year Ended December 31, 2004**

#### ***Net Revenue from Sales and Services***

Net revenue from sales and services increased by R\$556.3 million, or 12.7%, to R\$4,953.4 million in 2005, from R\$4,397.1 million in 2004.

Net revenue from sales and services relating to water services in 2005 increased by R\$315.5 million, or 12.4%, to R\$2,856.5 million in 2005, from R\$2,541.0 million in 2004. This increase was principally due to:

- a 3.9% increase in the volume of water distributed and invoiced in 2005;
- the effect of the tariff readjustment in 2004 of 6.78% and the impact, from August 2005, of a tariff increase of 2.38%, which together had an impact of 9.32%; and
- the migration of some households from lower to higher tariff categories due to their increased water usage, which accounted for an increase of 1.1% in revenues.

Net revenue from sales and services relating to sewage services increased by R\$240.8 million, or 13%, to R\$2,096.9 million in 2005, from R\$1,856.1 million in 2004. Volumes of sewage increased by 5.0%, while tariffs increased by 9.0%.

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

The cost of sales and services increased by R\$137.0 million, or 6.1%, to R\$2,390.4 million in 2005, from R\$2,253.4 million in 2004. As a percentage of net revenue from sales and services, cost of sales and services decreased to 48.3% in 2005 from 51.2% in 2004.

The increase in overall costs was principally due to the following factors:

- an increase of R\$48.2 million, or 6.0%, in payroll expenses and related charges, primarily due to annual salary adjustments of 7.9% that came into effect in May 2005, partially offset by a 1.6% decrease in the number of our employees. While the number of employees covered by this line item decreased to 17,448 in 2005 from 17,735 in 2004, productivity increased on a company-wide basis based on our operating index of the number of water and sewage connections per employee, which indicated 651 connections per employee in 2005 and 626 connections per employee in 2004;
- an increase of R\$37.1 million, or 14.2%, in outsourced services, principally due to a R\$17.0 million increase related to maintenance of domestic connections, a R\$10.0 million increase in distribution and collections network maintenance, a R\$3.6 million increase for technical and professional fees primarily related to execution of the plan for final sludge disposal in the Tietê River clean-up program, and a R\$2.5 million increase in costs related to hiring security companies;

- an increase of R\$24.4 million, or 6.1%, in energy costs, principally as a consequence of a 14.1% increase in average tariffs, and an increase of 2.2% in energy consumption due to increased water production. This increase was partially mitigated by the migration of 43% of our energy requirements to the “free market,” where we can more efficiently negotiate for the supply of energy, by the implementation of plans to improve energy efficiency, and by the ending of the additional charge for emergency energy capacity, which was gradually stepped to zero by the end of 2005;
- an increase of R\$20.8 million, or 24.6%, in materials, principally due to an increase of R\$8.1 million in materials used in the distribution and collections network maintenance, a R\$4.4 million increase in materials for domestic connection maintenance, an increase of R\$2.8 million in fuel expenses and a R\$1.1 million increase in several other types of materials; and
- an increase of R\$7.3 million, or 8.0%, in treatment materials, due to the higher volume of water treated and an increase in the price of certain materials. The average increase in prices of treatment materials was 11.6%, but more efficient operating procedures resulted in total costs not increasing to the same extent. Additionally, lower outbreaks of algae efflorescence resulted in less expenses, amounting to R\$2.7 million, in costs for coal to treat algae.

### **Gross Profit**

As a result of the factors discussed above, gross profit in 2005 increased by R\$419.3 million, or 19.6%, to R\$2,563.0 million in 2005, from R\$2,143.7 million in 2004. As a percentage of net revenue from sales and services, gross profit increased to 51.7% in 2005 from 48.8% in 2004.

### **Selling Expenses**

Selling expenses in 2005 increased by R\$35.4 million, or 7.0%, to R\$537.9 million in 2005, from R\$502.5 million in 2004. As a percentage of net revenue from sales and services, selling expenses decreased to 10.9% in 2005, from 11.4% in 2004.

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

- an increase of R\$15.4 million, or 23.0%, in expenses for outsourced services, principally an increase of R\$8.7 in fees for professional and technical services in connection with the study related to the implementation of a new tariff policy, as discussed above, an increase in costs for meter reading and billing in the amount of R\$4.9 million, and a R\$1.6 million increase in costs relating to other selling expenses;
- an increase of R\$13.7 million, or 5.7%, in bad debt expenses, net of recoveries. Bad debts of R\$79.8 million were partially offset by recoveries of R\$66.1 million, resulting from more efficient recovery procedures; and
- an increase of R\$4.5 million, or 3.3%, in payroll expenses and related charges due to the annual salary adjustment of 7.9%, as discussed above, the effect of which was partially mitigated by a reduction in the number of our employees.

These increases were offset by:

- a reduction of 1.6% in the number of employees with a commensurate increase in productivity; efficiencies adopted in order to reduce electrical costs such as the implementation of an efficiencies program and the migration of 43% of our energy

consumption to the “free market,” where we are able to pay less for energy; and more efficient use of water treatment materials.

### **Administrative Expenses**

Administrative expenses for 2005 increased by R\$21.9 million, or 7.0%, to R\$335.5 million in 2005, from R\$313.6 million in 2004. As a percentage of net revenue from sales and services, administrative expenses decreased to 6.7% in 2005, from 7.1% in 2004.

The increase in administrative expenses primarily reflected:

- an increase of R\$12.4 million, or 20.4%, in provisions for judicial proceedings, resulting from new claims as to which losses are probable;
- an increase of R\$3.6 million, or 14.2%, in tax expenses, principally for CPMF, generated by payment of debts in 2005;
- an increase of R\$3.1 million, or 17.9%, in depreciation and amortization, principally related to amortization of newly completed assets coming on line; and
- an increase of R\$2.6 million, or 2.4%, in payroll expenses, the effect of which was mitigated in part by a reduction in the number of employees.

### **Financial Expenses, Net**

Financial expenses, 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 time deposits and inflation-based indexation accruals, mainly relating to agreements entered into with some customers to settle overdue accounts receivable.

Financial expenses, net in 2005 decreased by R\$56.7 million, or 11.3%, to R\$447.0 million in 2005, from R\$503.7 million in 2004. As a percentage of net revenue from sales and services, financial expenses, net decreased to 9.0% in 2005, from 11.5% in 2004. Financial expenses decreased R\$79.9 million, or 12.5%.

The decrease in financial expenses was primarily due to:

- an increase of R\$147.7 million mainly in foreign exchange gains, reflecting the effects of the appreciation of the *real* against the U.S. dollar. In 2005, we recorded gains of R\$312.1 million, resulting from a 13.4% appreciation of the *real*. In 2004, we recorded gains of R\$179.7 million, resulting from a 8.8% appreciation of the *real*. The amount of debt denominated in dollars decreased by 32.3%, to US\$670 million in 2005, from US\$990 million in 2004; and
- a decrease of R\$77.1 million in interest and other charges related to foreign currency-denominated debt due to the decrease of 32.3% in the amount of our U.S. dollar-denominated debt and to the appreciation of the *real* against the foreign currency in which our non-*real* debt is denominated.

The decrease in financial expenses was offset by:

- an increase of \$77.6 million in interest and other charges related to our *real*-denominated debt due to our 6th, 7th, and 8th issuances of debentures in September 2004 and March and June 2005, respectively. As of December 31, 2005 and 2004, the balance of outstanding debentures was R\$2,009.3 million and R\$1,254.8 million, respectively;



- an increase of R\$38.0 million for monetary adjustments in provisions for judicial proceedings related to interest expenses, due to the increase in amounts provisioned with respect to suppliers and final consumer claims; and
- an increase of R\$33.2 million for income tax on remittances abroad, due to recoveries on such amounts that were recorded in 2004 and did not recur in 2005.

Financial income decreased by R\$23.2 million, or 16.8%, to R\$114.7 million in 2005, from R\$137.9 million in 2004, which was related to a decrease of R\$26.3 million in income from monetary variations, to R\$34.0 million in 2005, from R\$60.3 million in 2004, due to indexation adjustments.

As of December 31, 2005, 76.4% of our debt was denominated in *reais* and 23.6% was denominated in U.S. dollars.

### ***Income from Operations***

As a result of the factors discussed above, income from operations in 2005 increased by R\$418.7 million, or 50.8%, to R\$1,242.6 million in 2005, from R\$823.9 million in 2004.

### ***Non-Operating Expenses***

Non-operating expenses in 2005 decreased by R\$8.5 million, or 25.1%, to R\$25.4 million, from R\$33.9 million in 2004. Losses on disposal of obsolete assets were R\$19.1 million in 2005, compared to R\$34.4 million in 2004.

### ***Income Tax and Social Contribution Tax***

Income tax and social contribution tax (including deferred taxes) in 2005 increased by R\$74.6 million, or 30.8%, to R\$316.5 million from R\$241.9 million in 2004. This was primarily due to the increase in taxable income, which was R\$1,217.2 in 2005, compared to R\$790.0 million in 2004. This increase in profits was partially offset by tax benefits resulting from the declaration of interest on shareholders' equity. This benefit amounted to R\$118.4 million in 2005, compared to R\$52.0 million in 2004, over interest on shareholders' equity in the amounts of R\$348.2 million and R\$152.9 million, respectively.

### ***Extraordinary Item***

In accordance with the requirements of the CVM, under CVM Deliberation No. 371/2000, we have elected to recognize the actuarial transition liability of R\$266.1 million calculated as of December 31, 2001 with respect to our defined-benefit pension plan (Plan G1) on a straight-line basis against earnings over the five-year period ending December 31, 2006.

As permitted, the expense is recorded as an extraordinary item of R\$35.1 million, net of income tax, of R\$18.1 million, for both 2005 and 2004.

### ***Net Income***

As a result of the factors discussed above, net income increased by 68.8%, to R\$865.6 million in 2005, from R\$513.0 million in 2004. The bulk of this increase derived from profits from operations, which recorded a significant growth of 66.2%, and the 11.8% appreciation of the *real* contributed to the balance of the increase.

## **Year Ended December 31, 2004 Compared to Year Ended December 31, 2003**

### ***Net Revenue from Sales and Services***

Net revenue from sales and services in 2004 increased by R\$266.3 million, or 6.5%, to R\$4,397.1 million, from R\$4,130.8 million in 2003.

Net revenue from sales and services relating to water services in 2004 increased by R\$122.8 million, or 5.1%, to R\$2,541.0 million from R\$2,418.2 million in 2003. This increase was mainly due to the August 2003 tariff increase of 18.9% (and, to a lesser extent, the August 2004 tariff increase of 6.8%) and the increase in revenue due to our shift from wholesale to direct distribution, and improvements in billing and collection for water services in São Bernardo do Campo. This increase was offset by a 4.1% decrease in the volume of water distributed and invoiced in 2004, resulting from our campaign to reduce water consumption throughout the period, together with, from March 15, 2004, the effects of the usage reduction discount plan which, as discussed above, lowered usage, granted discounts on the bills of customers who lowered their usage, and shifted some households into lower tariff categories. Total discounts given to customers under this plan amounted to R\$74.1 million, which would otherwise have been recognized as revenue. Although the usage reduction discount plan ended in September 2004, the impact of the plan on our results of operations, including lowered usage of water by customers, continued throughout the year. By the end of the year, however, the impact of the plan began to reduce, and usage levels started to increase.

Net revenue from sales and services relating to sewage services in 2004 increased by R\$143.6 million, or 8.4%, to R\$1,856.1 million, from R\$1,712.5 million in 2003. Volumes of sewage increased by 2.8%, rising in the fourth quarter as the impact of our water usage reduction discount plan reduced, while tariffs increased by 6.8%. Additionally, revenue received for the first time for sewage services provided in São Bernardo do Campo after the acquisition of that municipality's water and sewage assets contributed to the increase in net revenue.

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

Cost of sales and services in 2004 increased by R\$186.2 million, or 9.0%, to R\$2,253.4 million, from R\$2,067.1 million in 2003. As a percentage of net revenue from sales and services, costs of sales and services increased to 51.2% in 2004, from 50.0% in 2003. The increase was primarily due to the following factors:

- an increase of R\$75.6 million, or 23.5%, in energy costs; R\$53.5 million of which was due to an increase of approximately 17.5% in energy tariffs, and R\$22.1 million was due to increased provisions for energy costs incurred but not yet measured or billed by the energy company;
- an increase of R\$53.2 million, or 25.7%, in outsourced services, primarily due to the costs of R\$47.0 million relating to the implementation of our "Global Sourcing" maintenance and materials project, to the works resulting from the acquisition of the São Bernardo do Campo water and sewage systems in the amount of R\$9.8 million, and to the maintenance of operating systems and security services; and
- an increase of R\$31.0 million, or 5.7%, in depreciation and amortization expenses, principally due to the transfer of sites under construction to assets in use.

### ***Gross Profit***

As a result of the above factors, gross profit in 2004 increased by R\$80.1 million, or 3.9%, to R\$2,143.7 million, from R\$2,063.6 million in 2003. As a percentage of net revenue from sales and services, gross profit decreased to 48.8% in 2004, from 50.0% in 2003.

### ***Selling Expenses***

Selling expenses in 2004 increased by R\$205.0 million, or 68.9%, to R\$502.5 million, from R\$297.5 million in 2003. As a percentage of net revenue from sales and services, selling expenses increased to 11.4% in 2004, from 7.2% in 2003.

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

- an increase of R\$204.0 million in bad debts expenses, net of recoveries caused by a more rigorous collection of bad debts through increased legal actions. Because accounts receivable in amounts in excess of R\$30,000 and overdue for more than 360 days are not generally recognized as bad debts until legal action is taken, our decision to bring more legal actions was related to the deterioration of the financial condition of the municipalities that buy water on a wholesale basis, which significantly increased the amount of bad debts recognized in 2004. Recoveries, which offset bad debt expenses, decreased from R\$195.5 million in 2003 to R\$62.9 million in 2004. In addition, a reversal of bad debt expenses in the amount of R\$129.0 million, which was recorded in 2003 upon the acquisition of the São Bernardo do Campo sewage and water systems, had no equivalent in 2004;
- an increase of R\$8.1 million, or 21.4%, in general expenses, due to an increase in fees for bank collection services; and
- an increase of R\$7.2 million, or 5.5%, in payroll and related charges, primarily resulting from a 4.2% increase in salaries which took effect in May 2004 and a R\$1.4 million bonus paid to certain employees in connection with financial performance.

These increases were offset by the following:

- a decrease of R\$15.6 million, or 18.9%, in outsourced services, primarily for debt collection services. These services have been temporarily suspended while we re-bid the contract for these services and considered our strategy for using outsourced contractors for collection services. This decrease should, therefore, not be regarded as a trend.

### ***Administrative Expenses***

Administrative expenses in 2004 increased by R\$59.5 million, or 23.4%, to R\$313.6 million, from R\$254.1 million in 2003. As a percentage of net revenue from sales and services, administrative expenses increased to 7.1% in 2004, from 6.2% in 2003. The increase in administrative expenses primarily reflected:

- an increase of R\$27.4 million, in payments to outsourced contractors, primarily advertising agencies in connection with the water usage reduction campaign, and professional services in connection with the issuance of debentures in September 2004; and
- an increase of R\$25.5 million, in costs for the implementation of our geographic information system SIGNOS, which, among other things, maps out the entire municipality infrastructure.

### ***Financial Expenses, Net***

Financial expenses, net consist principally of interest on our indebtedness, foreign exchange losses in respect of indebtedness and inflation-based indexation charges relating to indebtedness, offset partially by interest income on cash and time deposits and inflation-based indexation accruals, mainly relating to agreements entered into with some customers to settle overdue accounts receivable.

Financial expenses, net in 2004 increased by R\$157.2 million, or 45.4%, to R\$503.7 million from R\$346.5 million in 2003. As a percentage of net revenue from sales and services, financial expenses, net were 11.4% in 2004 and 8.4% in 2003. Financial expenses decreased by R\$15.3 million, or 2.3%, while financial income decreased by R\$170.4 million.

The decrease in financial expenses was primarily due to:

- a decrease in provisions for judicial proceedings related to interest expenses of R\$99.9 million due to a reduction in the amounts provisioned with respect to pending litigation with suppliers and construction companies;
- a decrease of R\$74.5 million in interest and other charges relating to *real*-denominated debt due to lower interest rates;
- an indexation-based decrease of R\$68.6 million in *real*-denominated debt;
- a decrease in income tax on remittances abroad in the amount of R\$61.1 million, relating to the recovery of amounts previously paid;
- a decrease of R\$36.9 million in interest and other charges relating to foreign currency-denominated debt due to the appreciation of the *real* against the foreign currency in which our non-*real* debt is denominated; and
- a decrease of R\$17.5 million in penalties that we had provided for with respect to payment of COFINS and PASEP, resulting from our participation in 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, pursuant to which these penalties were settled.

The decrease in financial expenses was partially offset by a R\$360.9 million decrease in foreign exchange gain in 2004 compared to 2003, reflecting the effects on our foreign currency-denominated debt of the appreciation of the *real* against the foreign currency in which our non-*real* debt is denominated during those periods. In 2004, we recorded a foreign exchange gain of R\$179.7 million, resulting from an 8.8% appreciation of the *real* against the U.S. dollar. In 2003, we recorded a foreign exchange gain of R\$540.6 million resulting from a 22.3% appreciation of the *real* against the U.S. dollar.

Financial income decreased by R\$170.3 million, or 54.7%, to R\$141.0 million in 2004, from R\$311.3 million in 2003, primarily due to:

- a R\$46.9 million decrease in interest income from R\$70.0 million in 2003 to R\$23.1 million in 2004. This decrease was primarily due to a R\$130.5 million decrease in cash and cash equivalents as we reduced our cash balances by repaying outstanding debt; and
- a decrease in income from monetary variations of R\$143.6 million, primarily reflecting the negotiation with the municipality of São Bernardo do Campo relating to the amortization of the amounts owed to us by this municipality and the settlement of claims against the State, both in 2003.

As of December 31, 2004, 62.0% of our debt was *real*-denominated, and 77.5% of such *real*-denominated debt was floating rate debt and indexed to take into account the effects of inflation.

### ***Income from Operations***

As a result of the above factors (including, in particular, foreign exchange gains), income from operations in 2004 decreased by R\$341.6 million, or 29.3%, to R\$823.9 million, from R\$1,165.5 million in 2003.

### ***Non-Operating Expenses***

Net non-operating expenses in 2004 decreased by R\$20.6 million, or 37.8%, to R\$33.9 million, from R\$54.5 million in 2003. In both periods, most of such expenses consisted of losses on disposal of property and write-offs of obsolete and other non-productive fixed assets, amounting to R\$34.4 million in 2004 and R\$61.7 million in 2003.

### ***Income Tax and Social Contribution Tax***

Income tax and social contribution tax (including deferred taxes) for 2004 decreased by R\$0.7 million, or 0.3%, to R\$241.9 million from R\$242.6 million in 2003, due to the reduction in profit before income tax and social contribution tax, that amounted to R\$790.0 million in 2004, compared to a profit of R\$1,111.1 million in 2003. This reduction in profits was partially offset by the fact that we took advantage of the income tax benefit on interest on shareholders' equity. This benefit totaled R\$52.0 million in 2004, compared to R\$171.4 million in 2003, relating to declared interest on shareholders' equity declared of R\$152.9 million and R\$504.9 million in 2004 and 2003, respectively.

For 2004 and 2003, the statutory composite tax rate was 34.0%.

### ***Extraordinary Item***

In accordance with the requirements of the CVM, under CVM Deliberation No. 371/2000, we have elected to recognize the actuarial transition liability of R\$266.1 million calculated as of December 31, 2001 with respect to our defined-benefit pension plan (Plan G1) on a straight-line basis against earnings over the five-year period ending December 31, 2006.

As permitted, the expense is presented as an extraordinary item, net of income tax, of R\$35.1 million (net of tax effects of R\$18.1 million) for 2003 and 2004.

### ***Net Income***

As a result of the above factors, net income in 2004 decreased by R\$320.3 million, or 38.4%, to R\$513.0 million, compared to net income of R\$833.3 million in 2003.

## **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 June 30, 2006, we had R\$336.0 million of cash and cash equivalents. Outstanding short-term debt was R\$642.4 million as of June 30, 2006, of which R\$119.8 million was denominated in foreign currency. Long-term debt was R\$5,778.1 million, of which R\$1,352.2 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\$1,655.3 million in 2003, R\$1,436.1 million in 2004 and R\$1,754.8 million in 2005. For the six months ended June 30, 2005 and 2006, our cash generated by operating activities was R\$723.5 million and R\$1,061.8 million, 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 on the overdue accounts receivable from the State, see “Related Party Transactions.”

*Debt Financing.* As of June 30, 2006, we had R\$5,778.1 million in long-term debt outstanding (excluding the current portion of long-term debt), of which R\$1,352.2 million consisted of foreign currency-denominated long-term debt. We had outstanding short-term debt of approximately R\$642.4 million as of June 30, 2006, representing the current portion of our long-term debt.

As of June 30, 2006, approximately R\$119.7 million of this short-term debt was denominated in foreign currencies. Substantially all of our foreign currency-denominated debt of R\$1,471.9 million as of June 30, 2006 was denominated in U.S. dollars or in baskets of foreign currencies.

As of June 30, 2006, our foreign currency-denominated debt consisted principally of:

(1) R\$ 953.7 million (US\$440.7 million) in U.S. dollar denominated loans from the Inter-American Development Bank. Under these loans, amortizations 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 7.70%. 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 “Business—Capital Expenditure Program—Tietê Project.”

(2) R\$487.0 million (US\$225.0 million) in aggregate principal amount of our 12.0% notes due 2008 sold in the international capital markets, which are subject of the Tender Offer.

(3) R\$9.5 million (US\$4.4 million) in U.S. dollar loans from the International Bank for Reconstruction and Development, or World Bank. Under the loan agreement, amortizations of principal are made in 20 semi-annual installments every month of April and October, with final maturity in April 2007. The principal amount is adjusted semi-annually for the variation in the basket of foreign currencies and accrues interest at a rate of 3.92%. We have granted as collateral some of our properties. For more information on the properties pledged, see “Business—Property, Plant and Equipment.” For a detailed discussion on the terms and guarantees of this loan agreement, see “Related Party Transactions—Government Guarantees on Financing.”

Our borrowings from multilateral institutions, such as the World Bank and the Inter-American Development Bank, 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 Inter-American Development Bank, we have granted a guarantee (*contra garantia*) to the Federal Government.

Our outstanding domestic debt was approximately R\$4,948.6 million as of June 30, 2006 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 Brazilian National Bank for Economic and Social Development (*Banco Nacional de Desenvolvimento Econômico e Social*), or BNDES, as well as debentures issued in April 2001, April 2002, September 2004 and March and June 2005.

The following summarizes our principal borrowings from Federal and State-owned banks:

(1) 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.

(2) We have entered into several line of credit agreements with Caixa Econômica Federal, pursuant to which amortizations of principal are made 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 2022. The principal amount accrues interest at a rate varying from 5.00% to 9.50%.

(3) In August 2002, we entered into a line of credit agreement with BNDES. The final maturity date will be in 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%, plus 3.00% per annum. If the TJLP exceeds 6%, such excess will be added to the principal amount payable at maturity.

In addition, we entered into a credit agreement on August 6, 2004 with the Japan Bank for International Cooperation, or JBIC, for the financing of the Environmental Recovery Program for the Santos Metropolitan Region, which was guaranteed by the Federal Government for an aggregate principal amount of ¥21,320 million (R\$422.8 million). The disbursements began in January 2006. As of June 30, 2006, the total amount disbursed was R\$8.8 million. In addition to the amount received under the JBIC credit agreement, we intend to invest up to R\$355.0 million in this program. Under this financing agreement, amortizations are made in semi-annual installments in August and February, with final maturity 2029. This obligation is guaranteed by the Federal Government. For further information on the terms and guarantees of this financing agreement, see “Related Party Transactions—Government Guarantees of Financing” and “Business—Capital Expenditure Program—Environmental Recovery Program for the Santos Metropolitan Region.”

In addition, we are currently negotiating with BNDES 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 1995. As part of the program:

(1) We issued R\$600.0 million in aggregate principal amount of debentures in September 2004 (our 6<sup>th</sup> issuance), offered in three separate series. The debentures of the first, second and third series will mature within three, five and six years after issuance, respectively. The debentures of the first series in the amount of R\$231.8 million bear interest at the interbank deposit rate (CDI) plus 1.75% per year, and the debentures of the second series in the amount of R\$188.3 million, and of the third series, in the amount of R\$179.9 million, bear interest at rates of IGP-M index plus 11.0% per year.

(2) We also issued R\$300.0 million in aggregate principal amount of debentures in March 2005 (our 7<sup>th</sup> issuance), offered in two series. The debentures of the first and second series will mature within four and five years, respectively, after issuance. The debentures of the first series, in the total amount of R\$200.0 million, bear interest at the interbank deposit rate (CDI) plus 1.5% per year, and the debentures of the second series, in the total amount of R\$100.0 million, bear interest at the rate of IGP-M index plus 10.8% per year.

(3) We also issued R\$700.0 million in aggregate principal amount of debentures in June 2005 (our 8<sup>th</sup> issuance), offered in two series. The debentures of the first and second series will mature within four and six years, respectively, after issuance. The debentures of the first series, in the total amount of

R\$350.0 million, bear interest at the interbank deposit rate (CDI) plus 1.5% per year, and the debentures of the second series, in the total amount of R\$350.0 million, bear interest at the rate of IGP-M index plus 10.75% per year.

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 their respective principal amounts; the increases are determined by reference to the daily government interest rate (*Taxa Referencial*) 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. On March 23, 2006, the fund issued senior and junior quotas to investors in Brazil with a value per unit of R\$500,000.00. The senior quotas will be amortized in 54 monthly installments. 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 and paid for and maintain in a deposit account 26 junior, or subordinated, quotas of this fund in the total amount of R\$13 million.

In March 2006, the fund advanced to us revenues derived from the provision of water and sewage services in the 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. See Note 9 to our audited annual financial statements and Note 8 to our unaudited interim financial statements.

The following table sets forth information on our outstanding debt as of June 30, 2006. See Note 8 to our unaudited interim financial statements as of and for the six months ended June 30, 2006 and see also Note 9 to our audited annual financial statements:

	As of June 30, 2006				
Facility	Current	Long Term	Total Aggregate Principal Amount	Final Maturity	Interest Rate <sup>(1)</sup>
	(in millions of reais)				
Real-denominated loans and financings:					
Federal Government/Banco do Brasil.....	204.6	1,943.9	2,148.5	2014	UPR + 8.50%
Debentures 4th Issuance .....	50.0	-	50.0	2006	CDI + 1.20%
Debentures 5th Issuance .....	45.0	-	45.0	2007	10.65% and IGP-M
Debentures 6th Issuance .....	-	619.7	619.7	2010	CDI + 1.75% and 11.00% and IGP-M
Debentures 7th Issuance .....	-	301.9	301.9	2010	CDI + 1.50% 10.80% and IGP-M
Debentures 8th Issuance .....	-	701.3	701.3	2011	CDI + 1.50% 10.75% and IGP-M
Caixa Econômica Federal <sup>(2)</sup> .....	45.6	458.1	503.7	2007/22	5.00% to 9.50%
Brazilian Economic and Social Development Bank (BNDES).....	31.1	169.2	200.3	2013	TJLP + 3.00%
FDIC – SABESP .....	41.7	208.3	250.0	2011	(up to 6.00%) CDI + 0.7%
Other .....	2.7	23.5	26.2	2009/11	12.00% and CDI and TJLP + 6.00%
Subtotal .....	420.7	4,425.9	4,846.6		
Accrued interest and charges .....	102.0	-	102.0		—
Total .....	522.7	4,425.9	4,948.6		



Facility	As of June 30, 2006				Interest Rate <sup>(1)</sup>
	Current	Long Term	Total Aggregate Principal Amount (in millions of reais)	Final Maturity	
Foreign currency denominated loans and financings:					
Long-term Notes: US\$225.0 million .....	-	487.0	487.0	2008	12% Variation in the basket of currencies + 3.00% to 7.70%
Inter-American Development Bank (IDB): US\$440.7 million .....	97.3	856.4	953.7	2025	Variation in the basket of currencies + 4.84%
World Bank: US\$4.4 million .....	9.5	-	9.5	2007	4.04%
Société Générale: €524.0 million .....	1.4	-	1.4	2006	1,8% and 2,5%
JBIC – YEN 465.7 million .....	-	8.8	8.8	2029	
Subtotal .....	108.2	1,352.2	1,460.4		
Accrued interest and charges .....	11.5	-	11.5		
Total .....	119.7	1,352.2	1,471.9		
<b>Total Debt</b> .....	<b>642.4</b>	<b>5,778.1</b>	<b>6,420.5</b>		

- (1) UPR stands for Standard Reference Unit (*Unidade Padrão Referência*) and is equal to the daily government interest rate (*Taxa Referencial—TR*), which was 0.19% per month as of June 30, 2006; CDI stands for Interbank Deposit Rate (*Certificado de Depósitos Interbancários*), which was 15.18% per annum as of June 30, 2006; IGP-M stands for *Índice Geral de Preços a Mercado*, which was 0.87% per annum as of June 30, 2006; TJLP stands for Long-term Rate Fixed by the Federal Government on a quarterly basis (*Taxa de Juros a Longo Prazo*), which was 8.15% per annum as of June 30, 2006.
- (2) Agreements to provide up to approximately R\$470.2 million in financing for our capital expenditure program until final maturity. We have pledged amounts in certain bank accounts as collateral for these loans.

**Financial Covenants.** We are subject to financial covenants under the agreements evidencing or governing our outstanding indebtedness.

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 Inter-American Development Bank and the World Bank. Each of these agreements contains, among other provisions, limitations on our ability to incur debt. The indenture relating to the 12.0% notes due 2008 is the most stringent of these debt agreements. This indenture prohibits, subject to some exceptions, the incurrence of additional debt in the event that (1) the ratio of Indebtedness to Adjusted Capitalization (as defined in the related indenture) is greater than 0.42x or (2) the Debt Service Coverage Ratio (as defined in the indenture) is less than 2.50x. These ratios are calculated using financial statements prepared under the constant currency method (which is an accounting methodology that differs from the Brazilian Corporate Law Method and that incorporates inflation accounting no longer commonly used in Brazil). 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. As of June 30, 2006, our ratio of Indebtedness to Adjusted Capitalization was 0.24x and our Debt Service Coverage Ratio was 3.52x, in each case as calculated in accordance with the above-mentioned indenture.

In addition, with respect to our outstanding domestic debt, 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 1.0, (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 4th and the 5th issuances contain no material financial covenants and the 6th, 7th and 8th issuances require us to maintain a current debt ratio higher than 1.0:1.0 and an EBITDA/expenditures ratio equal to or higher than 1.5:1.0.

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. 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 JBIC, the World Bank and the Inter-American Development Bank.

### **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, payment of pension plan and other employee benefits, including pension plan payments to certain of our former employees on behalf of the State, and dividend payments and other distributions to our shareholders, including the State.

*Debt-Service and Other Contractual Obligations.* Our debt service obligations and other contractual obligations as of December 31, 2005 were as follows:

	2006	2007	2008	2009	2010 and thereafter	Total
			(in millions of reais)			
Outstanding long-term debt due .....	759.0	781.5	914.3	1,156.6	3,052.8	6,664.2
Operational lease .....	10.1	2.7	0.5	0.02	-	13.3
Pension benefits - SABESPREV <sup>(1)</sup> .....	-	-	-	-	-	276.6
PAES program <sup>(2)</sup> .....	39.4	39.4	39.4	39.4	137.9	295.5
Take-or-pay contracts .....	192.3	168.0	155.9	159.6	468.2	1,144.0
<b>Total</b> .....	<b>1,000.8</b>	<b>991.6</b>	<b>1,110.1</b>	<b>1,355.62</b>	<b>3,658.9</b>	<b>8,393.6</b>

(1) Based on actuarial estimates. Amounts payable in any specific year depend on unknown factors including life expectancy.

(2) 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 current interest rates borne by our outstanding indebtedness, see Note 9 to our audited annual financial statements and Note 8 to our unaudited interim financial statements.

*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 2003 and 2004, our cash disbursements for purchases of property, plant and equipment under our capital expenditure program totaled R\$641.3 million and R\$670.3 million, respectively. In 2005, we planned to invest approximately R\$758.0 million under our capital expenditure program, but effectively invested R\$660.4 million. In the period from 2006 through 2010, our capital expenditure program will require disbursements of approximately R\$4.8 billion, of which R\$976.0 million are already committed. We plan to invest approximately R\$960.0 million in 2006 and R\$960.0 million in 2007. As of June 30, 2006, we had invested R\$331.5 million under our capital expenditure program.

*Pension Plan Payments and Employee Benefits.* We have been making State-mandated special retirement and pension payments to certain former employees who were employed by our predecessor entities prior to May 1974. These special payments totaled R\$46.2 million in the period from January

through June 2006, R\$43.5 million in the period from January through June, 2005, R\$96.4 million in 2005, R\$85.3 million in 2004 and R\$87.1 million in 2003. The State is required to reimburse us for these amounts, but has not been paying us on a timely basis. The State's obligation to us for these amounts is recorded under receivables from shareholder on the balance sheet and totaled R\$719.0 million as of June 30, 2006. As of December 31, 2005, 2004 and 2003 these receivables had reached R\$672.7 million, R\$576.3 million and R\$491.0 million, respectively, and they were reclassified to non-current assets in our financial statements. The special payments to former employees made by us are not reflected in our statement of operations, but nonetheless represent a significant component of our liquidity requirements. Although we have had discussions with the State regarding more timely reimbursement for the special payments to former employees, we cannot assure you as to when or whether such payments will be made by the State. We may continue to be held responsible for these special payments to former employees, irrespective of whether the State reimburses us or not. For further information on State-mandated special retirement and pension payments made by us to certain former employees, see "Related Party Transactions."

*Tax Financing Agreements.* We did not make payments in respect of certain Brazilian federal income tax and social contribution liabilities during the period from 1991 to mid-1996 mainly because we were contesting certain assessments by the federal tax authorities and, in the case of 1993 and 1994, because we did not have sufficient funds to meet all of our then existing liquidity and capital resources requirements. Under the *Programa de Recuperação Fiscal—REFIS* tax recovery program, we entered into an agreement with the Brazilian tax authorities regarding these tax obligations and have agreed to make payments on them in monthly installments ending in 2005. We were also required to pay interest on the unpaid balance of this tax liability. However, in July 2003, we included the amounts due under the REFIS program in the PAES program, which is an alternative payment plan for taxes owed. In accordance with this settlement agreement, we are paying amounts due, of approximately R\$317.0 million, in 120 monthly installments, from July 2003. See Note 11 to our audited annual financial statements and Note 10 to our unaudited interim financial statements. Payments in respect of this aggregate tax liability continue to constitute a liquidity and capital resource requirement that must be satisfied.

*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 to not less than 25% of the amounts available for distribution. The aggregate amount of distributions we made for 2005, 2004 and 2003 were R\$348.2 million, R\$152.9 million and R\$504.1 million, respectively. The aggregate amount of distributions we made for the six months ended June 30, 2006 was R\$129.6 million.

On April 28, 2005, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$38.2 million, to be paid within 60 days after our 2006 shareholders' meeting to shareholders of record as of May 9, 2005. On June 23, 2005, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$66.8 million, to be paid within 60 days after our 2006 shareholders' meeting to shareholders of record as of July 6, 2005. On October 20, 2005, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$85.2 million, to be paid within 60 days after our 2006 shareholders' meeting to shareholders of record as of November 3, 2005. On December 15, 2005, our board of directors approved the payment of dividends in the form of interest on shareholders' equity in the amount of R\$158.1 million, to be paid within 60 days of our 2006 shareholders' meeting to shareholders of record as of December 28, 2005. Payments of interest on shareholders' equity declared in 2005 began on June 27, 2006.

On April 20, 2006, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$129.6 million, to be paid within 60 days after our 2007 shareholders meeting to shareholders of record as of May 3, 2006.

As of June 30, 2006, our dividends payable to the State, due from 2004 through 2005, were in the amount of R\$260.2 million, with an additional R\$65.1 million related to 2006 due beginning in June 2007. We are currently unable to determine the amount, if any, of the 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.

### **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, dated 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 the 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; and
- 50% of retained earnings.

Distribution of interest on our shareholders' equity is a tax-deductible expense, for both income tax and social contribution purposes. The amount paid to shareholders as interest on shareholders' equity, net of any withholding tax, may be included as part of any mandatory dividend. We are required to pay a mandatory dividend of not less than 25% of our net income, subject to some exceptions and adjustments.

For tax purposes, payments of interest on shareholders' equity are recognized when the payments are declared, not when they are paid, within 60 days of the following general shareholders' meeting. In April, May and November 2003 and January 2004, we declared interest on shareholders' equity to be paid after our 2004 general shareholders' meeting. In February and December 2004 and January 2005, we declared interest on shareholders' equity to be paid within 60 days after our 2005 general shareholders' meeting. In April, June, October and December 2005, we declared interest on shareholders' equity to be paid within 60 days after our 2006 general shareholders' meeting. In April 2006, we declared interest on shareholders' equity in the amount of R\$129.6 million, to be paid within 60 days after our 2007 general shareholders' meeting.

Interest on shareholders' equity is recorded as part of, but is immediately reversed under, the financial expenses line item in our statement of operations. The tax deduction relating to distributions of interest on shareholders' equity is reflected under the income tax and social contribution line items in our statement of operations. This tax benefit consequently contributes positively to net income in our statement of operations.

### **Off-Balance Sheet Obligations**

We had no off-balance sheet obligations as of June 30, 2006 nor as of December 31, 2005, 2004 and 2003.

### **U.S. GAAP Reconciliation**

Our net income in accordance with the Brazilian Corporate Law Method was R\$833.3 million in 2003, R\$513.0 million in 2004 and R\$865.6 in 2005. Under U.S. GAAP, we would have reported net income of R\$642.6 million in 2003, R\$417.5 million in 2004 and R\$791.2 in 2005.

Our shareholders' equity in accordance with the Brazilian Corporate Law Method totaled R\$7,576.9 million as of December 31, 2003, R\$7,951.6 million as of December 31, 2004 and R\$8,482.5 million as of December 31, 2005. Under U.S. GAAP, we would have reported shareholders' equity of R\$6,085.6 million as of December 31, 2003, R\$6,364.8 million as of December 31, 2004 and R\$6,821.4 million as of December 2005.

The principal differences between the Brazilian Corporate Law Method and U.S. GAAP that affect our net income in 2003, 2004 and 2005, as well as shareholders' equity as of December 31, 2003, 2004 and 2005, relate to the treatment of the following items:

- additional inflation restatements and related depreciation which would be mandated by U.S. GAAP (but which are not permitted under the Brazilian Corporate Law Method) for 1996 and 1997 in recognition of Brazil's status as a highly inflationary country in those years;
- revaluations of property, plant and equipment recorded in 1990 and 1991 under the Brazilian Corporate Law Method, which would be reversed and partially replaced by supplemental inflation restatements based upon a general price index (IGP-M) for periods prior to 1990 under U.S. GAAP;
- pension plan (Plan G0) payments and other employee benefits for former employees of our predecessor companies which are obligations of the State and which are not treated as our expenses under the Brazilian Corporate Law Method, but which would be required to be treated as our expense on an actuarial basis under U.S. GAAP;
- pension plan (Plan G1) expenses which, through December 31, 2001, were recognized on an accrual basis only to the extent of required contributions for the relevant year or financial period under the Brazilian Corporate Law Method, but which would be required to be fully recorded on an actuarial basis under U.S. GAAP. Since January 1, 2002 under the Brazilian Corporate Law Method, recognition on an actuarial basis is required. There are some differences as compared with U.S. GAAP, basically regarding the calculation method, amortization period and recognition rules, resulting in different pension cost obligation; and
- additional accounting items, including, among others, capitalized interest, expensing of deferred charges, deferral of certain debt issue costs, and related deferred taxes.

See Note 22 to our audited annual financial statements for a description of these differences as they relate to us and a reconciliation of net income and total shareholders' equity from the Brazilian Corporate Law Method to U.S. GAAP.

## BUSINESS

### Overview

We believe we are one of the largest water and sewage service providers in the world based on population served in 2005. We operate water and sewage systems in the State of São Paulo, in which the City of São Paulo, Brazil's largest city, is located. According to the IBGE, the State of São Paulo is Brazil's most populous and economically productive state. As of March 2, 2006, we are authorized to provide water and sewage services outside the State of São Paulo, including in other countries, either directly or through national or international consortia. We may also have equity participations in other state or mixed-capital companies, and establish subsidiaries.

For the six months ended June 30, 2006, we recorded net revenue from sales and services of R\$2,658.0 million (US\$1,228.1 million) and net income of R\$503.5 million (US\$232.6 million). For the same period in 2005, we recorded net revenue from sales and services of R\$2,390.0 million (US\$1,104.3 million) and net income of R\$487.1 million (US\$225.1 million). Our Adjusted EBITDA increased to R\$1,286.5 million (US\$594.4 million) for the six months ended June 30, 2006 from R\$1,119.4 million (US\$517.2 million) for the same period in 2005. As of June 30, 2006 and 2005, we had total assets of R\$17,716.2 million (US\$8,185.6 million) and R\$17,787.1 million (US\$8,218.4 million), respectively, and shareholders' equity of R\$8,878.4 million (US\$4,102.2 million) and R\$8,341.2 million (US\$3,854.0 million), respectively. For the years ended December 31, 2005, 2004 and 2003, we recorded net revenue from sales and services of R\$4,953.4 million (US\$2,288.7 million), R\$4,397.1 million (US\$2,031.6 million) and R\$4,130.8 million (US\$1,908.6 million), respectively, and net income of R\$865.6 million (US\$399.9 million), R\$513.0 million (US\$237.0 million) and R\$833.3 million (US\$385.0 million), respectively. Our Adjusted EBITDA also increased to R\$2,285.6 million in the year ended December 31, 2005 from R\$2,076.5 million in the year ended December 31, 2003. As of December 31, 2005, 2004 and 2003, we had total assets of R\$17,435.2 million (US\$8,055.8 million), R\$16,783.8 million (US\$7,754.8 million) and R\$16,590.1 million (US\$7,665.3 million), respectively, and shareholders' equity of R\$8,482.5 million (US\$3,919.3 million), R\$7,951.6 million (US\$3,674.0 million) and R\$7,576.9 million (US\$3,500.9 million), respectively.

We provide water and sewage services to a broad range of residential, commercial, industrial and governmental customers in 367 of the 645 municipalities in the State of São Paulo, including the City of São Paulo. We also supply water on a wholesale basis to six municipalities in the São Paulo Metropolitan Region in which we do not operate water systems. Until December 2002, we divided our service territories into three regions: the São Paulo Metropolitan Region, the Interior Region and the Coastal Region. During 2003, we reorganized our corporate management structure by consolidating the municipalities which we serve in the interior and coastal regions into a single management unit we call "Regional Systems." Under this new structure, for the six months ended June 30, 2006, the São Paulo Metropolitan Region (including the municipalities to which we provide water on a wholesale basis) and the Regional Systems accounted for 75.6% and 24.4%, respectively, of our gross revenue from sales and services. For the year ended December 31, 2005, the São Paulo Metropolitan Region (including the municipalities to which we provide water on a wholesale basis) and the Regional Systems accounted for 75.5% and 24.5%, respectively, of our gross revenue from sales and services.

As of June 30, 2006, we provided water services to approximately 22.6 million people, approximately 60% of the urban population of the State of São Paulo, with a Water Coverage Ratio of 100%, through approximately 59,480 kilometers of water pipes and mains to more than 6.5 million water connections. As of June 30, 2006, we provided sewage services to approximately 18.4 million people, with a Sewage Coverage Ratio of 78%, through 38,669 kilometers of sewer lines to approximately 4.9 million sewage connections. In addition, we sold water on a wholesale basis to six municipalities with a total estimated population of approximately 3.2 million.

We have the power to adjust our tariffs and, historically, we have done it once a year, usually in the month of August, for a period of at least 12 months. We increased our tariffs for water and sewage services by 9.0% on August 31, 2005 and by 6.71% on August 31, 2006.

The State of São Paulo, our controlling shareholder, is required by our by-laws and State law to own at least 50% plus one of our common (voting) shares. As of June 30, 2006, the State of São Paulo currently owned 50.3% of our outstanding common shares. As a state-controlled company, we are an integral part of the governmental structure of the State of São Paulo. Our strategy and major policy decisions are formulated in conjunction with the Energy, Water Resources and Sanitation Secretariat of the State of São Paulo (*Secretaria Estadual de Energia, Recursos Hídricos e Saneamento*) as part of the overall strategic planning for the State of São Paulo. The majority of the members of our board of directors and our board of executive officers are appointed by the State Council for Protection of Capital of the State of São Paulo (*Conselho de Defesa de Capitais do Estado de São Paulo*—CODEC), a State agency presided over by the Secretary of the State Treasury and reporting directly to the Governor.

In addition, our capital expenditure budget is subject to approval by the legislature of the State of São Paulo and is approved in conjunction with the budget of the Energy, Water Resources and Sanitation Secretariat and of the State of São Paulo as a whole. However, the Governor of the State of São Paulo has the power to modify our capital expenditure budget after it has been approved. Our financial statements and accounting records are subject to review by the State Accounts Tribunal (*Tribunal de Contas*), as are all accounts of the State of São Paulo.

## **Our Strengths**

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

*Well-established business with significant size and scale.* We believe we are one of the largest water and sewage service providers in the world based on population served in 2005. We are the sole provider of water and/or sewage services in our areas of operation. We provide water services directly and through other public companies to approximately 25.8 million people (including the municipalities to which we provide water services on a wholesale basis), having a Water Coverage Ratio of 100% as of June 30, 2006, and sewage services to approximately 18.4 million people, having a Sewage Coverage Ratio of 78% as of June 30, 2006. From 2003 to 2005, our net revenue from sales and services has increased by an average of 19.9% per year and our net income has increased by an average of 3.9% per year. During the six months ended June 30, 2006, our net revenue from sales and services increased by 11.2% as compared to the six months ended June 30, 2005, and our net income increased by 3.4%.

*Operations in Brazil's most populous and wealthy state.* The State of São Paulo, part of the most developed and economically active region of Brazil, is the most populous state in Brazil, with an estimated population of 40.5 million as of June 30, 2006. The City of São Paulo had an estimated population of 10.8 million as of June 30, 2006, with 19.4 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\$494.8 billion in 2003, representing approximately 32% of Brazil's total GDP. The State of São Paulo generates more revenues from water and sewage services than any other Brazilian state.

*High-quality operations.* We believe that we adhere to high standards of service and utilize the best available technology in the sanitation business. Five of our water quality laboratories in the São Paulo Metropolitan Region and all of our ten laboratories in the Regional Systems have received ISO 9001/2000 certification and three in the Regional Systems have received ISO 17025 certification with respect to the quality of our management systems to respond to client needs and the technical ability of our laboratories to produce results. We believe our technology enhances the efficiency and quality of our operations.

*Access to low-cost and diverse sources of financing.* Strong cash flow generation from our operations and compliance with financial covenants place us in a privileged position in our industry to obtain low cost, long-term financing from Brazilian and international multilateral agencies and development banks. In addition, we are not dependent upon one or few sources of

financing. We benefit from various alternatives of funding available in the Brazilian and international markets for our working capital needs and our capital expenditure programs.

*Strong corporate governance practices.* In 2002, we joined the *Novo Mercado*, the highest corporate governance listing segment of the São Paulo Stock Exchange (*Bolsa de Valores de São Paulo – BOVESPA*). We are committed to maintaining certain corporate governance practices and disclosure requirements in addition to those already required under Brazilian law. These corporate governance practices require us to increase shareholders' rights and to enhance the quality of information provided to our shareholders.

*Expansion opportunities.* We had a Sewage Coverage Ratio of 78% as of June 30, 2006, and plan to increase this level to 86% by 2010 by adding over 1,080,000 sewage connections. Since January 1, 1997, we have obtained concessions for 33 additional municipalities (representing a total population of 2.2 million). In addition, there are municipalities in the State of São Paulo in which we currently do not operate water or sewage concessions or to which we currently supply water solely on a wholesale basis, which represent a total population of approximately 15.6 million. Our strong presence in the State and experience in providing water and sewage services place us in a privileged position to expand our Sewage Coverage Ratio in municipalities where we only provide water services and to expand our water and sewage services to municipalities where we are not yet operating, not only in the State of São Paulo but also in other states of Brazil and abroad.

## **Our Strategy**

Our mission is to make public sanitation services universally available in the State of São Paulo and to provide quality services in both the national and international markets. To this end, our strategic objectives are based upon the guiding principles of growth, quality, universalization of water services, social, economic and environmental sustainability, as well as our political and institutional relationships. We seek to implement these guiding principles through the following strategies:

*Continue to reduce operating costs and increase productivity and profitability.* We intend to continue our efforts to reduce operating costs and increase productivity and profitability. To this end, we plan to improve the management of our assets, as well as continue reducing our total salary and payroll expenses by decreasing the number of our employees, automating some of our operations, streamlining operational processes, implementing integrated planning and further investing in internal technological research and development. We are also continuing our efforts to improve our collection of overdue accounts receivable from municipalities to which we provide water on a wholesale basis, from the State and from other governmental entities. We are actively pursuing the overdue amounts and in some cases exploring opportunities to swap these amounts for rights and infrastructure to operate water and sewage systems.

*Ensure the quality and availability of our services in our existing service area.* Our goal is to maintain universal coverage of water services with a high standard of quality and availability. We intend to continue providing universal water services and meet population growth by adding 845,000 water connections by 2010 and to increase our Sewage Coverage Ratio to 86% by 2010. To ensure the quality and availability of our services, we also intend to improve customer relations by shortening response times for customer installations as well as through a focused public relations program to enhance our image. In addition, we are also developing short, medium and long-term marketing strategies, such as client segmentation and tailor-made solutions for each type of client, which we believe will help us increase our customer base.

*Maintain our existing concession base.* We intend to renew all of our existing concessions as they expire and have put together a task force to address concession expiration in a timely and effective manner. To this end, we are also seeking to develop closer relationships with the municipal governments that we serve to increase customer loyalty and thereby increase our revenues.



*Continue to expand our existing service area and obtain additional concessions.* Our goal is to expand sewage collection and treatment services. A significant portion of our capital expenditure program, which will require total expenditures of approximately R\$4.8 billion between 2006 and 2010, is designed to achieve this goal. We also regularly explore the possibility of obtaining additional water and sewage concessions in municipalities in the State of São Paulo in which we currently have no operations or to which we currently supply water solely on a wholesale basis, representing a total population of approximately 15.6 million. We evaluate possible expansion opportunities in terms of proximity to our existing service areas to maximize return on investment and improve our financial performance. We also intend to study, and take advantage of, opportunities in other Brazilian states and in other countries to expand our services and increase our market share.

*Set our tariffs to cover our costs of operations and to provide a return on investment.* We intend to continue periodically adjusting our tariffs for water and sewage services using a transparent formula which covers our operating costs and other expenses, accounts for inflation, and provides for return on investment. We generally adjust our tariffs once a year, usually in the month of August, for a period of at least 12 months. We increased our tariffs by 9.0% on August 31, 2005 and by 6.71% on August 31, 2006. To ensure proper adjustment of our tariffs and higher return on investment, we intend to structure our tariff structure to apply a formula which takes into account economic efficiency, future costs of operations and payment capacity of low-income families. We have also prepared a marketing strategy for the segmentation of our clients and of the market, taking into account specific characteristics and commercial potential, as well as proposals for improvement of our ability to segment our market and set appropriate tariffs for each segment.

*Continue to diversify sources of financing and reduce levels of indebtedness.* Our goal is to continue to secure funding from both public and private sources, in the Brazilian and international markets, and to restructure and refinance our indebtedness in order to reduce and diversify our debt exposure. In the six months ended June 30, 2006, we reduced our total indebtedness by 14.0%, to R\$6,420.5 million from R\$7,462.1 million during the same period in 2005 mainly through the repayment of the outstanding amount relating to our US\$275.0 million notes due 2005. In the same period, there was also a significant reduction in our foreign currency indebtedness of 36.2%, to R\$1,471.9 million from R\$2,307.0 million during the same period in 2005.

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

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

## **State of São Paulo**

The State of São Paulo is one of 26 states that, together with the Federal District of Brasília, constitute the Federative Republic of Brazil. The State of São Paulo is located in the southeastern region

of the country, which is, according to the IBGE, the most developed and economically active region of Brazil, and which includes the states of Minas Gerais, Espírito Santo and Rio de Janeiro. The State of São Paulo lies between the states of Rio de Janeiro and Minas Gerais to the North, the state of Paraná to the South, Mato Grosso do Sul to the West and the Atlantic Ocean to the East.

The State of São Paulo occupies 3.0% of Brazil's land mass and encompasses an area totaling approximately 96,000 square miles. According to the State of São Paulo Data System, the State of São Paulo had an estimated population of 40.5 million as of June 30, 2006.

As of June 30, 2006, the City of São Paulo, the State of São Paulo's capital, had an estimated population of 10.8 million, with 19.4 million inhabitants in the greater São Paulo Metropolitan Region. The São Paulo Metropolitan Region encompasses 39 cities and is the second largest metropolitan area in the Americas and among the four largest metropolitan areas in the world, according to the United Nations' World Urbanization Prospects, 1999 Revision. The São Paulo Metropolitan Region accounted for approximately 48% of the population of the State of São Paulo as of June 30, 2006.

According to the IBGE, in 2003, the most recent year for which this data is available, the GDP of the State of São Paulo was approximately R\$494.8 billion, representing approximately 32% of Brazil's total GDP, making it the largest economy of any state in Brazil, based on GDP. The State of São Paulo is the leading Brazilian state in terms of manufacturing and industrial activity, also according to the IBGE, with a strong position in car manufacturing, pharmaceuticals, computer production, steel making and plastics, among others, as well as the leading position in the banking and financial services industries. The State of São Paulo is the most important exporting state in Brazil, according to the Brazilian Ministry of Development, Industry and Foreign Trade (*Ministério do Desenvolvimento, Indústria e Comércio Exterior*).

## History

Until the end of the 19th century, water and sewage services in the State of São Paulo were generally provided by private companies. In 1877, the Province of São Paulo granted a concession for the provision of water and sewage services to *Companhia Cantareira de Água e Esgotos*. In 1893, the Government of the Province of São Paulo assumed responsibility for the provision of water and sewage services from the *Companhia Cantareira de Água e Esgotos* and formed the Office of Water and Sewers (*Repartição de Água e Esgotos*), a governmental agency. Since that time, water and sewage services in the São Paulo Metropolitan Region have been administered by the government of the State. Historically, water and sewage services in substantially all other municipalities of the State were administered by the municipalities directly either by municipal water and sewage departments or through *autarquias* of the municipal government. *Autarquias* are relatively autonomous public bodies with separate legal standing, assets and revenues, created by law to undertake administration of public services, which are considered to be better managed by a decentralized administrative and financial structure.

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

A major restructuring of the entities providing water and sewage services in the State of São Paulo occurred in 1968 with the creation of the *Companhia Metropolitana de Água de São Paulo*, or COMASP, whose purpose was to provide potable water wholesale for public consumption in the municipalities comprising 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 Sewage were transferred to COMASP. In 1970, the *Superintendência de Água e Esgoto da Capital*, or SAEC, was created by the government of the State to distribute water and collect sewage in the City of São Paulo. All assets previously owned by the Department of Water and Sewage in connection with such activities were transferred to SAEC. Also in 1970, the State created the *Companhia Metropolitana de Saneamento de São Paulo*, or SANESP, to provide sewage treatment services for the São Paulo

Metropolitan Region. All assets previously owned by the Department of Water and Sewage in connection with such activities were transferred to SANESP. The Department of Water and Sewage 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 Federal 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 Federal Government, which financed capital investments in, and assisted in the development of, state-controlled water and sewage companies. Since our formation, other State governmental and State-controlled companies involved in water supply and sewage collection and treatment in the State of São Paulo have been merged into us.

## **Corporate Organization**

During 2004, we reorganized our corporate management structure. As a result, we currently have six management divisions, each of which is supervised by one of our executive officers.

The allocation of responsibilities among the executive officers is made by the board of directors, in accordance with the by-laws and following receipt of an initial proposal from the Chief Executive Officer. The Chief Executive Officer is responsible for coordinating all management divisions in accordance with the policies and directives established by our board of directors and board of executive officers, performing the coordination, evaluation and control of all functions related to senior management, strategic planning, corporate organization, corporate communication, audit, ombudsman, new businesses and concession negotiation. The executive officers that are below the Chief Executive Officer are:

- the Corporate Management Officer, who is responsible for marketing, human resources and quality control programs, legal affairs, information technology, asset management, legal and procurement, and contracts.
- the Chief Financial Officer and Investor Relations Officer, who is responsible for financial planning, raising and allocating financial resources to all divisions within the Company, conducting capital markets and other debt transactions and managing debt levels, accounting, corporate governance and investor relations. This division also monitors and acts as controller for our other divisions.
- the Planning and Technology Officer, who is responsible for the integrated technical planning, environmental planning and management, technological development, management and control of water quality, strategic maintenance, integrated project management and coordination and execution of special projects.
- the Chief Operating Officer of the São Paulo Metropolitan Region Division, who is responsible for managing the distribution of water and collection of sewage for the São Paulo Metropolitan Region. The main function of the Chief Operating Officer of the São Paulo Metropolitan Region Division is planning, operating and maintaining the water and sewage systems and customer relation services in the metropolitan regions, the provision of wholesale water supply and sewage treatment, and the control of the financial and operational performance of its business units. The Chief Operating Officer of the São Paulo Metropolitan Region Division is also responsible for providing technical support to the autonomous municipalities, and intermediating and directly negotiating with local communities and municipalities in order to accommodate both the interests of the communities and our commercial interests.
- the Chief Operating Officer of the Regional Systems Division, who is responsible for managing the production of water and operation and maintenance of water and sewage

systems in municipalities in the Regional Systems. The Chief Operating Officer of the Regional Systems Division is also responsible for performing the same tasks as the Chief Operating Officer of the São Paulo Metropolitan Region for the Regional Systems Division.

## **Our Operations**

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

### ***Concessions***

Under the Brazilian Constitution, the authority to develop public water and sewage systems is shared by the states and municipalities, with the municipalities having primary responsibility for providing water and sewage services to their residents. The Constitution of the State of São Paulo provides that the State shall assure the correct operation, necessary expansion and efficient administration of water and sewage services in the State of São Paulo by a company under its control. Under applicable law, we are responsible for planning basic water and sewage services in the State of São Paulo, while respecting the autonomy of its municipalities. The municipalities are empowered to, and commonly do, grant long-term concessions to water and sewage companies to provide these services.

We provide water and sewage services to 325 municipalities in the State of São Paulo pursuant to concessions granted by the municipalities. Substantially all of these concessions have 30-year terms. As of June 30, 2006, 48 of our concessions have expired, all of which are under negotiation. Some of the expired concession contracts have been extended for a short term while we negotiate the terms and conditions of a final concession contract with each relevant municipality. Despite the expiration of the contracts, we continue to provide water and sewage services to all municipalities regardless of whether we have entered into concession contracts with them. From July 2006 through December 2006, 78 concessions will expire. During 2007, 28 concessions will expire and, from 2008 through 2010, 96 of our concessions will expire. The rest of our concessions will expire between 2011 and 2034. In February 2006, we created a new internal division to manage the renewal of expiring concessions. The main responsibility of this division, which reports directly to the Chief Executive Officer, is to maintain the existing concessions and acquire new ones.

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

- We assume all responsibility for providing water and sewage services in the municipality.
- We may determine and collect the tariffs for our services without prior authorization of the municipality.
- The assets comprising the existing municipal water and sewage systems are transferred from the municipality to us. Until 1998, we acquired municipal concessions and the existing water and sewage assets in exchange for our common shares issued at book value. Since 1998, we have acquired concessions and water and sewage assets by paying the municipality an amount equal to the present value of 30 years of estimated cash-flows, assuming at least a 12.0% discount factor to us, from the concession being acquired. Payment is made in cash.
- We are exempt from municipal taxes, and no royalty is payable to the municipality with respect to the concession.

- We are granted rights of way on municipal property for the installation of water pipes and mains and sewer lines.
- On termination of the concession, or upon cancellation for any reason, we are required to return the assets comprising the municipality's water and sewage system to the municipality and the municipality is required to pay us the non-amortized book value of our assets relating to the concession.

Under concession contracts executed prior to 1998, we were reimbursed for these assets through payment of either:

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

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

Following the enactment of the Concessions Law (Law No. 8,987/95) and of the Consortium Law (Law No. 11,107/05), all concession contracts had to be adapted to the new regime. This new regime gives municipalities a greater role and sets out more clearly the provision of services and the responsibilities of the parties. Therefore, all new concessions acquired by us and the new contracts to be executed after the expiration of the concessions will follow this new contract model. See "Government Regulation—Public Consortia Law."

Municipalities have the inherent power under Brazilian law to terminate concessions prior to their contractual expiration dates for reasons of public interest. The municipalities of Diadema and Mauá, two municipalities we previously served, terminated our concessions in February 1995 and December 1995, respectively. The municipality of Diadema terminated our concession after asserting that we did not provide adequate water and sewage services, while the municipality of Mauá did so with our consent. However, we currently serve both municipalities through the sale of water on a wholesale basis.

We currently do not anticipate that other municipalities will seek to terminate concessions due to our close relationship with municipal governments, recent improvements in the water and sewage services we provide and the obligation of the municipality to repay us for the return of the concession as described above. We cannot be certain, however, that other municipalities will not seek to terminate their concessions in the future.

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

We are also defendants in legal proceedings initiated by municipalities seeking to require us to exhibit documents and information in connection with our concessions. These legal proceedings involve the municipalities of Guariba, Ribeirão Pires, Itupeva and Monte Mor. For a detailed discussion of these proceedings, see "—Legal Proceedings—Other Legal Proceedings."

## **Operations in the São Paulo Metropolitan Region and in Other Metropolitan Regions**

We do not hold a formal concession to provide water and sewage services to the City of São Paulo, which accounts for 56.6% of our revenue, and to 40 other municipalities in the State of São Paulo. None of these other municipalities has a significant population, other than the municipality of Santos, which has a population exceeding 400,000. We believe that we have a vested and exclusive right to provide water and sewage services to the City of São Paulo and these other municipalities based, in some cases, upon a deed (*escritura pública*) and, also among other things, based on our ownership of the water and sewage systems serving the City of São Paulo and these other municipalities and certain succession rights resulting from the merger that formed us.

### **Wholesale Operations**

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

### **Description of Our Activities**

We provide basic sanitation services, which include the abstraction, treatment, processing and distribution of water, as well as the collection, removal and final disposal of sewage.

### **Water Operations**

Our supply of water to our customers generally involves abstraction of water from various sources, subsequent treatment and distribution to customers' premises. In the six months ended June 30, 2006, we produced approximately 1,445.5 million cubic meters of water. The São Paulo Metropolitan Region currently is, and has historically been, our core market, accounting for approximately 71% of water invoiced by volume in the six months ended June 30, 2006.

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

	Year ended December 31,			Six months ended June 30,	
	2003	2004	2005	2005	2006
<b>Produced</b>					
	(in millions of cubic meters)				
São Paulo Metropolitan Region .....	2,085.9	2,046.4	2,088.9	1,042.5	1,068.5
Regional Systems .....	733.8	724	741.2	373.3	375.9
<b>Total</b> .....	<u>2,819.6</u>	<u>2,770.5</u>	<u>2,830.1</u>	<u>1,415.8</u>	<u>1,444.5</u>
<b>Invoiced</b>					
São Paulo Metropolitan Region .....	932	954.5	997.8	491.8	512.8
Wholesale .....	346.2	251.4	258.7	128.2	130.2
Regional Systems .....	486.8	486.5	502.4	253.2	258.0
<b>Total</b> .....	<u>1,765.0</u>	<u>1,692.4</u>	<u>1,758.9</u>	<u>873.2</u>	<u>901.0</u>

The difference between the volume of water produced and the volume of water invoiced generally represents both physical and non-physical water loss. See “—Water Resources—Water Distribution” below. In addition, we do not invoice:

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

- water supplied for municipal uses such as firefighting;
- water consumed in our own facilities; and
- estimated water losses associated with water we supply to *favelas* (shantytowns).

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

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

	Year ended December 31,			Six months ended June 30,	
	2003	2004	2005	2005	2006
	(in millions of reais)				
São Paulo Metropolitan Region .....	3,268.8	3,456.8	4,044.2	1,937.1	2,176.9
Regional Systems .....	1,038.7	1,185.7	1,312.1	645.1	701.9
Total revenue from sales and services .....	4,307.5	4,642.5	5,356.3	2,582.2	2,878.8

### **Water Resources**

We can abstract water only to the extent permitted by the State Department of Water and Energy and pursuant to authorization contracts entered into with it. Under some circumstances, depending on the geographic location of the relevant river basin or reservoir, the approval of the National Water Agency (*Agência Nacional de Águas—ANA*) is also required. We currently abstract substantially all of our water supply from rivers and reservoirs, with a small portion being abstracted from groundwater. Our reservoirs are filled by impounding water from rivers and streams, by diverting flow from nearby rivers, or by a combination of these sources.

In order to supply water to the São Paulo Metropolitan Region, we rely on 17 reservoirs of non-treated water and 182 reservoirs of treated water, which are located in the areas under the influence of the eight water producing systems which comprise the interconnected water system of the São Paulo Metropolitan Region. Resource availability, or volume of water available at the source for public distribution in such areas, is 68.6 cubic meters per second and should increase to 72.0 cubic meters per second in 2006, when the planned extension and improvement in water sources will be concluded. Total current capacity, or volume of water that can be treated from the interconnected water system of the São Paulo Metropolitan Region, is 67.7 cubic meters per second and has been designed to reach 70.2 cubic meters per second in 2008. Average verified production or volume treated during the six months ended June 30, 2006 on the interconnected water system of the São Paulo Metropolitan Region was 66.9 cubic meters per second. The Cantareira, Guarapiranga and Alto Tietê systems, as a whole, supply approximately 84% of the water we produced for the São Paulo Metropolitan Region in the six months ended June 30, 2006.

The Cantareira system accounts for approximately 49% of the water that we provided to the São Paulo Metropolitan Region (including the municipalities to which we provide water on a wholesale basis) in the six months ended June 30, 2006, which represented 75.6% of our operating revenue for the six months ended June 30, 2006. The authorization (*outorga*) for the Cantareira system to use the water in the Piracicaba water basin was renewed on August 6, 2004 for a period of ten years.

With respect to water usage, federal and state agencies are authorized to collect charges from entities, such as us, for the abstraction of water from, or dumping of sewage into, water resources. Since

February 2004 we have been incurring expenses in connection with the use of water from the Paraíba do Sul River Basin and since January 2006 from the Piracicaba, Capivari and Jundiaí River Basin. Our tariff readjustment formula takes into consideration the variation of expenses considered as “non-administrable,” which these expenses fall under. We expect to continue to be able to pass on these expenses to our customers. However, we are uncertain as to the likely charges that may be assessed in connection with the abstraction of water from or the dumping of sewage into other water resources that we use, or whether we will be able to continue to pass on the cost of all of these charges to our customers. For more information on water usage regulation, see “Government Regulation—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> (in cubic meters per second)</b>
Cantareira .....	32.3
Guarapiranga .....	13.5
Alto Tietê .....	9.4
Rio Claro .....	4.7
Rio Grande (Billings reservoir) .....	3.8
Alto Cotia .....	1.0
Baixo Cotia .....	0.9
Ribeirão da Estiva .....	0.1
Total production rate .....	65.7

(1) Average of the twelve months ended June 30, 2006.

We own all of the reservoirs in our production systems other than the Guarapiranga and Billings reservoirs and a portion of some of the reservoirs of the Alto Tietê system, which is owned by other companies controlled by the State. We currently do not pay any charges with respect to the use of these reservoirs. In December 2001, we entered into an agreement with the State whereby the State, among other things, agreed to transfer the remaining reservoirs in the Alto Tietê system to us. However, the transfer of these reservoirs is currently being disputed and we are not certain whether this transfer will be legally allowed. See “—Legal Proceedings—Other Legal Proceedings.”

In the largest municipalities of the interior region, our principal source of water consists of surface water from nearby rivers. In the smaller municipalities of the interior region, we draw water primarily from wells. The coastal region is provided with water principally by surface water from rivers and mountain springs.

Statewide, we estimate that we are able to supply nearly all of the demand for water in all of the areas where we operate, subject to droughts and extraordinary climate events. In 2003, 2004, 2005 and in the six months ended June 30, 2006, we were able to meet the demand for water in the São Paulo Metropolitan Region, primarily as a result of our water conservation program, reductions in water loss, and the installation of 905,600 new water connections from 2000 through December 2004 and 158,300 new water connections in 2005 statewide. For the period from January 2006 through June 2006, we installed 77,200 new water connections.

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

In order to reach the final customer, the water is stored and transported through a complex and interconnected system comprising 1,075 km of water mains and 182 reservoirs. This water system



requires permanent operational supervision, engineering inspection, maintenance, quality monitoring and measurement control.

To ensure the continued provision of regular water supply in the São Paulo Metropolitan Region, we intend to invest R\$964.1 million from the years 2006 until 2010 to increase our water production and distribution capacities as well as to improve the water supply systems.

*Water Treatment.* We treat all water at our water treatment facilities prior to placing it into our water distribution network. We operate 200 treatment facilities, of which the eight largest, located in the São Paulo Metropolitan Region, account for approximately 72% of all water we produce. The type of treatment used depends on the nature of the source and quality of the untreated water. Water abstracted from rivers requires extensive treatment, while water drawn from groundwater sources requires less treatment. All water treated by us also receives fluoridation treatment.

*Water Distribution.* We distribute through our own networks of water pipes and mains, ranging in size from 2.5 meters to 100 millimeters in diameter. Storage tanks and pumping stations regulate the volume of water flowing through the networks to maintain adequate pressure and continuous water supply. As of June 30, 2006, our water network contained 59,480 kilometers of water pipes and mains and 6.5 million water connections. The following table sets forth the total number of kilometers of water pipes in our network for the periods indicated.

		As of December 31,			As of June 30,
	2003	2004	2005	2006	
Water distribution pipes and mains (kilometers) .....	56,777	57,321	58,000	59,480	
Number of connections (in thousands) .....	6,044	6,358	6,489	6,538	

Approximately 95.0% of the water pipes in our water distribution network are made of cast iron or polyvinylchloride (PVC). Distribution pipes at customers' residences typically are made from high-density polyethylene tubing. Our water mains are mostly made of steel, cast iron or concrete.

As of June 30, 2006, our water distribution pipes and mains included:

- 28,732 kilometers in the São Paulo Metropolitan Region; and
- 30,748 kilometers in the Regional Systems.

We have 314 storage tanks in the São Paulo Metropolitan Region with a total capacity of 1.8 million cubic meters, and 1,664 storage tanks in the Regional Systems. We have 139 treated water pumping stations in the São Paulo Metropolitan Region aqueduct system, including stations at treatment facilities, intermediate trunk transfer pumping stations and small booster stations serving local areas.

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

We expect that new customers will be responsible for covering part of the costs of connecting to our water distribution network. Our water connection policy is to pay for the cost of installation of up to 15 meters of pipe from our distribution network to the point of connection, with the remainder paid by the customer. Thereafter, the customer must cover the costs of connecting to the network from the customer's residence, including costs of purchasing and installing the water meter and related labor

costs. Industrial customers are responsible for the entire cost of connection. We perform the installation of the water meter and conduct periodical inspections and measurements. After completion of installation, the customer is responsible for the water meter.

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

	2006	2007	2008	2009	2010	2006- 2010
			(in thousands)			
São Paulo Metropolitan Region .....	75	80	80	80	75	390
Regional Systems .....	75	80	90	100	110	455
Total System .....	150	160	170	180	185	845

**Water Losses.** The difference between the amount of water produced and the amount of water invoiced generally represents both physical and non-physical water losses. Water loss percentage represents the quotient of (1) the difference between (a) the total amount of water produced by us (after excluding certain non-physical water losses set out below) less (b) the total amount of water invoiced by us to customers divided by (2) the total amount of water produced (after excluding certain non-physical water losses set out below) by us. We exclude the following from our calculation of water losses: (1) water discharged for periodic maintenance of water mains and water storage tanks; (2) water supplied for municipal uses such as firefighting; (3) water we consume in our facilities; and (4) estimated water losses associated with water we supply to *favelas* (shantytowns).

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

Using this calculation method, as of June 30, 2006, we experienced 619 liters/connections per day of water losses in the São Paulo Metropolitan Region and 354 liters/connections per day in the Regional Systems, averaging 513 liters/connections per day. We plan to reduce water losses in both regions to 480 liters/connections per day for the São Paulo Metropolitan Region and 294 liters/connections per day for the Regional Systems, which we expect will result in a total reduction to 414 liters/connections per day by 2009. According to the new calculation method, we experienced 513 liters/connections per day during the six months ended June 30, 2006, representing 32% water losses according to the old method. For the six months ended June 30, 2005, according to the old method, we experienced 33.4% water losses, equivalent to 537 liters/connections per day.

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

- reduction in the level of physical losses, which result mainly from leakage, primarily through the replacement and repair of water mains and pipes and installation of probing and other equipment, including strategically located pressure-regulating valves; and
- reduction of non-physical losses, which result primarily from the inaccuracy of our water meters installed at our customers' premises and at our water treatment facilities, and from clandestine and illegal use, through upgrading and replacing inaccurate water meters.

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

- the introduction of technically advanced valves to regulate water pressure throughout the water mains to correspond to downstream consumption needs each day. These valves

are programmed to respond automatically to variations in demand. During peak usage, the flow of water in the pipes is at its highest point; however, when demand decreases, pressure builds up in the water mains and the resulting stress on the network can cause significant water loss through cracks and an increase in ruptures of the pipes. The intelligent valves are equipped with probes programmed to feed data to the valve to reduce or increase pressure to the water mains as water usage fluctuates. As of June 30, 2006, we had installed 1,334 valves at strategic points in the network, with 834 valves installed in the São Paulo Metropolitan Region and 500 in the Regional Systems. We plan to install 122 additional valves through the end of 2006;

- the reconfiguration of interconnected water distribution to permit the distribution of water at lower pressure;
- the implementation of routine operational leak detection surveys in high water pressure areas in each case helping to reduce overall water losses;
- the monitoring of and improved accounting with respect to water connections, especially for large volume customers, regular checking on inactive customers and monitoring non-residential customers that are accounted for as residential customers and, therefore, are billed at a lower rate;
- fighting of fraud with the use of new, more sophisticated water meters that are more accurate and less prone to tampering;
- installation of water meters where none are present; and
- preventive maintenance of existing and newly installed water meters.

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

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

Water quality is monitored in all stages of the distribution process, including at the water sources, water treatment facilities and on the distribution network. We have 15 regional laboratories, one central laboratory, and laboratories located in all water treatment facilities that monitor water quality and purity as required by standards set by us and as required by law, which employ approximately 300 technicians, biologists, engineers and chemists. Our laboratories perform an average of 130,000 analyses per month on distributed water, with samples collected from residences. Our central laboratory located in the City of São Paulo is responsible for organic compound analysis using the chromatographic and spectrometric methods, as well as heavy metals analysis by atomic absorption technique. Five of our laboratories in the São Paulo Metropolitan Region and all of our laboratories in the Regional Systems have obtained ISO 9001/2000 certification and three of the Regional Systems have obtained ISO 17025 certification awarded by INMETRO with respect to the quality of our management systems and the technical ability of our laboratories to produce results.

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

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

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

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

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

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

### ***Sewage Operations***

We are responsible for the collection and removal of sewage through our sewage systems and for its subsequent disposal with or without prior treatment. As of June 30, 2006, we collected approximately 82% and 72% of all the sewage produced in the municipalities in which we operate in the São Paulo Metropolitan Region and the Regional Systems, respectively, accounting for approximately 78% of all the sewage produced in the municipalities in which we operated in the State of São Paulo during the six months ended June 30, 2006.

*Sewage System.* The function of our sewage system is to collect, remove and dispose of sewage. As of June 30, 2006, we were responsible for the operation and maintenance of 38,669 kilometers of sewer lines, of which approximately 19,502 kilometers are located in the São Paulo Metropolitan Region and 19,167 kilometers are located in the Regional Systems.

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

	As of December 31,			As of June 30,
	2003	2004	2005	2006
Sewage lines (kilometers) .....	35,759	36,435	37,181	38,669
Sewage connections (thousands) .....	4,462	4,747	4,878	4,938

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

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

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

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

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

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

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

	Projected New Sewage Connections					
	(in thousands)					
	2006	2007	2008	2009	2010	2006-2010
São Paulo Metropolitan Region .....	85	90	95	95	100	465
Regional Systems .....	70	85	160	210	90	615
Total .....	155	175	255	305	190	1,080

*Sewage Treatment and Disposal.* For the six months ended June 30, 2006, approximately 58% and 72% of the sewage we collected in the São Paulo Metropolitan Region and the Regional Systems respectively, or 62% of the sewage we collected in the State of São Paulo, was treated at our treatment facilities and afterwards discharged into receiving water bodies such as inland waters and the Atlantic Ocean, in accordance with applicable legislation. Our sewage treatment facilities have a finite capacity. Flows in excess of this capacity are discharged directly, untreated, to inland waters and the Atlantic Ocean. Currently we operate 433 sewage treatment facilities and eight ocean outfalls.

The purpose of sewage treatment is to reduce the polluting impact of the incoming sewage in order to comply with State Decree No. 8,468, and the CONAMA Resolution No. 357/05, which stipulates maximum concentrations of certain substances prior to discharge into the environment. Although the flow and composition of sewage arriving at sewage treatment facilities varies, on average more than 98.0% of its content is water. Our sewage treatment relies essentially on physical separation processes and on natural biological processes to break down organic matter and reduce the amount of harmful organisms and chemicals.

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

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

We operate 43 activated sewage treatment facilities, each of which also contains a primary treatment facility. The five largest activated sewage treatment facilities located in the São Paulo Metropolitan Region have treatment capacity of approximately 18 cubic meters of sewage per second.

Sewage treatment in the Regional Systems will vary according to the particularities of each area. In the interior region, treatment consists largely of aeration ponds where the organic matter is aerobically digested and the treated sewage is discharged to receiving waters. There are 350 secondary treatment facilities in the interior region which have treatment capacity of approximately 9.4 cubic meters of sewage per second.

The majority of sewage collected in the coastal region receives secondary treatment and disinfection and is then discharged into rivers and into the Atlantic Ocean. We have 65 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 several legal proceedings related to environmental matters. See “—Legal Proceedings.” In addition, our capital expenditure program includes projects to increase the amount of sewage that we treat. See “—Capital Expenditure Program” and “Government Regulation—Sewage Requirements.”

*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 the six months ended June 30, 2006, we produced approximately 28,223 tons of sludge-dry base, of which 2,434 tons were discharged into landfills and the remainder was used for agricultural purposes. In addition, we are testing new technologies for sludge disposal as fertilizer in forest projects, fuel development and concrete manufacturing.

## Customers

We currently operate water and sewage systems for 367 of the 645 municipalities in the State of São Paulo. The following table provides information regarding volumes of water and sewage invoiced, by type of customer, for the periods presented.

	Year ended December 31,						Six months ended June 30,			
	2003		2004		2005		2005		2006	
	Volume <sup>(1)</sup>	%	Volume <sup>(1)</sup>	%	Volume <sup>(1)</sup>	%	Volume <sup>(1)</sup>	%	Volume <sup>(1)</sup>	%
<b>Water</b>										
Residential .....	1,199.1	67.9	1,222.1	72.2	1,257.8	72.5	634.1	72.6	656.7	72.9
Commercial .....	142.5	8.1	142.4	8.4	145.3	8.3	72.1	8.3	73.8	8.2
Industrial .....	30.8	1.8	31.8	1.9	33.4	1.9	16.2	1.9	17.2	1.9
Governmental .....	46.4	2.6	44.7	2.6	45.7	2.6	22.6	2.5	23.1	2.6
Subtotal .....	1,418.8	80.4	1,441.0	85.1	1,500.2	85.3	745.0	85.3	707.8	85.6
Wholesale .....	346.2	19.6	251.4	14.9	258.7	14.7	128.2	14.7	130.2	14.4
<b>Total .....</b>	<b>1,765.0</b>	<b>100.0</b>	<b>1,692.4</b>	<b>100.0</b>	<b>1,758.9</b>	<b>100.0</b>	<b>873.2</b>	<b>100.0</b>	<b>901.0</b>	<b>100</b>
<b>Sewage</b>										
Residential .....	918.9	82.8	947.6	83.0	997.9	88.3	494.7	83.4	514.8	83.5
Commercial .....	125.6	11.3	127.4	11.2	131.9	11.0	65.2	11.0	67.2	10.9
Industrial .....	29.2	2.6	31.1	2.7	32.0	2.7	15.7	2.6	16.2	2.6
Governmental .....	36.0	3.3	35.3	3.1	36.4	3.0	17.9	3.0	18.4	3.0
<b>Total .....</b>	<b>1,109.7</b>	<b>100.0</b>	<b>1,141.4</b>	<b>100.0</b>	<b>1,198.2</b>	<b>100.0</b>	<b>593.5</b>	<b>100.0</b>	<b>616.6</b>	<b>100.0</b>

(1) In millions of cubic meters.

In addition to serving residential, commercial, industrial and governmental customers in municipalities in which we hold concessions, we provide wholesale water services to six municipalities having a total estimated population of 3.2 million. The State is our largest customer.

## Tariffs

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

Although we have the power to set our tariffs for water and sewage services, the State of São Paulo, our controlling shareholder, through its ownership of our common shares and control of our board of directors, may interfere in our tariff adjustment. For example, we did not increase tariffs in 2000 due to a State policy for the year of not increasing tariff rates for some public carriers, such as public transportation and water supply services.

The most recently implemented tariff regulations allow us to more aggressively set tariffs and to more realistically cover the operational costs of water and sewage systems. In addition, the new tariff regulations allow us to calculate the water and sewage service tariffs in order to better adapt the tariff value to the peculiarities of each service, the diversity of the regions covered and the social and economic conditions of the end-user.

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. We believe this tariff schedule will help prevent our commercial and industrial customers from switching to the use of private wells.

On August 29, 2003, we developed and implemented a new readjustment formula for our tariffs to better reflect changes in our cost structure. According to this new formula, the cost components of the Tariffs Readjustment Index, or IRT, are separated into two parts ("Part A" and "Part B"), where "Part A" encompasses all costs related to energy, to water and sewage treatment materials, to federal, state and local taxes, and to financial compensation due to use of water resources; and where "Part B" encompasses all other costs and expenses. The readjustment 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.

We establish separate tariff schedules for our services in each of the São Paulo Metropolitan Region and each of the interior 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 are higher tariffs than our costs of providing the 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 interior and coastal regions.

We divide tariffs into two categories: residential and non-residential. The residential category is subdivided into standard 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:

- commercial, industrial and public customers;
- "not-for-profit" entities that pay 50% of the prevailing non-residential tariff; and
- government entities that have entered into a water loss reduction agreement with us and pay 75% of the prevailing non-residential tariff.

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 interior region, sewage tariffs are approximately 20% 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 (1) customer category and class and (2) volume of water consumed charged during the years



and period stated in the São Paulo Metropolitan Region, which accounted for approximately 75.6% of our gross revenue from sales and services in the six months ended June 30, 2006.

Customer Category Consumption (in cubic meters per month)	2003	As of December 31,		As of August 31,
		2004	2005	
		(reais/cubic meter) <sup>(1)</sup>		2006
<b>Residential:</b>				
<b>Basic Residential:</b>				
0-10 <sup>(2)</sup> .....	0.96	1.03	1.12	1.19
11-20 .....	1.50	1.60	1.74	1.86
21-50 .....	3.75	4.00	4.36	4.65
Above 50 .....	4.13	4.41	4.81	5.13
<b>Social:</b>				
0-10 <sup>(2)</sup> .....	0.33	0.35	0.38	0.40
11-20 .....	0.57	0.61	0.66	0.70
21-30 .....	1.99	2.12	2.31	2.47
31-50 .....	2.84	3.03	3.30	3.52
Above 50 .....	3.14	3.35	3.65	3.89
Customer Category Consumption (in cubic meters per month)	2003	As of December 31,		As of August 31,
		2004	2005	
		(reais/cubic meter) <sup>(1)</sup>		2006
<b>Favela (shantytown):</b>				
0-10 <sup>(2)</sup> .....	0.25	0.27	0.29	0.31
11-20 .....	0.28	0.30	0.33	0.35
21-30 .....	0.94	1.00	1.09	1.16
31-50 .....	2.84	3.03	3.30	3.52
Above 50 .....	3.14	3.35	3.65	3.89
<b>Non-Residential:</b>				
<b>Commercial/Industrial/Governmental:</b>				
0-10 <sup>(2)</sup> .....	1.93	2.06	2.24	2.40
11-20 .....	3.75	4.00	4.36	4.65
21-50 .....	7.23	7.72	8.41	8.97
Above 50 .....	7.52	8.03	8.75	9.34
<b>Commercial/Not-for-profit entities:</b>				
0-10 <sup>(2)</sup> .....	0.96	1.03	1.12	1.20
11-20 .....	1.88	2.01	2.19	2.34
21-50 .....	3.62	3.87	4.22	4.50
Above 50 .....	3.76	4.01	4.37	4.66
<b>Government entities with reduction agreement:</b>				
0-10 <sup>(2)</sup> .....	1.45	1.54	1.68	1.80
11-20 .....	2.81	3.00	3.27	3.49
21-50 .....	5.42	5.79	6.31	6.73
Above 50 .....	5.64	6.02	6.56	7.00

(1) Water and sewage tariffs are the same per cubic meter.

(2) The minimum volume charged is for ten cubic meters per month.

In the six months ended June 30, 2006, the average tariff calculated for the Regional Systems was 25% below the average tariff of the São Paulo Metropolitan Region.

During mid-1999 until mid-2001, we did not raise our tariffs, due to a State policy of not increasing tariffs for some public services. In June 2001, we increased our average tariffs by approximately 13.1%, which was broadly in line with the prevailing inflation rates in Brazil since mid-1999, and in August 2002 we raised our tariffs by approximately 8.2%. Using a new readjustment formula approved by our board of directors, in August 2003 we raised our tariffs for water and sewage services by approximately 18.9%, and in August 2004 we raised our tariffs for water and sewage services by approximately 6.8%.

The application of the formula in 2005 would result in a tariff increase of 11.12%, part of which increase is attributable to the increase in the federal taxes. Because this increase was much higher than the accumulated inflation levels for the corresponding period, we decided to adjust the tariff by 9%, effective August 31, 2005. The remaining percentage (1.94%) was deferred to the 2006 tariff adjustment. On August 31, 2006, we increased our tariffs by 6.71%.

In 2004, we initiated certain studies for the restructuring of our tariffs. These studies include a study of our costs, taking into account economic efficiency, future costs of operation and payment capacity of low-income families. We have also prepared a marketing strategy for the segmentation of our

clients and of the market, taking into consideration specific characteristics and commercial potential as well as proposals for improvement of our tariff policies.

These studies were finalized in January 2006 and have been delivered to our board of executive officers and board of directors. The resulting recommendations are currently being detailed for implementation.

See “Government Regulation—Tariff Regulation of São Paulo” for additional information regarding our tariffs.

## **Billing Procedures**

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

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

Water and sewage bills can be paid at some banks and other locations in the State of São Paulo. These funds are paid over to us and average service fees between R\$0.32 and R\$1.15 per transaction are charged for collection and remittance of these payments.

Customers must pay their water and sewage bills by the due date if they wish to avoid paying a fine. We generally charge a penalty fee and interest on late bill payments. In 2003, 2004 and 2005, we received, respectively, payment of 90.9%, 94.1% and 90.8% of the amount billed to our retail customers, and 93.8%, 94.4% and 91.1% of the amount billed to those customers other than State entities, within 30 days after the due date. For the six months ended June 30, 2006, we received payment of 91.7% of the amount billed to our retail customers and 92.7% of the amount billed to those customers other than State entities, within 30 days after the due date. Substantially all of the amounts not paid within 30 days are owed by State customers. With respect to wholesale sales, in 2005 and in the six months ended June 30, 2006, we received payment of 60.6% and 62.6%, respectively, of the amount billed within 30 days.

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

## **Competition**

We believe there are at least two reasons behind a possible increase in our participation in the domestic sanitation market. There are 273 municipalities in the State of São Paulo that operate their own water and sewage systems and that collectively have a population of approximately 12.3 million, or approximately 30% of the population of the State of São Paulo, excluding the population of the municipalities to which we provide water services on a wholesale basis. In addition, there are private water companies which provide water and sewage services to a small number of municipalities in the State of São Paulo, which may indicate a potential opportunity for the increase of our market share.

In general, we do not face any competition in the municipalities in which we provide water and sewage services. However, governments of these municipalities may also compete with us, if they resume the water and sewage services that were granted to us and start providing these services directly to the local population. In this case, the municipal governments would be required to indemnify us for the unamortized portion of our investment. See “—Our Operations—Concessions.” In the past, municipal governments have terminated our concessions contracts before the expiration date. Also, municipal governments have tried to expropriate our assets in an attempt to resume the provision of water and sewage services to local populations. See “—Legal Proceedings.” We negotiate expired concession contracts and concession contracts to be expired with the municipalities in an attempt to maintain our existing areas of operations.

We face a limited level of competition with respect to the supply of water to large customers. Several large industrial customers located in municipalities served by us use their own wells to supply themselves with water. This use of private wells has been increasing in recent years. We have established new tariff schedules for commercial and industrial customers in order to help retain these customers. Additionally, we already face competition for the disposal of non-residential, commercial and industrial sludge in the São Paulo Metropolitan Region.

### Capital Expenditure Program

Our capital expenditure program is designed to improve and expand our water and sewage system and to increase and protect our water sources in order to meet the growing demand for water and sewage services in the State of São Paulo. Our capital expenditure program has four specific goals in the municipalities we serve: (1) to continue to meet the maximum demand for treated water; (2) to expand the percentage of households connected to our sewage system; (3) to increase the treatment of sewage collected; and (4) to increase operating efficiency and reduce water losses.

From 1998 through 2004, our capital expenditure program included capital expenditures totaling R\$4.8 billion in the aggregate, primarily to build up our infrastructure and for our program to reduce water losses. In 2003 and 2004, our cash disbursements for purchases of property, plant and equipment under our capital expenditure program totaled R\$641.3 million and R\$670.3 million, respectively. In 2005, we planned to invest approximately R\$758.0 million under our capital expenditure program, but effectively invested R\$660.4 million. For the period between 2006 and 2010, we have budgeted capital expenditures totaling approximately R\$4.8 billion in the aggregate. For the six months ended June 30, 2006 we invested in the aggregate R\$331.5 million.

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

	Planned Capital Expenditures					
	2006	2007	2008	2009	2010	2006-2010
	(in millions of reais)					
Water .....	331	346	339	339	339	1,693
Sewage .....	507	518	512	512	512	2,561
Others .....	122	96	109	109	109	546
<b>Total .....</b>	<b>960</b>	<b>960</b>	<b>960</b>	<b>960</b>	<b>960</b>	<b>4,800</b>

Our capital expenditure program from 2006 through 2010 will continue to focus on achieving our targets by making regular investments in and expanding our infrastructure as well as making investments in our program for the reduction of water losses throughout the 367 municipalities that we serve. The following is a description of four of the principal projects in our capital expenditure program.

### Metropolitan Water Program

Demand for our water services has grown steadily over the years in the São Paulo Metropolitan Region and has exceeded at times the capacities of our water systems there. As a result, prior to September 1998, certain of our customers in this region received water only on certain days of the week.

We refer to this as “rotation.” In order to remedy this situation, we implemented the Metropolitan Water Project to improve regular water supply to the entire São Paulo Metropolitan Region. This program was terminated in 2000, but we have maintained our investment projections for the São Paulo Metropolitan Region. In 2005, we invested R\$201.9 million in this region and for the six months ended June 30, 2006 we invested R\$72.5 million. We budgeted for capital expenditures of R\$964.1 million from 2006 through 2010.

### ***Tietê Project***

The Tietê River crosses the São Paulo Metropolitan Region and receives most of the region’s run-off and wastewater. The environmental status of the river reached a critical level in 1992. As a way of reversing the situation, the State of São Paulo created a recovery program to save the river. The Tietê Project is designed to reduce pollution of the Tietê River by installing sewage collection lines along the banks of the Tietê River and its tributaries. These lines collect untreated sewage and deliver it to our sewage treatment facilities. We completed the first phase of the program during the years of 1992 and 1998.

In connection with the first phase of the Tietê Project, in June 1998, we completed construction of three additional sewage treatment facilities and invested a total of US\$900.0 million, of which US\$450.0 million was financed by the Inter-American Development Bank and US\$450.0 million was funded by us. As of June 30, 2006, we owed US\$278.6 million to the Inter-American Development Bank for the financing it provided. For further information on the agreement entered into with the Inter-American Development Bank, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Capital Sources.” We now provide secondary treatment to approximately 60% 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 11 cubic meters of sewage per second. Currently, untreated sewage is delivered to our secondary treatment facilities along the Tietê River and the Tamanduateí River before treated sewage is discharged into those rivers. We plan to build additional collection lines to direct more untreated sewage to our treatment facilities.

We are currently in the second phase of the Tietê Project, for which we budgeted for additional capital expenditures of approximately US\$400.0 million from 2000 through 2007, US\$200.0 million of which is financed by the Inter-American Development Bank. We have also entered into a loan agreement and an on-lending agreement with BNDES for R\$60.0 million and R\$180.0 million, respectively, to finance this second phase. For the six months ended in June 30, 2006, we had spent R\$82.2 million on this phase of the Tietê Project.

As part of the second phase of the Tietê Project, we implemented the geographic information system named SIGNOS. SIGNOS is a management information system which automates and integrates various business processes, including project management, maintenance, operations and customer service and maps out our entire municipal infrastructure in the São Paulo Metropolitan Region. In addition, this phase included the undertaking of a project aimed at evaluating and potentially revising our current tariff structure in order to cover the systems operation and maintenance costs and appropriately remunerate current and future investments. This project is also financed by our loan with the Inter-American Development Bank.

### ***Regional Systems Investment Programs***

We currently have a number of projects in progress and planned for the Regional Systems, including projects relating to abstraction of water and collection, removal and final disposal of sewage. We spent R\$195.0 million, R\$212.0 million, R\$222.0 million and R\$141.9 million on these projects in 2003, 2004, 2005 and in the six months ended June 30, 2006, respectively, and we have budgeted for additional capital expenditures of approximately R\$1.7 billion from 2006 to 2010.

### ***Environmental Recovery Program for the Santos Metropolitan Region***

On August 6, 2004, we entered into a credit agreement with JBIC for the financing of the Environmental Recovery Program for the Santos Metropolitan Region, which was guaranteed by the Federative Republic of Brazil, for a total amount of R\$422.8 million. For further information on the agreement entered into with the JBIC, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Capital Sources.” The total investment to be made with respect to this project is R\$777.9 million and the balance will be our responsibility. The first disbursements under this agreement began in January 2006. The main goals of this program are to improve and expand the water and sewage systems in the municipalities comprising the Santos Metropolitan Region.

### **Research and Development**

Our policy is to invest continually in the modernization of equipment and in the technology needed to identify, evaluate and improve our provision of basic sanitation services while promoting environmental protection and maintaining our competitiveness and profitability. Our research and development function is divided into committees according to strategy and complexity. In 2004 and 2005, we have spent R\$4.2 million and R\$4.7 million, respectively, on research and development. We have also partnered with several research institutions.

### **Energy Consumption**

The use of energy is material to our operations, and as a result we are one of the largest users of energy in the State of São Paulo. We obtain energy primarily from *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.

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% of our energy requirements to the “free market” where we can more efficiently negotiate the supply of energy and improve energy efficiency. See “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

### **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. As of June 30, 2006, we owned 200 water treatment facilities and 59,480 kilometers of water pipes and mains, 441 sewage treatment facilities and 38,669 kilometers of sewer lines, as well as 16 water quality 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 PAES program. Three of our properties in the amount of R\$60.5 million were pledged as collateral for the financing granted by the International Bank for Reconstruction and Development.

As of June 30, 2006, the total net book value of our property, plant and equipment was R\$14,165.7 million, including concession assets acquired.

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

## Environmental Matters

Our water and sewage operations are subject to stringent Brazilian federal, state and local laws and regulations relating to the protection of the environment.

In the State of São Paulo, the Environmental Sanitation Technology Company (*Companhia de Tecnologia de Saneamento Ambiental*), or CETESB, is responsible for pollution control pursuant to State Law No. 997, of May 31, 1976. In particular, the construction and operation of water and sewage treatment facilities, as well as the release of effluents and final disposal of the sludge generated as a result of the water and sewage treatment process, must comply with environmental standards established by State environmental laws, such as State Decree No. 8,468, of September 8, 1976, as amended.

Non-compliance with environmental laws and regulations can lead to the imposition of criminal and administrative penalties, in addition to civil liability which may arise as a result of environmental damages. Pursuant to Federal Law No. 9,605, of February 12, 1998, individuals (including but not limited to the directors, officers and managers of legal entities) may be penalized with imprisonment or other restrictions on personal rights for violations of environmental rules and regulations, and legal entities may be penalized with fines, restrictions on rights, including, among other things, rights to be granted tax benefits and to enter into contracts with public entities, and mandatory rendering of services in the public benefit. At the administrative level, penalties range from warnings and fines to partial or total suspension of corporate activities, and may also include the forfeiture of, or restriction on, tax incentives, and the cancellation or interruption of participation in credit facilities granted by government banks, as well as a prohibition on contracting with entities of the public sector.

Our procedure for constructing and operating water and sewage facilities involves the mandatory compliance with environmental legal requirements. Firstly, for those projects which have a significant environmental impact, studies are prepared by independent experts who make recommendations on measures designed to minimize the environmental consequences of a project. The environmental impact report is then submitted to governmental authorities for analysis and approval. Once the environmental impact assessment is approved, the project goes through a three-stage licensing process, which includes the following licenses:

- Previous license – to define the exact location and scope of work;
- Installation license – to begin construction; and
- Operation license – to operate the facility.

In order to obtain the environmental licensing of those undertakings that have a significant environmental impact, environmental agencies may impose on us an obligation to establish a nature conservation area. In order to fulfill this obligation, we are required by environmental regulations to spend not less than 0.5% of the total cost of the relevant undertaking for that purpose. We also have a policy of implementing programs to encourage water conservation in order to minimize the environmental impact of our ongoing operations.

In order to improve our compliance with environmental regulations, since 1995, we have maintained a division responsible for developing environmental impact studies and programs. It is also our policy to implement water conservation programs in order to minimize the impact of our operations on our water supply. We believe that we are in material compliance with all relevant environmental laws and regulations.

Although our environmental compliance costs have not been substantial to date, we believe these costs will increase as water and sewage treatment capacity increases. The amount and timing of future expenditures required to comply with environmental laws and regulations could substantially increase in relation to current levels.

## Industrial and Intellectual Property

### 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: Reuse of the Water (*Reuso da Água*), Rational Use of the Water (*Uso Racional da Água*) and Tietê Project (*Projeto Tietê*). We have also filed applications with the INPI for registration of the trademarks “PURA—PROGRAMA DE USO RACIONAL DA ÁGUA” and “HORA H—SABESP,” “Universidade Empresarial SABESP,” “SIGNOS (*Sistema de Informação Geográfica no Saneamento*)” and “SCORPION” (a software to control operational measures, reduction in water losses and on-line information for water distribution and sewage collection), which are still under examination and are pending a final decision.

### Patents

We have a patent granted by INPI covering a differential pressure gauge with digital reading. We have also filed a patent application to cover an engine-powered starting system to automatically correct product dosage in conventional dispensers by gravity, and we have other pending applications at the INPI.

### Software

To manage our activities, we use software systems to manage our activities which we have acquired from vendors. 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” and “Electronic Price Quotation” (*Cotação Eletrônica de Preços*), and have secured registration of these programs at the INPI and the agency of trademarks. AQUALOG is the only Brazilian software designed to monitor water treatment. SGL (Bid Management System) is an electronic price quotation system that allows us to view and control all bid and acquisitions proceedings in real time.

### Employees

As of June 30, 2006, we had 17,289 full-time employees. During the six months ended June 30, 2006, we had an average of 297 trainees and 597 apprentices (*aprendizes*), as defined by Federal Law No. 10,097 of 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:

	As of December 31,			As of June 30,
	2003	2004	2005	2006
Total number of employees .....	18,546	17,735	17,448	17,289
<b>Number of employees by category of activity:</b>				
Projects and operations .....	11,287	11,474	11,450	11,371
Administration .....	3,850	2,997	2,812	2,790
Finance .....	894	621	614	604
Marketing .....	2,515	2,643	2,572	2,524
<b>Number of employees by corporate division:</b>				
Head office .....	1,351	1,257	2,029	2,023
São Paulo Metropolitan Region .....	9,642	9,055	8,046	7,922
Regional Systems .....	7,553	7,423	7,373	7,344

The average tenure of our employees is approximately 16 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 80% 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*—SINTAEMA, *Sindicato dos Trabalhadores da Região Urbana de Santos, São Vicente, Santos Metropolitan Region, Litoral Sul e Vale Ribeira*—SINTIUS, the *Sindicato dos Engenheiros do Estado de São Paulo*—SEESP and the *Sindicato dos Advogados de São Paulo*—SASP. Every year we negotiate collective bargaining agreements, which establish the level of compensation and other benefits of our employees.

Our most recent collective bargaining agreements, which became effective on May 1, 2006 and will expire on April 30, 2007, do not contemplate total job protection for our employees. However, we have a formal understanding with the unions that represent our employees that we would not dismiss more than 2.0% of our current employees before April 30, 2007.

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 December 1999, a five-day strike in January 2000, a four-day strike in June 2000, a one-day strike in September 2001, a two-day strike in November 2001, a two-day strike in June 2002, a two-day strike in May 2003, a two-day strike in May 2004, a two-day strike in June 2005 and a one-day strike in May 2006. Under Brazilian law, our non-administrative employees are considered “essential employees” and therefore are limited in their right to strike.

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

We have established a defined-benefit 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. Our contributions include the responsibility assumed relating to service prior to the constitution of SABESPREV, which is payable up to February 2011. We made contributions to the pension plan totaling R\$11.6 million in 2003, R\$10.3 million in 2004 and R\$11.3 million in 2005. For the six months ended June 30, 2006, we made contributions to the pension plan totaling R\$7.4 million. See Note 11 to our unaudited interim financial statements. Based on independent actuarial reports, as of December 31, 2005, our obligation under this plan was R\$329.8 million. See Note 12 to our audited annual financial statements.

In August 1996, we established a profit-sharing plan for all employees who have been employed for at least six months. In 1999, we did not pay any profit-sharing amounts to our employees due to State Decree No. 43,794, which prohibited any profit-sharing amounts to be paid in 1999 to employees of State-controlled companies, including us. 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. On October 2, 2000, we entered into a collective bargaining agreement with the unions that represent our employees, which established a new profit-sharing plan for all employees who have been employed for at least three months. Under the profit-sharing plan, we, after negotiations with the employee labor unions, set annual company-wide and business unit-specific operational and financial targets. Payments can be in an aggregate amount of up to the equivalent of our total payroll for one month and are made to the extent the targets are achieved. In the past, one-quarter of the profit-sharing payments was made to the extent that company-wide targets were satisfied, while the other three-quarters were made to the extent the business unit-specific targets were reached. The profit-sharing payments were reduced, on a pro rata basis, if the targets were not fully satisfied and payments were made semiannually. We recorded profit-sharing expenses of R\$40.0 million in respect of 2003, R\$40.3 million in respect of 2004, R\$44.3 million in respect of 2005 and R\$23.2 million in respect of the six months ended June 30, 2006. 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.



## **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 through public bids involving major Brazilian and international insurance companies in Brazil. As of June 30, 2006, we had paid a total aggregate amount of R\$4.9 million in premiums, covering approximately R\$643.7 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. We believe that we maintain insurance at levels customary in Brazil for the type of business in which we are engaged.

## **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 June 30, 2006, we estimated that these legal proceedings totaled approximately R\$2,504.3 million. 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 this total amount of contingencies, approximately R\$1,098.7 million relate to tariff-related legal proceedings and consumers claims, approximately R\$388.7 million relate to contractors claims, approximately R\$414.2 million relate to civil and tax proceedings, approximately R\$45.0 million relate to labor proceedings, approximately R\$544.2 million relate to civil public actions related to environmental matters and R\$13.6 million relate to other proceedings. On the same date, the provisions for legal contingencies totaled R\$628.3 million, of which approximately R\$283.2 million relate to tariff-related legal proceedings and consumers claims, approximately R\$198.1 million relate to contractors claims, approximately R\$93.6 million relate to civil and tax proceedings, approximately R\$30.2 million relate to labor proceedings and approximately R\$23.3 million relate to civil public actions related to environmental 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: (1) 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 (2) the calculation of the provisioned amounts, which is based on the value attributed to the lawsuits by the plaintiff and takes into account legal opinions of counsel in charge of each lawsuit. Once such methodology is applied, as a general rule, we make the provisions only for the lawsuits that are considered as probable loss.

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 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 does not suffice to pay the contingencies due, we could incur greater costs than those that were originally foreseen. If these costs are significant, our results of operations and financial condition could be negatively affected.

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

We are a party to civil public actions brought by municipalities that seek cessation of the collection of 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 systems 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*) as well as some non-governmental organizations through a number of environmental civil public actions: (1) aiming to enjoin us from releasing untreated sewage into certain local water courses; (2) in some cases seeking remedies for environmental damages, which have not yet been specified and evaluated by technical experts of the courts; and (3) aiming to require us to install and operate sewage treatment facilities in those locations. In each case, we are subject to daily fines for noncompliance therewith. We dispute these decisions to try to revert them. In our response to these lawsuits we emphasize that the installation and operation of sewage treatment facilities in those locations is included in our business plan and that the immediate cessation of the release of untreated sewage into the relevant local water courses would hinder us from collecting sewage – a primary necessity – in those locations, causing even more damages against the environment and public health. In most of these lawsuits, no final judicial decision has yet been reached by local judges. 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 to which we are party include the following:

(1) The Public Prosecution Office of the State of São Paulo has brought a civil public action before the São Bernardo do Campo Court (*5a. Vara Cível de São Bernardo do Campo*) seeking reparation for environmental damage caused by us dumping sludge from our water treatment facilities into certain receiving waters, the immediate cessation of this practice and the implementation of an environmental recovery project. The Court of Justice of the State of São Paulo (*Tribunal de Justiça do Estado de São Paulo*) ruled against us and ordered that we stop dumping sludge within a year from the date the decision is considered final, or to pay a daily penalty of R\$10,000, in addition to repair the environmental damage. This decision is not yet final. We are currently unable to evaluate the extent or cost of any remedy that we may be held responsible for in connection with this matter. We have not made any provisions for this proceeding.

(2) The Public Prosecution Office of the State of São Paulo brought a civil public action against us before the Paraguaçu Paulista Courts of Law (*1a. Vara de Paraguaçu Paulista*), which seeks reparation for and cessation of environmental damage allegedly caused by the release of raw sewage into the Alegre River, situated in the municipality of Paraguaçu Paulista. The court ruled against the Company in the first instance, requiring that we (a) cease the release of raw sewage into the Alegre River; (b) invest in a water and sewage treatment facility in the municipality of Paraguaçu Paulista; and (c) pay an administrative penalty in the amount of R\$116.9 million for environmental damages (the adjusted amount, as of June 30, 2006, was approximately R\$160 million). The decision imposes an additional daily penalty on us if we fail to comply with (a) and (b) above. We have appealed this decision and we have begun construction of projects necessary to enable our compliance with items (a) and (b), which we expect to be concluded by October 2007. As of June 30, 2006, we had not recorded any provisions for this legal proceeding as we considered the probability of loss relating to this matter not probable.

On September 21, 2006, the Court of Justice of the State of São Paulo ruled against our appeal. While we maintain our legal right to appeal the decision issued by the Court of Justice of the State of São Paulo, we are currently negotiating with the Public Prosecution Office of the State of São Paulo relating to the terms and conditions of a possible settlement agreement, which, if entered into, will result in the effective settlement and termination of this legal proceeding. While the exact amounts payable under any such settlement have not yet been quantified and the terms of any such settlement remain subject to further negotiation, our management believes that the total estimated disbursements will be considerably less than the aggregate amount of the administrative penalties required by the court's decision as described above.

Our management has not yet determined the amounts associated with this legal matter that will be reflected in our financial statements for the nine-month period ending September 30, 2006 (the "September Financial Statements"). In the event that we are unable to settle with the Public Prosecution Office of the State of São Paulo under the terms currently contemplated, our results of operations as reflected in our September Financial Statements may be materially adversely affected.

(3) A civil public action was brought against us by the Coordination Council for the Civil Entities of Piracicaba (*Conselho Coordenador das Entidades Cíveis de Piracicaba*) concerning the limits for water collection from the Piracicaba River and the operation of the Cantareira water distribution system. The plaintiff requests, among other things, a prohibitory injunction in order to restrict the amount of water we collect, the reduction of the Piracicaba River's collection limit and the payment of damages to the riparian cities in order to cover the direct and indirect environmental damages caused by the installation and operation of the Cantareira water distribution system. After our defense, the injunction was not granted, and this action is now awaiting judgment by the lower court. This proceeding is still at an initial stage and no amount has been determined so far for the alleged damage. We have not made any provisions for this proceeding.

(4) On February 25, 2003, a request for a preliminary injunction was filed against us, aiming at restricting us from disposing sewage without due treatment, in the municipality of Lutécia. The injunction was granted in order to determine that payments for water and sewage services by users be deposited with the court until we have made the necessary investment in the water and sewage system of the municipality, in addition to paying a daily fine in the amount equivalent to 1,000 minimum salaries (approximately R\$350,000) in the event we do not cease to discharge untreated sewage. The injunction was suspended at our request until a final ruling is issued. After submission of an expert report, the Public Prosecution Office of the State of São Paulo requested that we be sentenced to pay an amount of R\$82.8 million in addition to the daily fines. We and the Public Prosecution Office of the State of São Paulo are engaged in negotiations in order to settle this legal proceeding. We have not made any provisions for this proceeding.

### ***Labor Proceedings***

We are a party to numerous lawsuits and administrative proceedings involving SINTAEMA and current and former employees.

On January 9, 1990, SINTAEMA initiated a lawsuit against us, alleging that we had failed to pay certain employee benefits and were required to make a penalty payment to SINTAEMA under a then existing collective bargaining agreement. On July 31, 1992, the labor court issued a ruling against us, but did not award damages to SINTAEMA at that time. We and SINTAEMA are currently engaged in negotiations concerning the amount to be paid by us. We also filed a writ of mandamus seeking a court decision establishing that the penalty imposed against us, totaling approximately R\$5.6 million, is excessive since it exceeds the principal amount by a large margin. Our request was denied by the courts and the lawsuit is now awaiting a final decision at the Superior Labor Court (*Tribunal Superior do Trabalho*). We currently cannot predict the amount that we will be required to pay to SINTAEMA and we have not made any provisions for this proceeding.

We are defendants in 2,688 labor proceedings and in one civil public action initiated by and on behalf of some of our current and former employees relating to certain benefits awarded by Law No. 4,819, dated August 26, 1958. In all cases, we claim that the State, and not us, is responsible for the payments due to the plaintiffs. As of the date of this offering circular, we and the State have not agreed on the amounts to be reimbursed. The civil public action is now awaiting decision on the merits. Some labor and civil proceedings have been ruled upon by the lower courts, but no final decision has been issued in any of the legal proceedings as of the date of this offering circular. An injunction was granted by a lower court in the civil public action to compel us to pay the benefits awarded by Law No. 4,819 to all plaintiffs in that lawsuit.

As of June 30, 2006, the total amounts involved related to these proceedings were R\$63.9 million, and we had established a provision totaling R\$30.2 million with respect to potential damages in lawsuits and administrative proceedings involving present and former employees, including the lawsuits described in the preceding paragraphs, based on calculations made by our legal and human resources departments.

### ***Tax Proceedings***

We filed a claim in July 1999 to challenge the creation by the municipality of the City of São Paulo of a tax on the use of public areas. The tax would apply to our water and sewage mains and other installations located in public areas. Based on the advice of our internal legal counsel, we believe that this municipal tax is unlawful because it was established by a municipal decree instead of a municipal statute. We are currently disputing the creation of this tax and any related tax assessment. On May 11, 2000, the trial court of the State of São Paulo (*12a. Vara da Fazenda Pública do Estado de São Paulo*) issued a decision upholding this municipal tax. We have appealed the trial court decision to the Court of Justice of the State of São Paulo. A recently approved law enacted the tax on the use of public areas in the City of São Paulo. In April 2004, we filed a request for an injunction seeking the suspension of the tax assessment by the municipality. The injunction was granted by the lower court and later maintained in the decision issued by the lower courts. The municipality has appealed this decision to the Court of Justice of the State of São Paulo and the decision is still pending. We currently cannot estimate the potential increase in our expenses if we were required to pay this tax or if any future assessment of this tax is retroactive to 1999. To date, we have not established a provision for any potential expense arising from this municipal tax.

We also took legal action to challenge a City of São Paulo municipal law enacted in December 2002 that revoked our blanket exemption from municipal taxes. As a result of the loss of our exemption from municipal taxes, we may be subject to a tax on services charged at a rate of 5.0% on our gross revenue from water and sewage services. Our request for an injunction against the municipality was granted by the Court of Justice of the State of São Paulo, and this injunction was maintained after the filing of an appeal by the municipality. However, on May 5, 2005, the lower tax court issued a decision against us and revoked the injunction granted in our favor. We appealed the decision to maintain the effects of the injunction until a trial decision in this legal proceeding is issued, but our appeal was denied. To date, despite our efforts to obtain a decision from the Superior Court of Justice to maintain the effects of the injunction until a final judgment, we have not been able to revert the lower tax court decision. We intend to challenge the loss of the exemptions to the fullest extent permitted by law. This legal action, for which potential expenses amount to approximately R\$112.3 million, was assessed by our tax advisors as being a possible loss; accordingly, no provision has been recorded.

In November 2004, we took legal action against the municipality of Bragança Paulista against the imposition of a new charge 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 an injunction suspending the imposition of this charge and preventing the municipality from collecting any current or future amounts due in respect of this charge until there is a final decision on the merits. In June 2005, the lower court ruled in our favor and the injunction was maintained. The municipality appealed the decision and, as of the date of this offering circular, a trial decision was still pending. 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.

### ***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 parts 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 party to many lawsuits related to compensation awards. As of June 30, 2006, we estimated that we will be required to make payments totaling R\$280.2 million with respect to all

condemnation matters. After we make these payments, we will have ownership of the property, which will be recorded as our asset. Therefore, we have not made any provisions for this proceeding.

### ***Concession-Related Legal Proceedings***

In connection with discussions we had with the municipality of Presidente Prudente, we filed a claim against the municipality seeking a court decision determining a continuation of the concession agreement that we have with that municipality until the indemnification payment owed to us in connection with the return of water and sewage system of Presidente Prudente is made. The lower court issued a decision in our favor to the effect that we still continue to provide services in the municipality until the indemnification provided for in the concession agreement is paid to us.

On March 25, 2004, the Public Attorney's Office filed a civil action against the municipality of Itapira, its mayor, the Municipal House of Representatives and us, claiming that Municipal Law No. 3,593/04 is unconstitutional and seeking termination of the concession agreement we entered into with the municipality of Itapira. Although an injunction was granted, the Court of Justice of the State of São Paulo has stayed the injunction. On March 23, 2005, the House of Representatives of Itapira approved a decree revoking the concession agreement. In addition, Municipal Law No. 3,730/05 was enacted revoking an earlier law which authorized the municipality to enter into the concession agreement with us. The municipality of Itapira has further filed an action against us seeking to repossess the assets related to its water and sewage services and has obtained an injunction which was later confirmed by a court decision. We appealed against this ruling but we have not been able to suspend the effects of the decision until final judgment. Accordingly, we are currently not rendering water and sewage services at Itapira. As of the date of this offering circular, a trial decision on this litigation was pending. We have not made any provisions for this proceeding.

On October 10, 2003, the municipality of Monte Mor filed a lawsuit against us, seeking the additional issuance and delivery of shares by us, as consideration for our concession to render basic water and sewage services. The lawsuit was dismissed without judgment on the merits of the case, but it is still subject to appeal. We have not made any provisions for this proceeding.

The municipality of Sandovalina has brought a legal action against us seeking to (1) obtain the termination of the concession entered into with us and (2) obtain remedies for environmental damage and alleged losses caused to the municipality due to our failure to provide sewage treatment, as well as other damage caused to public property. We have responded with a counterclaim against the municipality for payment of R\$115,400 related to the supply of water from December 1999 to August 2003. We are also seeking the payment of a contractual indemnification based on the early termination of the contract. We are currently operating the water and sewage systems of Sandovalina, and the lawsuit is still in the fact-finding phase. We have not made any provisions for this proceeding.

We are also defendants in legal proceedings initiated by municipalities seeking to require us to produce documents and information in connection with our concessions. These legal proceedings include the following: (1) a preliminary proceeding (*ação cautelar*) started by the municipality of Guariba seeking a court order requiring us to produce documents in order to inform an account revision proceeding; (2) the municipality of Ribeirão Pires has proposed preliminary proceedings seeking the production of documents to inspect the services which we provide; (3) the municipalities of Itupeva and Monte Mor have proposed proceedings seeking to obtain a court order to require us to produce documents and information in order to evaluate the possibility of renewal of our concession agreement.

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

We are party to a number of proceedings with the Public Prosecution Office of the State of São Paulo and several municipalities which have contested our right to charge a tariff for sewage services provided as opposed to charging a fixed fee for these services. In most of these proceedings, we have received decisions in our favor. In addition, the Superior Court of Justice of Brazil (*Superior Tribunal de*

*Justiça*) has confirmed the understanding that we have the right to charge a tariff for the sewage services we provide.

Approximately 960 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 charged and collected and those tariffs. We have obtained final decisions both in favor and against us in these lawsuits and, as of June 30, 2006, we have established a provision in the amount of R\$283.2 million with respect to these lawsuits. We cannot predict, however, the amounts we would have to pay to these customers if they were to prevail in their lawsuits, nor can we provide assurance that new lawsuits will not be brought by other customers on similar grounds.

The Association of Distinguished Bars and Restaurants (*Associação de Bares e Restaurantes Diferenciados*—ABREDI), has initiated several lawsuits to challenge the 10.0% penalty fee we charge on late water and sewage payments. In several of these cases, lower 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 was granted against us and we appealed such decision. Notwithstanding these legal proceedings, we have reduced to 2.0% the penalty fee we charge on late bill payments by all of our customers.

### ***Contractors' Claims***

Certain contractors have filed claims against us alleging underpayment of inflation indexation adjustments and monetary losses incurred in connection with introduction of the *real*. Based on advice from our legal counsel, as of June 30, 2006, we established a provision for these claims in the amount of R\$198.1 million to meet probable losses arising from unfavorable decisions in these actions.

### ***Other Legal Proceedings***

We are a party to a series of lawsuits initiated by the municipality of Ferraz de Vasconcelos in 1997, seeking payment of penalties in the aggregate amount of R\$70.1 million, which we allegedly owe for damages caused during construction in the municipality. Several of these lawsuits have already been rejected by lower courts but are still subject to appeal. We have not made any provisions for these proceedings.

In December 1997, the municipality of Santos enacted a law expropriating our water and sewage systems in Santos. In response, we filed an action seeking an injunction against this expropriation, which was denied by the lower court. This decision was later reversed by the Court of Justice of the State of São Paulo, which issued a preliminary order suspending that law. On August 2, 2002, a decision on this matter was rendered in our favor by a lower court, but that decision remains subject to appeal. Despite the pending lawsuit, we continue to provide water and sewage services to Santos.

We are a party to several administrative proceedings with the Environmental Sanitation Technology Company (*Companhia de Tecnologia de Saneamento Ambiental*) seeking the imposition of penalties for environmental damages allegedly caused by us and other regulatory matters. We have not made any provisions for these proceedings.

On October 29, 2003, the Public Prosecution Office of the State of São Paulo on behalf of the people of the State of São Paulo, brought a civil public action in a trial court of the State of São Paulo (12a. *Vara da Fazenda Pública do Estado de São Paulo*) alleging that a transfer to us of ownership of the Alto Tietê System reservoirs from the State Department of Water and Energy 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. In response, we filed an appeal which is pending final decision.

In December 1996, we filed a claim to collect payment due from the municipality of Diadema. In December 2005, the Court of Justice of the State of São Paulo ruled in our favor. This legal proceeding was followed by several other related legal proceedings, some of which are currently pending. A civil public action and an annulment action have been decided in our favor.

We entered into a settlement agreement with the municipality of Mauá at the time the concession was terminated in which Mauá agreed to make the payments owed to us in connection with the return of water and sewage systems. However, to date Mauá has not yet made any payments to us under the settlement agreement. We filed a claim against Mauá in December 1996 and a decision was issued in February 2005 by the lower court requiring Mauá to pay us the amount of R\$153.2 million. The municipality of Mauá and SAMA—Saneamento Básico do Município de Mauá appealed this decision.

We are a party to a substantial number of other legal proceedings, in addition to the lawsuits and administrative proceedings discussed above, in the normal 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.

## GOVERNMENT REGULATION

In Brazil, water and sewage services, although not specifically regulated, are subject to extensive Brazilian federal, state and, in certain respects, local laws and regulations governing, among other things:

- the granting of concessions to provide water and sewage services;
- the implementation of public private partnerships;
- public bidding requirements for appointment of water and sewage service provider;
- water usage;
- water quality and environmental protection;
- tariffs for water and sewage services; 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 common 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 furnishing 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 furnish these services directly or through a concession granted to a third party.

### Pending Legislation

At the present time, there is no specific regulation related to sanitation services in Brazil. The Brazilian Federal Congress has, from time to time, discussed proposals for regulation to establish directives for basic sanitation services. Both the House of Representatives and the Senate in Brazil have agreed upon the creation of a joint committee (*comissão mista*) that will be responsible for the organization and systemization of the proposed regulation for water and sewage services in Brazil. Several bills are under debate at the Brazilian Federal Congress. Among these bills, as of the date of this offering circular, proposed federal regulation No. 219, or Proposed Law No. 219, has been agreed upon by the joint committee and approved by the Brazilian Senate and is currently being discussed at the Brazilian House of Representatives.

Proposed Law No. 219 establishes general guidelines for the sanitation services sector and aims at establishing standards and rules for the rendering of the sanitation services. According to such proposed law, among other things:

- water and sewage services may be rendered on a “regional” or municipal and state joint management basis;



- the entity responsible for providing sanitation services is not defined but a Complementary State Law may create common interest sanitation services;
- service for customers in default may be interrupted;
- a municipal, a state or a municipal-state fund to sustain the universalization of sanitation services or to be used for credit facility agreements may be created;
- we would be able to continue to render services until December 31, 2010 to the municipalities for which we do not hold concession agreements or for which the terms of these agreements have expired; and
- compensation for investments shall be paid to the concessionaire in four installments and by means of pledge on assets.

On May 23, 2005, a new proposed law, or Proposed Law No. 5,296, was submitted to the Brazilian House of Representatives. The proposed law does not define whether the entity responsible for sanitation services will be the state or the municipality, but divides sanitation services into two categories: "local interest" sanitation services and "integrated" sanitation services. Services in connection with the distribution of water and sewage collection will be attributed to the local interest, and thus the municipality will always be the entity responsible for those services. Other services, such as water treatment, may be also considered to be of local interest, if they are rendered to a single municipality; otherwise they will be considered to be of integrated interest. A state, however, might also be responsible for those services if it enacts a State complementary law which establishes metropolitan areas, urban agglomerations and micro-regions and includes those services in the category of common interest sanitation services to be planned, regulated, and controlled by that state.

According to Proposed Law No. 5,296, any entity responsible for sanitation services will be required to abide by guidelines relating to planning, regulating and controlling those services. If the entity responsible does not follow those guidelines, it will not be eligible for voluntary funds from the Federal Government. The provision of sanitary services, either in the local interest or the integrated interest, may be made by the responsible entity itself, by state companies created to provide that service, or indirectly by concession or an agreement between the responsible entity and any other state or private company. In any case, the entity responsible for the provision of the services will not be able to plan, regulate or fix tariffs.

Proposed Law No. 5,296 is being analyzed by the House of Representatives and has recently been attached to other proposed federal laws in connection with the regulation of sanitation services.

Additionally, Proposed Law No.155/2005 has also recently been submitted to the Brazilian Federal Congress. This proposed law, which has been under consideration by the Brazilian Senate since May 11, 2005, does not define whether the entity responsible for the sanitation services will be the state or the municipality, but it also divides sanitation services into two categories: "local interest" sanitation services and "common interest" sanitation services. According to the proposed law, the holder of the sanitation services will define the entity responsible for the regulation of those services, and will establish, among other things, investment plans and tariff policies. This proposed law also provides that the provision of sanitation services may be interrupted if the user of those services does not make timely payments.

We cannot assure you when or if any of the legislation described above will be adopted, the final form of these laws if they are approved, or how this legislation would affect our business.

## **Concessions**

Concessions for water and sewage services are evidenced by contracts between the state or municipal government, as the case may be, and a concession under which the concessionaire is granted the right to supply these services in a particular municipality or region. Our concessions usually have a contractual term of not longer than 30 years, although a number of our concessions are of unlimited duration. However, our concessions generally may be terminated at any time if certain quality and safety standards are not met or if there is a default under the concession contract. A majority of our concessions are automatically renewable, though we often renegotiate terms and conditions unless notice of termination is received by the non-rescinding party at least six months prior to the expiration date of the concession. A municipality that elects to take control of its water and sewage services must either provide such services itself, auction the concession to potential concessionaires through a competitive public bidding process, or enter into agreements with a public entity directly. Although the State Constitution provides that the relevant municipality would have to pay us the non-amortized book value of our assets relating to that concession and assume any related indebtedness, exclusive of any amounts paid to us by the relevant municipality upon any termination or non-renewal of a concession, such a termination payment may not be paid and any termination could adversely affect our cash flows, results of operations and financial condition. In addition, municipalities hold elections for the office of Mayor every four years. If certain municipalities choose not to renew their concessions, it could adversely affect our cash flows, results of operations and financial condition.

Federal legislation enacted in 1995, and subsequently amended, governs the granting of concessions in Brazil. The Federal Concessions Law regulates the granting of concessions by federal, state and municipal governments. In addition, the Federal Public Bidding Law sets forth the bidding procedures related to the granting of concessions. At the São Paulo State level, the State Concessions Law corresponds to the Federal Concessions Law, and the State Public Bidding Law corresponds to the Federal Public Bidding Law. In the event of any conflict between federal and state law, federal law prevails.

## **Concessions Laws**

The Federal Concessions Law and the State Concessions Law require that a concession granted by a public entity be based on a public bidding process. The Federal Public Bidding Law provides, however, that the public bidding process can be waived in certain circumstances, including in the case of services to be rendered by a public entity created for such specific purposes prior to the enactment of that law, *provided* that the prices for such services are compatible with those prevailing in the market. In addition, a provision of the Brazilian Constitution provides for waivers of the public bidding requirement in similar situations. Based on this provision, we were granted concessions by municipalities after enactment of the Brazilian Constitution without a public bidding process, although under current law we may be required to bid to acquire new concessions. We did not have any of our concessions cancelled or revoked following promulgation of the Federal Concessions Law. The requirements of the Federal and State Concessions Laws will, however, govern the grant of new concessions to us in the future. In February 1998, the Attorney General of the State, in response to a request we made, delivered an opinion that any municipality in the State of São Paulo may grant to us a concession to operate the municipality's water and sewage services without having to resort to a public bidding process. In April 1998, a State court issued a judgment substantially to the same effect. However, in 2005, the Superior Court of Justice declared void a concession agreement executed after the enactment of the Federal Concession Law, which was not preceded by a public bidding process. There can be no assurance that future decisions by the Brazilian courts will interpret the concessions laws to allow municipalities to grant concessions without a public bidding process.

The legislature of the City of São Paulo approved Law No.13,670 of November 25, 2003, which regulates Article 148 and the sole paragraph of Article 149 of the Organic Law of the Municipality of the City of São Paulo, concerning water supply and sewage public services, establishes the Municipal Regulation System of Water Supply and Sewage Public Services, creates the Regulatory Authority for Water and Sewage Services of São Paulo, addresses its organization and operation, and establishes the

Municipal Sanitation Plan. Pursuant to this Law, the Mayor of the City of São Paulo has authority to grant and monitor formal concessions for water and sewage services in the City of São Paulo. Following the enactment of Law No.13,670, the Governor of the State has filed a legal action alleging that this law is unconstitutional, as a result of which the enforcement of Law No.13,670 had been suspended. On April 20, 2005, the court ruled in favor of the governor of the State, by a majority of votes. The City of São Paulo appealed the decision and a final judgment was still pending as of the date of this offering circular.

### **Public Consortia Law**

On April 6, 2005, the Federal Government enacted Law No.11.107, which regulates Article 241 of the Brazilian Constitution. This new regulation provides general principles to be observed when public consortia enter 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. Considering the nature of the services rendered by us, it is possible that, in the future, we may have interest and/or opportunity to contract in a manner provided for in this newly enacted law in order to regulate the relationship with some municipalities to which it renders basic sanitation services.

On January 13, 2006, the Governor of the State of São Paulo enacted State Decree No. 50,470, which provides for the rendering of water and sewage services in the State of São Paulo. According to this Decree, we may enter into agreements with municipalities in connection with the provision of water and sewage services by means of the so-called program agreements. In addition, the Decree establishes that we will continue to render services in the areas where the concession is granted by the State.

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 ("CORSANPA") to provide the State of São Paulo with a more independent regulatory ability in relation to sanitation services. CORSANPA will be directly subordinated to the Secretary of Energy, Hydric Resources and Sanitation of the State of São Paulo.

CORSANPA's responsibilities will include, among other things: (1) the regulation and control of the sanitation services for which the State is responsible, including monitoring the progress of our performance and the progress of dispute resolution between Sabesp and Sabesp's customers, (2) the approval of agreements entered into between us and municipalities, and (3) carrying out studies for the creation of a regulatory agency for the sanitation sector and proposing legal and regulatory measures, as applicable. CORSANPA will also propose the terms of cooperation agreements between the State and municipalities to better regulate our relationship with the communities to which we currently provide services (or may intend to provide services in the future), but where the State has no granting authority.

### **Public-Private Partnerships**

The Public-Private Partnership ("PPP") is a form of contract with the public administration used for the concession of services only 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 enacted on May 19, 2004. PPPs may be used for: (1) implantation, expansion, improvement, reform, maintenance, or management of public infra-structure; (2) provision of public services; and (3) exploitation of public assets and non-material rights belonging to the State.

Payment is conditional upon performance. The payment may be collected through: (i) fares 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 — CPP. CPP may grant guarantees, enter into insurance contracts, and participate in PPP contracts.

## Public Bidding Procedures

Pursuant to the Federal Public Bidding Law, the public bid process commences with publication by the granting authority in the federal, state or municipal official gazette, as the case may be, and another leading Brazilian newspaper, of an announcement that it 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:

- the purpose, duration and goals of the bid;
- a description of the qualifications required for adequate performance of the services covered by the bid;
- the deadlines for the submission of bids;
- the criteria used for selection of the winning bidder; and
- 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

In July 2000, the National Water Agency, a federal agency under the Ministry of the Environment, was established to develop the National System for Water Resources Management. According to existing law, federal and state agencies 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 Managing (*Sistema Nacional de Gerenciamento de Recursos Hídricos*), as well as administrative costs regarding the bodies and entities pertaining thereto and they may be loaned or provided as grants or subsidies to governmental agencies and corporations, including us, for use in the development and maintenance of water resources.

The legislature of the State and the Federal Government enacted legislation under which we must pay charges to the Federal Government, the State or an agency in respect of the use of water from specified sources. Since February 2004 we have been incurring expenses in connection with the use of water from the Paraíba do Sul River Basin and since January 2006 from the Piracicaba, Capivari and Jundiaí River Basin.

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 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.

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 other 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 National Water Agency 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 State Department of Water and Energy is the public authority responsible for granting such authorizations. According to a report prepared in May 2001, the granting of rights for our water usage should be regulated in 391 of our projects.

Under state law, implementation of any project that involves the use of surface or underground water requires prior authorization or licensing from the competent government authority.

The State Department of Water and Energy has as its objectives establishing (1) a policy for the use of water resources with a view to developing the water business of the State, and (2) plans, studies and projects related to the integral use of water resources, directly or by means of agreements with third parties. The State Department of Water and Energy has established the standards which regulate abstraction of water from water resources in the State of São Paulo.

On December 29, 2005, State Law No.12,183 established the basis for the fees charged by governmental water agencies in the State of São Paulo for the abstraction of water from the State of São Paulo's water resources. The fees will be implemented gradually and a specific official register of users of water resources will be created. The proposed fees must be, in each case, approved by a decree from the State Governor, after the consideration by the State Department of Water and Energy. State Law No.12,183 also established that, until December 2009, the fees charged for the use of water resources by public or private water and sewage services providers will correspond to 50% of the fees charged for the

other users of water resources. Fines applied for the non-payment of the fees may vary from 2% of the debt to the suspension of the right of use of the water resources.

## **Water Quality**

An ordinance issued by the Ministry of Health (*Ministério da Saúde*) of the Federal Government sets forth the standards of potability of all water for human consumption in Brazil. This ordinance is modeled on the U.S. Safe Drinking Water Act and regulations promulgated by the U.S. Environmental Protection Agency thereunder. The Secretariat of Health (*Secretaria de Estado da Saúde*) of the State has also set minimum standards for the potability of water for human consumption which are more restrictive than the national rules and must be observed by us.

We analyze test samples at our laboratories to determine compliance with Ordinance No. 518 enacted on March 25, 2004, and state law using "Standard Methods" (181st Edition) procedures established by the American Water Works Association. A Presidential Decree enacted in 2005 determined that the disclosure of the water quality to consumers is mandatory.

## **Sewage Requirements**

State law sets forth regulations regarding pollution and protection of the environment in the State of São Paulo. The standards for disposal of industrial effluents set forth in this law broadly correspond to the standards for such disposal set by the U.S. Environmental Protection Agency. State law generally prohibits the discharge of pollutants into water, air or land in the State of São Paulo.

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 characteristics, which allow such effluents to be treated by our treatment facilities and discharged in an environmentally safe manner. Effluents which exceed such characteristics are prohibited from being discharged into the public sewage system. State law requires industries that produce industrial sewage to pre-treat such sewage so that maximum levels of certain parameters, such as pH, temperature, sediment, grease, oil and metals, are reduced to environmentally sound levels prior to release into our sewer lines.

Environmental Sanitation Technology Company (*Companhia de Tecnologia de Saneamento Ambiental*) or CETESB, a State-controlled company under the jurisdiction of the Secretariat of the Environment of the State, 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 operating Installation and Operation Licenses issued to sewage treatment facilities and other pollution sources. Although we have not received formal authorization from CETESB to discharge untreated sewage into waters, we continue to discharge such sewage. Our capital expenditure program includes the Tietê Project, which is designed to reduce the discharge of untreated sewage into the Tietê River, a major river in the São Paulo Metropolitan Region. CETESB participates in the development of this project. There can be no assurance that we will not be required in the future to obtain specific consents or authorizations for discharges of untreated sewage.

The disposal of sludge must also meet the requirements of State law. CETESB also regulates the discharge of effluents into bodies of water under State law and must approve all of our treatment facilities without prejudging whether we have complied with standards established by federal legislation.

State law also stipulates the basis for fees to be charged for discharging effluents into the State of São Paulo's water resources. Although neither the State nor its agencies currently assesses fees for the discharges, we cannot assure you that the fees will not be charged in the future.

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

### **Tariff Regulation of São Paulo**

The tariffs we set 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 have 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.

In determining tariffs, we may also consider the costs associated with the exploitation of water resources, depreciation, provision for bad debts, amortization of expenses and adequate remuneration for investments. We usually submit new tariffs to the Governor of the State for approval, although we are not required by law to do so. We implemented a new readjustment formula designed to better reflect costs in August 2003. See “Business—Tariffs.”

We maintain three different tariff schedules, depending upon whether a customer is located in the São Paulo Metropolitan Region or the interior or coastal regions comprising our Regional Systems. There are four levels of volume consumed for each category of customer. Customers are billed on a monthly basis. We are also authorized to enter into individual contracts with certain customers, such as municipalities, to sell water or sewage services on a wholesale basis.

Our tariff system also establishes criteria for billing and collection of services and for the publicity to be given to such criteria and tariffs. Tariffs are published in the Official Gazette of the State of São Paulo (*Diário Oficial do Estado de São Paulo*).

We may be subject to a federal law which, in the case of water and sewage services, provided pursuant to certain concessions, effectively prohibits tariffs that would produce a return on assets in excess of 12% per annum. Return on assets is calculated using operating income (before financial and certain other expenses) measured against operational assets (property, plant and equipment and certain other assets), based on our financial statements prepared in accordance with the Brazilian Corporate Law Method. We could be subject to the above return on assets limitation in adjusting tariffs because substantially all of our concessions were granted during the period in which these rate regulations were in effect. We are not, however, subject to such limitations in setting tariffs under our newer concessions. The above return on assets limitation does not apply to renewals of existing concessions.

In addition to the specific regulation mentioned above, we are also subject to general rules such as periodic readjustments established by Law 9,069/95 which established, among other things, the *Real Plan*.

### **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 issuer, 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 Inter-American Development Bank or the JBIC. 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 issuer. 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 Treasury Secretariat and the Central Bank, which, after reviewing the financial terms and conditions of the transaction, 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.

Finally, our external credit transactions are also subject to the prior approval of the Secretariat of Finance of the State.

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

The National Monetary Council resolutions limit the amount that Brazilian 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.

### **Conselho Estadual de Saneamento—Conesan**

State law regulates the provision of sanitation services and establishes rules for the planning of sanitation-related public works in the State of São Paulo. The State plan for public sanitation services must integrate institutional, technological, financial and administrative resources to ensure that a healthy environment is created for inhabitants of the State of São Paulo. The State plan must also assist in developing and organizing the sanitation sector in the State of São Paulo.



Pursuant to State law, the State's sanitation policy is implemented by the State Sanitation System (*Sistema Estadual de Saneamento*). The State Sanitation Fund (*Fundo Estadual de Saneamento*) collects funds and manages resources to fund the programs approved in the sanitation plan.

The State Sanitation Council (*Conselho Estadual de Saneamento*) must approve proposals related to the sanitation plan and prepare an annual report regarding environmental health issues confronting the State. The State Sanitation Council establishes protocols for the development of investment programs approved by the State Sanitation System and resolves disputes related to the State Sanitation System's implementation of the sanitation plan.

## MANAGEMENT

Under our by-laws and the Brazilian Corporate Law, we are managed by our board of directors (*Conselho de Administração*), which currently consists of ten 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 the board of directors and, therefore, our direction and future operations. Upon the election of a new Governor and any resulting change in the administration of the State, all or some of the members of the board of directors, including the chairman, have historically been replaced by designees of the new administration. The board of directors may in turn replace some or all of the executive officers.

### Board of Directors

Our by-laws provide for a minimum of five and a maximum of 11 directors. The members of our board of directors are elected at a general shareholders' meeting to serve renewable one-year terms. Each member of our board of directors must be one of our shareholders, under the Brazilian Corporate Law, and a resident of Brazil, under our by-laws. Pursuant to our by-laws, our employees have the option to elect one member of our board of directors, who must be an employee with more than two years of service to us. Currently, our employees have not elected a director. In addition, pursuant to the 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 27, 2006, except for Mr. Pallin, who was elected during an extraordinary shareholders' meeting held on June 19, 2006. The tenure of the directors will end upon the election of the new members at the general shareholders' meeting to be held in April 2007. Currently, we have four 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 current members of our board of directors and their respective positions:

Director	Position
Mauro Guilherme Jardim Arce .....	Chairman
Fernando Carvalho Braga .....	Vice-Chairman
Alexander Bialer .....	Independent Director*
Fernando Maida Dall'Acqua .....	Independent Director*
Gustavo de Sá e Silva .....	Independent Director*
Ademar Pereira .....	Director
Fernando Vasco Leça do Nascimento .....	Director
Mário Engler Pinto Junior .....	Director
Mônica Herman Salem Caggiano .....	Director
Farrer Jonathan Paul Lascelles Pallin .....	Independent Director*

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

### 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 (1) independence, (2) technical expertise, and (3) availability. The members may be appointed simultaneously as their appointment to the board of directors, or by later resolution of the board of directors. The members are responsible for all matters concerning accounting, internal accounting and audit.

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

At a board meeting held on June 26, 2006, the following members of the board of directors were elected to serve on our audit committee:

Director	Position
Farrer Jonathan Paul Lascelles Pallin .....	Coordinator and Financial Expert
Fernando Maida Dall'Acqua.....	Member
Mario Engler Pinto Junior.....	Member

## Board of Executive Officers

Our board of executive officers is composed of six executive officers appointed by our board of directors for renewable two-year terms. Our executive officers are responsible for all matters concerning our day-to-day management and operations.

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. Members of our board of executive officers have individual responsibilities established by our board of directors and our by-laws. The terms of all current members of our board of executive officers will expire in May 2007.

The following are the current members of our board of executive officers and their respective positions:

Executive Officer	Position
Dalmo do Valle Nogueira Filho .....	Chief Executive Officer
Reinaldo José Rodriguez de Campos .....	Corporate Management Officer
Rui de Britto Álvares Affonso .....	Chief Financial Officer and Investor Relations Officer
Paulo Massato Yoshimoto .....	Chief Operating Officer of the São Paulo Metropolitan Region Division
Enéas Oliveira de Siqueira .....	Chief Operating Officer of the Regional Systems Division
José Everaldo Vanzo .....	Planning and Technology Officer

## Biographical Information

The following is basic biographical information, including age, of each of the members of our board of directors and our board of executive officers.

*Mauro Guilherme Jardim Arce.* Mr. Arce has been the chairman of our board of directors since January 2002. Mr. Arce has also been Secretary of the Water Secretariat since January 2002 and, since February 1999, Secretary of the Energy, Water Resources and Sanitation Secretariat. These two Secretariats were combined in March 2003 and Mr. Arce became the Secretary of the Energy, Water Resources and Sanitation Secretariat, a position that he holds until this date. Mr. Arce was chief executive officer of Sabesp from November 2002 to May 2003. From January 1995 to February 1998, Mr. Arce was director of generation and transmission of energy at Companhia Energética de São Paulo—CESP. He was Adjunct Secretary of Energy Secretariat of the State of São Paulo from February 1998 to January 1999. He holds a bachelor's degree in electric engineering from Universidade Presbiteriana Mackenzie and a master's degree in electrical systems engineering at Pontifícia Universidade Católica do Rio de Janeiro. He has a master's degree in power engineering from the Rensselaer Polytechnic Institute in Troy, New York.

*Fernando Carvalho Braga.* Mr. Braga has been a member of our board of directors since July 2001 and vice-chairman of the board since April 2003. Currently, Mr. Braga is Secretary of Economy and

Planning of the State of São Paulo. Mr. Braga was a Special Advisor to the Governor of the State of São Paulo from January 2003 to March 2006. He was a special advisor for privatization to the Planning and Finance Secretariat of the State of São Paulo from 1995 to 2002. Mr. Braga is also a member of the board of directors of Banco Nossa Caixa S.A., Companhia Energética de São Paulo—CESP, Empresa Paulista de Planejamento Metropolitano—EMPLASA, Companhia Paulista de Parcerias—CPP, and of the Conselho de Defesa de Capitais—CODEC. He is also a member of the fiscal council of Drogasil S.A. Mr. Braga was the Executive Secretary of the State Privatization Program in the State of São Paulo from June 1996 to March 2006. He holds a degree in economics from Mackenzie University in São Paulo.

*Alexander Bialer.* Mr. Bialer has been a member of our board of directors since April 2003. He is also the chairman of the board of directors of GE Hydro Inepar, a member of the Advisory Board of GE Brasil Previdência, a member of the Consultant Board of Synergy Group, GE CELMA and TRAFIO, a member of the board of directors of AVIANCA, and member of the Superior Board of Strategy of Associação Brasileira de Desenvolvimento da Infraestrutura—ABDIB. He worked at GE Brasil from 1980 to 2002 in several positions. He worked at Avon from 1971 to 1973, at Máquinas Piratininga in 1974, and at ASEA from 1975 to 1980. He holds a degree in mechanical engineering from Instituto Tecnológico da Aeronáutica—ITA and a specialization in systems administration from the Business Administration School of Fundação Getúlio Vargas. Mr. Bialer is currently a consultant at Nucleon Engenharia.

*Fernando Vasco Leça do Nascimento.* Mr. Leça has been a member of our board of directors since March 2006. He is currently the chairman of the Fundação Memorial da América Latina. From 2003 to 2005, he was private secretary to Dr. Geraldo Alckmin, the São Paulo State Governor. In 2002, Mr. Leça was the State Secretary for Employment and Labor Relations. Mr. Leça was also head of SEBRAE/SP from 1999 to 2002, vice-chairman of Banco Nossa Caixa S.A. from 1995 to 1998, Deputy Minister of Treasury in São Paulo from 1993 to 1995. Mr. Leça is also a member of the board of directors of the Empresa Metropolitana de Águas e Energia S.A.—EMAE. He holds a law degree from the Faculdade de Direito de São Bernardo do Campo, with a master's degree from the Pontifícia Universidade Católica de São Paulo.

*Fernando Maida Dall'Acqua.* Mr. Dall'Acqua has been a member of our board of directors since September 1997. Mr. Dall'Acqua is also a member of the board of directors of Companhia Energética de São Paulo—CESP, Companhia de Transmissão de Energia Elétrica Paulista—CTEEP, Empresa Metropolitana de Águas e Energia S.A.—EMAE, Desenvolvimento Rodoviário S.A.—DERSA and Companhia Paulista de Obras e Serviços—CPOS. Mr. Dall'Acqua has been a professor at the Business Administration School of Fundação Getúlio Vargas since 1992. He was the Secretary of the Secretaria da Fazenda do Governo do Estado de São Paulo from 2001 to 2002. Mr. Dall'Acqua renders consultancy services to private companies, such as: Grupo Pão de Açúcar, Natura, Método Engenharia, Banco Bilbao Viscaya, Petroquímica Ipiranga and Estater Consultoria. Mr. Dall'Acqua has also done consulting work for the Inter-American Development Bank – IDB in relation to tax and foreign loan adjustments, and for the Federal Ministry of Planning in connection with port matters. He holds a degree in agronomy from Escola Superior de Agricultura Luis de Queiróz da Universidade de São Paulo, a master's degree in business administration/economics from the Business Administration School of Fundação Getúlio Vargas, and a Ph.D. in economics from the University of Wisconsin.

*Gustavo de Sá e Silva.* Mr. Sá e Silva has been a member of our board of directors since April 2001. Mr. Sá e Silva is a member of the board of directors of Companhia Energética de São Paulo—CESP and Empresa Metropolitana de Água e Energia S.A.—EMAE, a member of the Consultant Board of Fundação Antonio e Helena Zerrener and of the Board of Associação-ALUMNI. Mr. Sá e Silva is an Emeritus Professor and from 1954 to 1994 was a professor of the Marketing Department of the Business Administration School of Fundação Getúlio Vargas and a director of that school for four terms. He is currently an Advisor to the Getúlio Vargas Foundation's President. Mr. Sá e Silva holds a degree in economics and business administration from the Faculdade de Ciências Econômicas de São Paulo da Fundação Silvío Álvares Penteado. He has been named a professional manager by the Conselho Regional de Administração de São Paulo and holds a master's degree in business administration from Michigan State University.

*Ademar Pereira.* Mr. Pereira has been a member of our board of directors since April 2006. He was a director of the Faculdade de Direito da Universidade Presbiteriana Mackenzie, where he is currently the Head Professor of Commercial Law and Academic Dean. Mr. Pereira is a retired judge at the State of Mato Grosso do Sul. He has a master's degree in Political and Economic Law from the Universidade Presbiteriana Mackenzie and a Ph.D. in Law from the Universidade de Salamanca, Spain.

*Mário Engler Pinto Junior.* Mr. Engler has been a member of our board of directors since March 2006. Mr. Engler has been a Public Attorney for the State of São Paulo Public Attorney's Office since 1984, having been the Adjunct General Public Attorney from 2000 to 2003. As an Attorney of the State of São Paulo, Mr. Engler rendered legal advice to the State Privatization Program (Programa Estadual de Desestatização—PED) and to 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 board of directors of the Conselho de Defesa dos Capitais do Estado—CODEC (an institution responsible for the control and supervision of state-owned companies) since 2002, and he renders advice to the Secretariat of Treasury in relation to corporate finances. Mr. Engler is also a member of the board of directors of Companhia Paulista de Parcerias—CPP and of Companhia do Metropolitano de São Paulo—METRO. He holds a law degree from the Faculdade de Direito da Universidade de São Paulo, where he is currently a Commercial Law Ph.D. student.

*Mônica Herman Salem Caggiano.* Ms. Caggiano has been a member of our board of directors since April 2006. Ms. Caggiano is an Associate Professor of Constitutional Law at the Public Law Department of the Faculdade de Direito da Universidade de São Paulo and is responsible for the post-graduation program as Head Professor of Constitutional Law of the Universidade Presbiteriana Mackenzie. She teaches at the Post-Graduation Programme of Political and Economic Law. She is also co-ordinator of the Specialization Course in Entrepreneurial Law of the Universidade Presbiteriana Mackenzie and a member of the Departmental Board of the State Law Department of the Faculdade de Direito da Universidade de São Paulo. She is also a member of the Instituto Pimenta Bueno—Associação Internacional dos Constitucionalistas. She is Cultural Director of CEPES—Centro de Estudos Políticos e Sociais. In addition, she was Public Attorney of the municipality of São Paulo from 1972 to 1996, General Public Attorney for the municipality of São Paulo from 1994 to 1996, and Secretary of Legal Affairs of the municipality of São Paulo from 1995 to 1996. She was a member of the Municipal Committee for Accidents with Municipal Vehicles—COMUV and Chief Executive of the Office of the Deputy Governor of the State of São Paulo, from January 2003 to March 2006. She has been Special Assistant to the Governor of the State of São Paulo, since April 2006. She has a master's degree and a Ph.D. from, and is a Senior Assistant Professor at, the Faculdade de Direito da USP.

*Farrer Jonathan Paul Lascelles Pallin.* Mr. Pallin has been a member of our board of directors since June 2006. He is a chartered accountant in England and Wales and a Brazilian registered accountant. In 2004, he retired from PricewaterhouseCoopers, or PwC, where he had been a partner since 1977. At PwC he worked in the audit and management consulting departments, he was the partner responsible for corporate finance management consulting, and was also a member of the management team. From 1999 onwards, he was the partner responsible for operations in South America with responsibilities that included finance, infra-structure, technology and risk management. Throughout his career, he has been deeply involved in advising multi-national and national clients, in both private and public sectors, on mergers and acquisitions and corporate restructuring, including various privatization programs. Currently, he is the chairman of the fiscal council of Arcelor Brasil S.A., having chaired the fiscal council of Companhia Siderúrgica de Tubarão in 2005 and 2006. From 1991 to 2005, he was a director of the Hospital Samaritano, where he was the chairman from 1995 to 1999, and, between 1992 and 1994 he was chairman of the British Chamber of Commerce and Industry in Brazil and the Council of European Chambers of Commerce. He holds an MBA from the Cranfield Institute of Technology in England.

*Dalmo do Valle Nogueira Filho.* Mr. Nogueira Filho has been our chief executive officer since May 2003. He was the Secretary of the Strategic Management Secretariat of the State of São Paulo from January 2002 to December 2002. Mr. Nogueira Filho was a member of the board of directors of Sabesp from April 1999 to January 2002. Mr. Nogueira Filho has also been a member of the board of directors of

various companies controlled by the State of São Paulo. He was the Adjunct Secretary of the Strategic Management Secretariat of the State of São Paulo from January 1995 to January 2002. He holds a law degree from Universidade de São Paulo and he has been a professor at *Escola de Administração de Empresas de São Paulo* since 1972.

*Reinaldo José Rodriguez de Campos.* Mr. Campos has been our corporate management officer since November 2002. Mr. Campos worked at Companhia Energética de São Paulo—CESP in two periods: from 2001 to 2002 as director of administration, and from 1975 to 1999 in several positions, including director of generation and transmission of energy. He was a technical director at Companhia de Transmissão de Energia Elétrica Paulista—CTEEP in 1999 and worked as a consultant at Administradora de Serviços do Mercado Atacadista de Energia Elétrica—ASMAE from 1999 to 2001. Mr. Campos was a member of the board of directors of Operadora Nacional do Sistema Elétrico—ONS from 1998 to 1999. He held several positions at Companhia Paulista de Força e Luz—CPFL from 1968 to 1975. He holds a degree in electric engineering from the Universidade Presbiteriana Mackenzie in São Paulo.

*Rui de Britto Álvares Affonso.* Mr. Affonso has been our chief financial officer and investor relations officer since July 2003. He has been a professor at Instituto de Economia da Universidade Estadual de Campinas—UNICAMP since 1986, a professor at Faculdade de Economia e Administração—USP from 1983 to 1999, and a director of public economy at FUNDAP from 1994 to 2003. He also represents Brazil on the Board of the Forum of Federations (a non-governmental entity based in Canada) since 2000. Mr. Affonso has also held several positions at State Government. Mr. Affonso holds a degree in economics from the Universidade de São Paulo—USP, a master's and a Ph.D in economics from Universidade Estadual de Campinas—UNICAMP.

*Paulo Massato Yoshimoto.* Mr. Massato has been our metropolitan distribution officer since February 2004. Mr. Yoshimoto has been working at Sabesp 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 losses, and metropolitan planning and development departments. Mr. Yoshimoto has also held a number of different positions at the Empresa Metropolitana de Planejamento—EMPLASA, from 1975 to 1983. He holds a degree in civil engineering from Escola de Engenharia de Lins.

*Enéas Oliveira Siqueira.* Mr. Siqueira has been our regional systems officer since February 2004 and has worked for Sabesp since 1974. Mr. Siqueira has always worked in the sanitation area. His career began in 1974 as officer of the Serviço Autônomo de Água e Esgoto—SAAE, of the municipality of Caçapava, in the State of São Paulo. At Sabesp, he has held several officers' positions in the areas of operation of systems and management of enterprises. Before becoming the regional systems officer, Mr. Siqueira was a representative of Sabesp at the special committee of the Paraíba do Sul River since its foundation in 1994 and at the Committee for Integration of the Paraíba do Sul River—CEIPAV since 1997. He holds a degree in civil engineering from Universidade de Taubaté and a master's degree in City Management from Fundação Álvares Penteado—FAAP.

*José Everaldo Vanzo.* Mr. Vanzo has been our technology and planning officer since February 2004. He has been working for Sabesp since 1977 in several other positions. Mr. Vanzo holds a degree in civil engineering from Escola de Engenharia de São Carlos—USP, and he has a specialization in Public Health Engineering from Faculdade de Saúde Pública—USP. He also holds a degree in law from Faculdade de Direito de Franca and has an MBA from Faculdade de Economia e Administração—USP.

## **Fiscal Council**

Our fiscal council (*Conselho Fiscal*), which is established on a permanent basis and generally meets once a month, consists of five members and five alternates elected at the general shareholders' meeting for renewable one-year terms. 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 current members and alternate members of our fiscal council were elected in the general shareholders' meeting held on April 27, 2006. The tenure of the members and alternate members of our fiscal council will end upon the election of the new members and alternate members at the general shareholders' meeting to be held in April, 2007.

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

<b>Fiscal Council Members</b>	<b>Alternates</b>
Francisco Martins Altenfelder Silva.....	Vanildo Rolando Neubauer
Jorge Michel Lepeltier.....	Alexandre Luiz Oliveira de Toledo
Dilma Seli Pena Pereira.....	Angelo Alberto Fornasaro Melli
Maria de Fátima Alves Ferreira.....	Tomás Bruginski de Paula
João Carlos Araujo dos Santos .....	Artur Quartim Barbosa Araujo

## **Compensation**

Pursuant to the 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.

For the year ended December 31, 2005, 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 approximately R\$2.1 million. In addition, in 2005, the executive officers accrued pension benefits of approximately R\$0.3 million, and we have set aside R\$0.3 million with respect to these pension benefits. The members of our board of directors did not receive any such benefits.

None of our directors and executive officers is party to an employment contract providing for benefits upon termination of employment, except for those officers who are also our employees, in which case they are granted all benefits regularly applicable to employees. We do not have stock-option plans for our directors and executive officers.

## PRINCIPAL SHAREHOLDERS

Our outstanding share capital as of June 30, 2006 consisted of 28,479,577,827 common shares, without par value. Under our by-laws and the laws of the State of São Paulo, 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 June 30, 2006.

	Common shares	
	Shares	%
State of São Paulo .....	14,313,511,867	50.3
Directors and executive officers of Sabesp <sup>(1)(2)</sup> .....	758,486	—
Others <sup>(3)</sup> .....	14,165,307,474	49.7
Total <sup>(4)</sup> .....	<u>28,479,577,827</u>	<u>100.0</u>

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

(2) This number includes one common share held by one member of our fiscal council.

(3) As of March 28, 2006, Alliance Capital Management L.P. beneficially owned 0.04% of our common shares through funds and investment companies controlled by it.

(4) As of June 30, 2006, our outstanding common shares were held by 2,000 registered shareholders.



## **RELATED PARTY TRANSACTIONS**

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

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

Many of our transactions with the State of São Paulo reflect policies of the State that depend on decisions of elected officials or public servants and are accordingly subject to change. They may be particularly open to reconsideration following State elections, which are next scheduled to be held in October 2006. Among the practices that could change are those described below concerning the application of dividends to offset accounts receivable from the State, the provision of State guarantees, and the terms on which we use state-owned reservoir facilities.

### **Provision of Services**

We provide water and sewage services to the Federal Government, the 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 approximately R\$296.1 million during the year ended December 31, 2005 and R\$155.9 million for the six months ended June 30, 2006. Our accounts receivable from the State totaled R\$294.2 million as of December 31, 2005 and R\$330.2 for the six months ended June 30, 2006. 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 which merged to form Sabesp, who provided service to us between our inception and 1974, when the law was prospectively repealed, acquired a legal right to receive supplemental pension benefit payments which 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. During 2005 and the six months ended June 30, 2006, we made payments to former employees of R\$96.4 million and R\$46.3 million, respectively, in respect of Plan G0. The State did not make any reimbursements in this period. See Note 6 to our audited annual financial statements and Note 5 to our unaudited interim financial statements. The amount owed to us by the State for reimbursement of these costs was R\$672.7 million as of December 31, 2005 and R\$719.0 million as of June 30, 2006. The State, however, has not agreed with this amount. We have undertaken to conduct a joint inquiry with the State with respect to the methodology employed in determining such reimbursement amounts to ensure we reach a mutual agreement.

### **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 State Department of Water and Energy. 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
- 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.

As a result, a portion of these amounts became a long-term receivable from the State in our financial statements on December 31, 2001.

The agreement provided that the State Department of Water and Energy would transfer to us ownership of the Taiacupeba, Jundiá, Biritiba, Paraitinga and Ponte Nova reservoirs, which make up 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 July and August 2002, a State-owned construction company (*Companhia Paulista de Obras e Serviços—CPOS*), on behalf of the State, and an independent appraisal firm (*Engenharia de Avaliações—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, with the first payment to be made upon the latest of (1) 210 days after the date of the agreement, (2) agreement by the parties on the fair value of the reservoirs and (3) conclusion of the audit by a State-appointed auditor of amounts owed. 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 State Department of Water and Energy 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 of the State of São Paulo, 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 lower 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. Our management does not expect these analyses to differ significantly from the amounts we have recorded in respect of these amounts. 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 described above 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 original first payment was to be made in July 2002. Based on Official Notice No. 53/2005 of the State Capital Defense Council (CODEC), dated March 21, 2005, negotiations are still ongoing between us and the State with a view to restatement of the debt for supplemental retirement and pension benefits, under the terms defined in the December 2001 agreement, including amounts due after November 2001. These negotiations are expected to be consolidated in a second amendment to the December 2001 agreement. We hired FIPECAFI to validate the actual values to be reimbursed by the State, provided by the Office of the State Attorney General. See Note 6 to our audited annual financial statements and Note 5 to our unaudited interim financial statements.

At a meeting held on January 30, 2002, our board of directors unanimously declared dividends, in the form of interest on shareholders' equity, in an aggregate amount of R\$489.8 million. This distribution was paid on June 25, 2002, to shareholders of record as of February 7, 2002. Accordingly, the State was entitled to receive R\$432.7 million of this distribution and we paid the State R\$347.3 million of this amount. The State applied approximately R\$202.3 million of the dividend it received to settle current accounts receivable owed by the State or its controlled entities. We have withheld the remaining share of the dividend that the State was entitled to pending the State's payment of certain accounts receivable owed to us.

At a meeting, our board of directors reviewed our 2002 budget, which incorporated the payment to the State, and one of our directors voted against us making this payment. We cannot assure you that our minority shareholders will not contest the payment of a cash distribution to the State on the grounds that it is inconsistent with the September 1997 protocol of understanding.

On April 29, 2002, our board of directors declared dividends, in the form of interest on shareholders' equity, in an aggregate amount of R\$108.2 million, paid in June 2003 to shareholders of record as of June 17, 2002. The State applied the entire amount of this dividend, or R\$77.4 million, to accounts receivable owed to us.

On April 24, May 29, and November 20, 2003, and on January 8, 2004, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in aggregate amounts of R\$40.2 million, R\$118.2 million, R\$154.9 million and R\$190.8 million, respectively. These dividends were paid on June 29, 2004.

On February 26, 2004, December 16, 2004 and January 13, 2005, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$39.3 million, R\$85.4 million and R\$28.2 million, respectively. These dividends were paid on June 28, 2005.

On April 28, 2005, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$38.2 million, to be paid within 60 days after our 2006 general shareholders' meeting. On June 23, 2005, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$66.8 million, to be paid within 60 days after our 2006 shareholders' meeting to shareholders of record as of July 6, 2005. On October 20, 2005, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$85.2 million, to be paid within 60 days after our 2006 shareholders' meeting to shareholders of record as of November 3, 2005. On December 15, 2005, our board of directors approved the payment of dividends in the form of interest on shareholders' equity in the amount of R\$158.1 million, to be paid within 60 days of our 2006 shareholders' meeting to shareholders of record as of December 28, 2005. On April 20, 2006, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$129.6 million, to be paid within 60 days after our 2007 shareholders' meeting to shareholders of record as of May 3, 2006. The payments on interest on shareholders' equity declared in 2005 began being made on June 27, 2006.

On March 22, 2004, we and the State executed the first amendment to the December 2001 agreement. Under this amendment, the State acknowledged a debt owed to us of R\$581.8 million,

related to unpaid accounts receivable from the State until February 29, 2004, and we acknowledged the aggregate amount of R\$518.7 million due to the State as dividends in the form of interest on shareholders' equity. See Note 6 to our audited annual financial statements and Note 5 to our unaudited interim financial statements.

Accordingly, we and the State agreed to set-off each other's credit up to the limit of R\$404.9 million (value adjusted up to February 2004). The remaining amount of R\$176.9 million as of February 29, 2004 of the State's consolidated debt will be paid in monthly consecutive 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.

With the execution of the March 2004 agreement, we were able to reconcile the compensation of part of the values owed to us by the State for the use of water and sewage services until February 2004 with values owed to the State by us as interest on shareholders' equity. The remaining amount of interest on shareholders' equity owed by us to the State, of R\$113.8 million was netted against accounts overdue after February 2004.

This amendment did not alter the payment terms and conditions related to the supplemental retirement and pension benefits we pay on behalf of the State, which remain governed by the terms of the December 2001 agreement itself.

As of June 30, 2006, the amounts owed to us by the State for the provision of water and sewage services included R\$161.6 million, which was considered overdue as of February 29, 2004. As of June 30, 2006 the State owed us an additional R\$168.6 million in accounts receivable related to the provision of water and sewage services rendered from February 2004. With respect to reimbursement for pensions paid on behalf of the State, the State owed us R\$719.0 million as of June 30, 2006 (R\$320.6 million of which was acknowledged by the State in the December 2001 agreement subject to a further audit). We expect amounts owed to us by the State for water and sewage services and reimbursements for pensions paid to increase in the future. We have not established any provisions for any amounts due to us by the State, because we expect to recover these amounts and loss is not considered probable.

During 2005, we received payment installments from the State in the amount of R\$35.8 million, for the months from May to December 2005 and we offset the remaining balance of interest on shareholders' equity owed by us to the State in the amount of R\$105.5 million against the balance due to us for water and sewage services provided as contemplated in the first amendment to the December 2001 agreement.

In the six months ended June 30, 2006, we received payment installments from the State in the amount of R\$28.0 million, for the months from January to June 2006. As of June 30, 2006, our dividends payable to the State, due from 2004 through 2005, were in the amount of R\$260.2 million, with an additional R\$65.1 million related to 2006 due beginning in June 2007. We are currently unable to determine the amount, if any, of the 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.

### **Investment of Liquid Assets**

Our cash and cash equivalents invested with State financial institutions in short-term securities amounted to R\$330.8 million as of June 30, 2006.

### **Government Guarantees of Financing**

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

On December 17, 1992, the State entered into a loan agreement with the World Bank in the amount of US\$119.0 million. This loan was guaranteed by the Federal Government and its proceeds were designated to finance the environmental clean-up of the Guarapiranga basin. Pursuant to this agreement, we would receive a loan from the State to be used in the expansion of the wastewater collection network and sewage treatment facilities in the Guarapiranga reservoir. As a result, on March 12, 1993, we entered into an agreement with the State pursuant to which the State transferred to us US\$37.0 million of this loan, which loan amount was increased to US\$42.5 million pursuant to an amendment entered into between the State and us in September of 1999. We have pledged three of our properties as collateral for this financing in the amount of R\$60.5 million, according to a valuation of the properties carried out in November 2005. As of June 30, 2006 our outstanding debt relating to this loan was approximately US\$4.4 million.

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\$2,148.5 million as of June 30, 2006. The Federal Government has guaranteed, and the State has provided a counter-guarantee, in respect of the financial agreement we entered into with the Inter-American Development Bank in 2000 for the total aggregate amount of US\$200 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 JBIC for the financing of the Environmental Recovery Program for the Santos Metropolitan Region, which was guaranteed by the Federal Government, with counter-guarantee from the State of São Paulo, for an aggregate principal amount of R\$422.8 million. In addition to the amount received under the JBIC credit agreement, we intend to invest up to R\$355.1 million in this program. We are currently also negotiating with BNDES and Caixa Econômica Federal for additional loans to finance portions of our capital expenditure program.

### **Use of State-Owned Reservoir Facilities**

We currently use the Guarapiranga and Billings reservoirs and a portion of some of the reservoirs of the Alto Tietê system, which are owned by another company controlled by the State. 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.

The arrangement not to pay any fees to the State for the use of certain reservoirs of the Alto Tietê system is addressed by a number of formal agreements first entered into on March 31, 1992 and on April 24, 1997 and later amended on March 16, 2000 and on November 21, 2001. As part of these arrangements, we agreed to fund 100.0% of the estimated costs of the 1992 agreement equal to R\$27.8 million and 75.0% of the 1997 agreement equal to R\$63.4 million which was already disbursed, and the Government of the State, through the State Department of Water and Energy, agreed to fund approximately 25% of the estimated costs of the 1997 agreement equal to R\$21.1 million, to construct ducts, tunnels and other facilities to interconnect the Tietê River with the Biritiba and Jundiaí reservoirs and with other bodies of water in exchange for our use of the reservoirs over a 30-year period. The amendments to the 1997 agreement increased our obligations under this agreement by R\$5.9 million.

We have the right to draw water from and release emissions into the reservoirs in the Alto Tietê system over a 30-year period which began in 1997.

Our use of the Billings and Guarapiranga reservoirs is provided for through a grant issued by the State Department of Water and Energy. We have the right to use these reservoirs as long as we remain responsible for maintaining them and funding their operating costs.

### **Water Use Incentive Agreements**

We have entered into agreements with public entities, including State entities and municipalities, that manage approximately 6,000 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 period of 12 months 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.

### **Transactions with SABESPREV Pension Fund**

SABESPREV is the funded defined-benefit pension plan that we established to provide our employees with retirement and pension benefits. The assets of SABESPREV are independently held, but we nominate the majority of directors of SABESPREV. Both we and our employees make contributions to the pension plan. We contributed R\$10.3 million during 2004 and R\$11.3 million during 2005. In the six months ended June 30, 2006, we contributed R\$7.4 million.

On May 29, 2001, a Federal law was enacted which, among other things, 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 such 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.

## DESCRIPTION OF THE NOTES

### General

The notes will be issued pursuant to an indenture dated as of November 3, 2006 between the Company and Deutsche Bank Trust Company Americas, as trustee (the “Trustee”). The summary of certain provisions of the indenture set forth below does not purport to be complete and is qualified in its entirety by reference to all of the provisions of the indenture and the notes. Capitalized terms not otherwise defined herein have the meanings specified in the indenture. Whenever sections or defined terms of the indenture are referred to, such sections or defined terms are hereby incorporated herein by such reference.

The notes will be issued in an aggregate original principal amount of U.S.\$140,000,000. The notes will mature on November 3, 2016 and will be payable at 100% of the principal amount thereof. The notes will bear interest from the Closing Date at the rate of 7.5% per annum.

Interest on the notes will be payable semiannually in arrears on May 3 and November 3 of each year (each, an “Interest Payment Date”), commencing on May 3, 2007, to the holders of record at the close of business on October 19 or April 18 (whether or not a business day), as the case may be, preceding such Interest Payment Date (each a “Regular Record Date”), except for the final payment of principal and interest, which will be made against presentation of the notes.

The Company will pay interest on overdue principal and, to the extent permitted by applicable law, on overdue installments of interest, at 1.00% per annum in excess of the rate otherwise payable on the notes. Interest will be computed on the basis of a 360-day year of twelve 30-day months.

### Book-Entry; Delivery and Form

Notes offered and sold to qualified institutional buyers pursuant to Rule 144A will be issued in the form of one or more registered notes in global form, without interest coupons (collectively, the “Restricted Global Note”). Notes offered and sold in offshore transactions to non-U.S. Persons in reliance on Regulation S will initially be issued in the form of one or more registered notes in global form, without interest coupons (collectively, the “Regulation S Global Note”). Prior to the expiration of the later of the 40th day after the later of the commencement of the offering of the notes and the issue date (such period through and including such 40th day, the “Restricted Period”), transfers by an owner of a beneficial interest in the Regulation S Global Note to a transferee who takes delivery of such interest through the Restricted Global Note may be made only in accordance with applicable procedures and the certification requirements set forth in the indenture. The Restricted Global Note and the Regulation S Global Note (hereinafter referred to, collectively, as the “Global Notes”) will be deposited with a custodian for DTC and registered in the name of a nominee of DTC. The Global Notes (and any notes issued in exchange therefor) will be subject to certain restrictions on transfer described under “—Registration, Transfer and Exchange of Notes.”

The notes will be issued only in fully registered form, without exception, in denominations of U.S.\$100,000 and integral multiples of U.S.\$1,000 in excess thereof. No service charge will be made for any registration of transfer or exchange of notes, but the Company may require payment of a sum sufficient to cover any tax or other governmental charge payable in connection therewith.

DTC has advised the Company as follows: DTC is a limited-purpose trust company organized under the laws of the State of New York, a member of the Federal Reserve System, a “clearing corporation” within the meaning of the New York Uniform Commercial Code, and a “clearing agency” registered pursuant to the provisions of Section 17A of the Exchange Act. DTC was created to hold securities of institutions that have accounts with DTC (“Agent Members”) and to facilitate the clearance and settlement of securities transactions among Agent Members in such securities through electronic book-entry changes in accounts of Agent Members, thereby eliminating the need for physical movement

of securities certificates. Agent Members include securities brokers and dealers, banks, trust companies, clearing corporations and certain other organizations. Access to DTC's book-entry system is also available to others such as brokers, dealers, banks and trust companies that clear through or maintain a custodial relationship with an Agent Member, whether directly or indirectly.

Upon the issuance of the Global Notes, DTC or its custodian will credit, on its book-entry registration and transfer system, to the accounts of Agent Members their respective beneficial interests in the principal amount of notes represented by each such Global Note. Such accounts initially will be designated by or on behalf of the Initial Purchaser. Ownership of beneficial interests in a Global Note will be limited to Agent Members or persons who hold interests through Agent Members. Ownership of beneficial interests in the Global Note will be shown on, and the transfer of that ownership will be effected only through, records maintained by DTC (with respect to Agent Members' interests) and records of Agent Members (with respect to interests of persons other than Agent Members). The laws of some jurisdictions may require that certain purchasers of securities take physical delivery of such securities in definitive form. Such laws may impair the ability to transfer or pledge beneficial interests in a Global Note.

So long as DTC, or its nominee, is the registered holder and owner of a Global Note, DTC or such nominee, as the case may be, will be considered the sole legal owner and holder of the notes represented by such Global Note for all purposes of such notes and indenture. Except as set forth below, owners of beneficial interests in a Global Note will not be entitled to have the notes represented by the Global Note registered in their names, will not receive or be entitled to physical delivery of notes in definitive form and will not be considered to be the owners or holders of any notes represented by the Global Note. The Company understands that under existing industry practice, in the event an owner of a beneficial interest in a Global Note desires to take any action that DTC, as the Holder of the Global Note, is entitled to take, DTC would authorize the Agent Members to take such action, and that the Agent Members would authorize owners of beneficial interests to take such action or would otherwise act upon the instructions of the owners.

Investors may hold their interests in the Regulation S Global Note directly through the Euroclear or Clearstream, if they are participants in such systems, or indirectly through organizations which are participants in such systems. After the Restricted Period, investors may also hold such interests through organizations other than Euroclear and Clearstream that are Agent Members. Euroclear and Clearstream will hold such interests in the Regulation S Global Note on behalf of their participants through customer securities accounts in their respective names on the books of their respective depositories, which in turn will hold such interests in the Regulation S Global Note in customer securities accounts in the respective depositories' names on the books of DTC.

Payment of principal of and interest on the notes represented by a Global Note registered in the name of and held by DTC or its nominee will be made to DTC or its nominee, as the case may be, as the registered owner and holder of the Global Note.

The Company expects that DTC or its nominee, upon receipt of any payment of principal or interest in respect of a Global Note will immediately credit the accounts of Agent Members with payments in the amounts proportionate to their respective beneficial interests in the principal amount of such Global Note as shown on the records of DTC or its nominee. The Company also expects that payments by Agent Members to owners of beneficial interests in such Global Note held through such Agent Members will be governed by standing instructions and customary practices, as is now the case with securities held for accounts of customers registered in the names of nominees for such customers. The Company will have no responsibility or liability for any aspect of the records relating to, or payments made on account of, beneficial ownership interests in a Global Note in respect of any Note or for maintaining, supervising or reviewing any record relating to such beneficial ownership interests or for any other aspect of the relationship between DTC and the Agent Members or the relationship between the Agent Members and the owners of such beneficial interests.

Transfers between Agent Members will be effected in the ordinary way in accordance with the applicable procedures of DTC and will be settled in same-day funds. Transfers between participants in



Euroclear and Clearstream will be effected in the ordinary way in accordance with their respective rules and operating procedures.

Although DTC, Euroclear and Clearstream are expected to follow the foregoing procedures in order to facilitate transfers of interests in the Regulation S Global Note and in the Restricted Global Note among participants of DTC, Euroclear and Clearstream, they are under no obligation to perform or continue to perform such procedures, and such procedures may be discontinued at any time. Neither the Trustee nor the Company will have any responsibility for the performance by DTC, Euroclear or Clearstream or their respective participants or indirect participants of their respective obligations under the rules and procedures governing their operations.

### **Registration, Transfer and Exchange of Notes**

The Trustee, as agent of the Company (in such capacity, the “Registrar”), shall maintain at its principal office in New York, a register of notes for the registration of notes and the transfers and exchanges thereof. The Company may also appoint additional agents (each such additional agent being herein called a “Co-Registrar”) for the purpose of maintaining, at one or more offices located elsewhere than the City of New York, a register or registers in which, subject to such reasonable regulations as it may prescribe, the Company may provide for the registration of, and the registration of transfers of, notes. The Company may vary or terminate the appointment of any Co-Registrar or approve any change in the location of any Co-Registrar, *provided* that there shall at all times be a Co-Registrar in Western Europe and, *provided, further*, that at least one Co-Registrar located in Western Europe will, as long as the notes are listed on the Luxembourg Stock Exchange and the rules of the Luxembourg Stock Exchange so require, be located in Luxembourg. The register maintained by the Registrar and the register or registers maintained by the Co-Registrar or Co-Registrars are herein called, collectively the “Note Register.” In the event that the Corporate Trust Office of the Registrar is not at any time in the City of New York, the Company shall appoint and maintain a Co-Registrar in the City of New York for the purpose of maintaining the Note Register in New York.

Upon registration of a Note in the Note Register by the Registrar or any Co-Registrar, such Note shall for all purposes of the indenture be deemed to be duly registered in the Note Register, *provided, however*, that in making any determination as to the identity of Persons who are registered Holders of notes, the Registrar and the Trustee shall be fully protected in relying (i) upon the Note Register and (ii) upon a certificate of any Co-Registrar as to the names and addresses of the registered Holders of the notes and the principal amounts and numbers of such notes. The Registrar and the Trustee shall be entitled to obtain a list of the names and addresses of the registered Holders of notes from any Co-Registrar not later than fifteen Business Days prior to the date of payment, and at such other times as the Registrar or the Trustee may reasonably request.

Every Note presented or surrendered for registration of transfer or exchange shall (if so required by the Company or the Registrar) be duly endorsed, or be accompanied by a written instrument of transfer in form satisfactory to the Company and the Registrar duly executed by the Holder thereof or his attorney duly authorized in writing. In the case of a surrender by the Holder for transfer of part of a Note only, a new Note in the amount transferred will be issued to the transferee and a new Note in the amount of any balance will be issued to the Holder or as the Holder shall direct. In the event of a partial transfer of notes, new notes may be obtained at the office of the Company or any Paying Agent.

Successive registrations and registrations of transfers and exchanges as aforesaid may be made from time to time as desired, and each such registration shall be noted on the Note Register. No service charge shall be made for any registration of transfer or exchange of the notes, but the Registrar may require payment of a sum sufficient to cover any tax or other governmental charge payable in connection therewith and any other amounts required to be paid by the provisions of the notes and the expenses of delivery other than by regular mail (if any).

Each Note authenticated and delivered upon any registration of transfer of or in exchange for or in lieu of the whole or any part of any other Note shall be the valid and binding obligation of the Company

and shall evidence the same debt and shall carry all the rights to payments and other benefits which were carried by the whole or such part, as the case may be, of such other Note.

For so long as the notes are listed on the Luxembourg Stock Exchange, presentment or surrender of a Note for registration of transfer or exchange may be made by the Holder thereof to the Co-Registrar in Luxembourg with the same effect as if made to the Registrar in New York.

Prior to due presentment for registration of transfer, the Company, the Trustee, the Registrar, each Paying Agent and each Co-Registrar may treat the Person in whose name a Note is registered in the Note Register as the owner thereof for all purposes, whether or not such Note is overdue, and neither the Company, the Trustee, or any other Paying Agent, the Registrar, nor any Co-Registrar shall be affected by notice to the contrary.

Notwithstanding any other provision of the indenture or the notes, transfers of a Global Note, in whole or in part, and transfers of beneficial interests therein of the kind described in clauses (ii), (iii) or (iv) below, shall be made only in accordance with this paragraph, and all transfers of an interest in the Regulation S Global Note shall comply with clause (vi) below.

(i) *General.* A Global Note may not be transferred, in whole or in part, to any person other than DTC or any successor to DTC or a nominee thereof, and no such transfer to any such other person may be registered; *provided* that this clause (i) shall not prohibit any transfer of a Note that is issued in exchange for a Global Note but is not itself a Global Note. No transfer of a Note to any person shall be effective under the indenture or the notes unless and until such Note has been registered in the name of such person. Nothing in this clause (i) shall prohibit or render ineffective any transfer of a beneficial interest in a Global Note effected in accordance with the other provisions of this paragraph.

(ii) *Restricted Note to Regulation S Global Note.* If the holder of a beneficial interest in the Restricted Global Note, or the Holder of a Definitive Note which bears the Securities Act Legend (a "Restricted Definitive Note") wishes at any time prior to expiration of the Restricted Period to transfer such interest or the whole or any part of the principal amount of such Restricted Definitive Note to a person who wishes to take delivery thereof in the form of a beneficial interest in the Regulation S Global Note, such transfer may be effected, subject to the rules and procedures of DTC, Euroclear and Clearstream, in each case to the extent applicable (the "Applicable Procedures"), only in accordance with the provisions of this clause (ii). Upon receipt by the Registrar or Co-Registrar at its office in New York of (1) written instructions given in accordance with the Applicable Procedures from an Agent Member directing the Registrar or Co-Registrar to credit or cause to be credited to a specified Agent Member's account a beneficial interest in the Regulation S Global Note in a principal amount equal to that of the beneficial interest in the Restricted Global Note (or principal amount of the Restricted Definitive Note) to be so transferred and, in the case of a Restricted Definitive Note, the surrender thereof with the assignment of transfer on the reverse thereof duly completed, (2) a written order given in accordance with the Applicable Procedures containing information regarding the account of the Agent Member (and the Euroclear or Clearstream account, as the case may be) to be credited with, and the account of the Agent Member to be debited for, such beneficial interest or, in the case of a Restricted Definitive Note, written instructions regarding the account of the Agent Member (and the Euroclear or Clearstream account, as the case may be) to be credited with the principal amount of the Restricted Definitive Note to be transferred and (3) a certificate in substantially the form specified in an exhibit to the indenture given by the holder, the Registrar or Co-Registrar shall instruct DTC (A)(I) in the case of a transfer of a beneficial interest in the Restricted Global Note, to reduce the principal amount thereof and to increase the principal amount of the Regulation S Global Note, by the principal amount of the beneficial interest in the Restricted Global Note to be so transferred, or (II) in the case of a transfer of a Restricted Definitive Note, to increase the principal amount of the Regulation S Global Note by the principal amount of the Restricted Definitive Note to be so transferred, and (B) to credit or cause to be credited to the account of the person specified in such instructions (which shall be the Agent Member for Euroclear or Clearstream or both, as the case may be) a beneficial interest in the Regulation S Global Note having a principal amount equal to the amount by which the principal amount of the Restricted Global Note was reduced upon such transfer

(or, in the case of a transfer of a Restricted Definitive Note, the principal amount thereof to be so transferred.) In the case of a transfer of a Restricted Definitive Note, the Registrar or Co-Registrar shall cancel such Restricted Definitive Note and issue a new Restricted Definitive Note in the amount of any untransferred portion thereof.

(iii) *Restricted Note to Unrestricted Global Note.* If the holder of a beneficial interest in the Restricted Global Note wishes at any time to transfer such interest or the Holder of a Restricted Definitive Note wishes at any time to transfer the whole or any part of the principal amount of such Restricted Definitive Note to a person who wishes to take delivery thereof in the form of a beneficial interest in the Regulation S Global Note following the expiration of the Restricted Period (following the expiration of the Restricted Period the Regulation S Global Note is referred to as the “Unrestricted Global Note”), such transfer may be effected, subject to the Applicable Procedures only in accordance with this clause (iii). Upon receipt by the Registrar or Co-Registrar at its office in New York of (1) written instructions given in accordance with the Applicable Procedures from an Agent Member directing the Registrar or Co-Registrar to credit or cause to be credited to a specified Agent Member’s account a beneficial interest in the Unrestricted Global Note in a principal amount equal to that of the beneficial interest in the Restricted Global Note (or principal amount of the Restricted Definitive Note) to be so transferred, and, in the case of a Restricted Definitive Note, the surrender thereof with the assignment of transfer on the reverse thereof duly completed, (2) a written order given in accordance with the Applicable Procedures containing information regarding the account of the Agent Member (and, in the case of any such transfer pursuant to Regulation S, the Euroclear or Clearstream account for which such Agent Member’s account is held) to be credited with, and the account of the Agent Member to be debited for, such beneficial interest or, in the case of a Restricted Definitive Note, written instructions regarding the account of the Agent Member (and, in the case of any such transfer pursuant to Regulation S, the Euroclear or Clearstream account for which such Agent Member’s account is held) to be credited with the principal amount of the Restricted Definitive Note to be transferred and (3) a certificate in substantially the form specified in an exhibit to the indenture given by the holder, the Registrar or Co-Registrar shall instruct DTC (A)(I) in the case of a transfer of a beneficial interest in the Restricted Global Note, to reduce the principal amount thereof, and to increase the principal amount of the Unrestricted Global Note, by the principal amount of the beneficial interest in the Restricted Global Note to be so transferred, or (2) in the case of a transfer of a Restricted Definitive Note, to increase the principal amount of the Unrestricted Global Note by the principal amount of the Restricted Definitive Note to be so transferred, and (B) to credit or cause to be credited to the account of the person specified in such instructions a beneficial interest in the Unrestricted Global Note having a principal amount transfer (or, in the case of a transfer of a Restricted Definitive Note, the principal amount thereof to be so transferred.) In the case of a transfer of a Restricted Definitive Note, the Registrar or Co-Registrar shall cancel such Restricted Definitive Note and issue a new Restricted Definitive Note in the amount of any untransferred portion thereof.

(iv) *Regulation S Global Note or Unrestricted Global Note to Restricted Global Note.* If the holder of a beneficial interest in the Regulation S Global Note or the Unrestricted Global Note or the Holder of a Restricted Definitive Note or a Definitive Note which does not bear the Securities Act Legend (an “Unrestricted Definitive Note”) wishes at any time to transfer such interest or the whole or any part of the principal amount of such Definitive Note to a person who wishes to take delivery thereof in the form of a beneficial interest in the Restricted Global Note, such transfer may be effected, subject to the Applicable Procedures only in accordance with this clause (iv). Upon receipt by the Registrar or Co-Registrar at its office in New York of (1) written instructions given in accordance with the Applicable Procedures from an Agent Member directing the Registrar or Co-Registrar to credit or cause to be credited to a specified Agent Member’s account a beneficial interest in the Restricted Global Note equal to that of the beneficial interest in the Regulation S Global Note or Unrestricted Global Note to be so transferred (or in the case of a Definitive Note, the principal amount thereof to be transferred), and, in the case of a Definitive Note, the surrender thereof with the assignment of transfer on the reverse thereof duly completed, (2) a written order given in accordance with the Applicable Procedures containing information regarding the account of the Agent Member to be credited with, and the account of the Agent Member (or, if such account is held for Euroclear or Clearstream, the Euroclear or Clearstream account, as the case may be) to be debited for, such

beneficial interest, or, in the case of a Definitive Note, written instructions regarding the account of the Agent Member (and, in the case of any such transfer pursuant to Regulation S, the Euroclear or Clearstream account for which such Agent member's account is held) to be credited with in respect of the principal amount of the Definitive Note to be transferred and (3) with respect to a transfer of a beneficial interest in the Regulation S Global Note (but not the Unrestricted Global Note) or a transfer of a Restricted Definitive Note, a certificate substantially in the form specified in an exhibit to the indenture given by the holder of such beneficial interest (or the Holder of such Restricted Definitive Note), the Registrar or Co-Registrar shall instruct DTC (A)(I) in the case of a transfer of a beneficial interest in the Regulation S Global Note or Unrestricted Global Note, to reduce the principal amount of the Regulation S Global Note or Unrestricted Global Note, as the case may be, and to increase the principal amount of the Restricted Global Note, by the principal amount of the beneficial interest in the Regulation S Global Note or Unrestricted Global Note to be so transferred, or (2) in the case of a Definitive Note, to increase the principal amount of the Restricted Global Note by the principal amount of the Definitive Note to be so transferred, and (B) to credit or cause to be credited to the account of the person specified in such instructions a beneficial interest in the Restricted Global Note having a principal amount equal to the amount by which the principal amount of the Regulation S Global Note or Unrestricted Global Note, as the case may be, was reduced upon such transfer (or, in the case of a Definitive Note, the principal amount thereof to be so transferred.) In the case of a transfer of a Definitive Note the Registrar or Co-Registrar shall cancel such Definitive Note and issue a new Definitive Note in the amount of any untransferred portion thereof.

(v) *Other Exchanges.* In the event that a Global Note or any portion thereof is exchanged for notes other than Global Notes, such other notes and any Definitive Notes then outstanding may in turn be exchanged (on transfer or otherwise) for notes that are not Global Notes or Definitive Notes or for beneficial interests in a Global Note (if any is then outstanding) only in accordance with such procedures, which shall be substantially consistent with the provisions of clauses (i) and (iv) above (including the certification requirements intended to insure that transfers of beneficial interests in a Global Note comply with Rule 144A, Rule 144 or Regulation S under the Securities Act, as the case may be) and any Applicable Procedures, as may be from time to time adopted by the Company and the Trustee.

(vi) *Interests in Regulation S Global Note to be Held Through Euroclear or Clearstream.* Until the termination of the Restricted Period, interests in the Regulation S Global Note may be held only through Agent Members acting for and on behalf of Euroclear and Clearstream, *provided* that this clause (vi) shall not prohibit any transfer in accordance with clause (iv) hereof.

If interests in any Global Note are transferred to the beneficial owners thereof in the form of Definitive Notes, such Global Note shall be surrendered by the DTC to the Registrar or the Co-Registrar located in the City of New York, without charge, and the Trustee shall authenticate and deliver, upon such transfer of interests in such Global Note, an equal amount of definitive notes of authorized denominations, and cause the reduction of the Global Note by such principal amount. Any Definitive Note delivered in exchange for an interest in the Restricted Global Note shall bear a legend regarding transfer restrictions applicable to the Restricted Global Note.

### **Payments of Principal and Interest**

Payment of the principal of the notes (together with accrued interest) or payment upon redemption will only be made following surrender thereof at the office of the Trustee or any other Paying Agent, subject to applicable laws, to the person in whose name such Note is registered as of the close of business, New York time, on the due date for such payment. Payments of interest on a Note (other than the last payment of principal and interest, which is payable on surrender of the Note as aforesaid) will be made to the person in whose name such Note is registered at 5:00 p.m., New York time on the Regular Record Date (whether or not a business day) immediately preceding the Interest Payment Date. Payments of principal and interest will be made on the notes by a U.S. dollar check drawn on a bank in the City of New York (which, for payments of interest other than the final payment, will be mailed to the Holder at such Holder's registered address) or, at the option of a Holder holding at least U.S.\$100,000

principal amount of notes, upon receipt by the relevant Paying Agent of appropriate wiring instructions no later than the Regular Record Date (or, with respect to payments at maturity, 15 days prior to maturity) for such payment, by wire transfer to a U.S. dollar account maintained by the Holder with a bank located in the City of New York. If any day for payment of principal or interest or redemption in respect of any Note is not a business day in the city in which the relevant Paying Agent is located, the Holder shall not be entitled to payment until the next business day following such day in such place and shall not be entitled to any interest or other payment as a result of such delay. Upon surrender of notes (duly endorsed in blank) for payment prior to the Stated Maturity as a result of acceleration by the Holders as described under "Events of Default," the Trustee shall, at the direction of the Company, cause such notes to be transferred to a third party upon payment in full as and when due, to the Holder surrendering such notes, of the principal of the Note together with accrued interest due.

The Company agrees that so long as any of the notes are outstanding, it will maintain a Paying Agent in a Western European city (which will be Luxembourg so long as the notes are listed on the Luxembourg Stock Exchange and the rules of such Exchange so require) for payments on the notes. The Company has initially appointed Deutsche Bank Trust Luxembourg as the Luxembourg Paying Agent in Luxembourg and Deutsche Bank Trust Company Americas as the Principal Paying Agent. Subject to the foregoing, the Company shall have the right at any time to terminate any such appointments and to appoint any other Paying Agents in such other places as the Company may deem appropriate upon receipt of notice.

The Company has appointed the Principal Paying Agent to receive payment of the principal amount of, and interest on, the notes. Payment of such sums to the Principal Paying Agent in accordance with the indenture will satisfy the obligation of the Company to make such payments. The Company has agreed to indemnify the Holders against any failure on the part of the Principal Paying Agent or any Paying Agent to pay any sum due in respect of the notes.

Payments in respect of the notes shall be made in such coin or currency of the United States of America as at the time of payment shall be legal tender for the payment of public and private debts.

Subject to applicable law, the Trustee and the Paying Agents shall pay to the Company upon request any monies held by them for the payment of principal or interest that remains unclaimed for two years, and, thereafter, Holders entitled to such monies must look to the Company for payment as general creditors.

### **Additional Amounts**

All payments by the Company in respect of the notes shall be made free and clear of, and without withholding or deduction for or on account of any present or future taxes, duties, assessments, or other governmental charges of whatsoever nature imposed or levied by or on behalf of Brazil or any political subdivision or authority thereof or therein having power to tax (each a "Taxing Jurisdiction"), unless the Company is required by law to withhold or deduct such taxes, duties, assessments, or other governmental charges. In such event, the Company shall make the required withholding or deduction, make payment of the amount so withheld or deducted to the appropriate government authority and pay such additional amounts ("Additional Amounts") as may be necessary to ensure that the net amounts received by the Holders after such withholding or deduction shall equal the respective amounts of principal and interest which would have been receivable in respect of the notes in the absence of such withholding or deduction; *provided, however*, that no such Additional Amounts shall be payable:

- (i) with respect to any tax which would not have been imposed but for the existence of any present or former connection between such Holder, on the one hand, and the Taxing Jurisdiction, on the other hand, other than the mere receipt of such payment or the ownership or holding of such notes;
- (ii) if such payment would not have been subject to such taxes, duties, assessments or other governmental charges had the request for payment been made within 30 days of the related due date or, in case the full amount of funds payable had not been provided to the Principal Paying Agent

when due, within 30 days of the date on which such funds have been received by the Principal Paying Agent and notice thereof has been given;

(iii) to the extent that the taxes, duties, assessments or other governmental charges would not have been imposed but for the failure of such Holder to comply with any certification, identification or other reporting requirements concerning the nationality, residence or identity or connection to Brazil of the Holder (A) if such compliance is required or imposed by law as a precondition to exemption from all or a part of such tax, duty assessment or other governmental charge and (B) at least 30 days prior to the first Interest Payment Date with respect to which the Company will apply this clause (iii), the Company shall have notified the Holders that such Holders will be required to comply with such requirement;

(iv) in respect of any estate, inheritance, gift, sales, transfer, capital gains, excise or personal property or similar tax, assessment or governmental charge; or

(v) in respect of any combination of the above.

No Additional Amounts will be paid to a Holder that is a depository or its nominee, a fiduciary or a partnership or other than the sole beneficial owner of such payment to the extent a beneficiary or settlor with respect to such fiduciary or a member of such partnership or beneficial owner would not have been entitled to receive payment of the Additional Amounts had the beneficiary, settlor, member or beneficial owner been the Holder of the Note.

The Company will make any required withholding or deduction and remit the full amount withheld or deducted to the relevant taxing authority in accordance with applicable law. The Company will furnish to the Trustee, within 30 days after the date of payment of any such taxes, certified copies of tax receipts or other documentation reasonably satisfactory to the Trustee evidencing that payment. Upon request, copies of those receipts or other documentation, as the case may be, will be made available to the Holders.

At least 30 days prior to each date on which any payment under or with respect to the notes is due and payable, if the Company will be obligated to pay Additional Amounts with respect to such payment, we will deliver to the Trustee an Officers' Certificate stating the fact that such Additional Amounts will be payable and the amounts so payable and will set forth such other information necessary to enable the Trustee to pay such Additional Amounts to the Holders of notes on the payment date.

These obligations will survive any termination or discharge of the notes and the indenture.

All references to principal of and interest on the notes shall include any Additional Amounts payable by the Company in respect of such principal and such interest.

## **Redemption**

Unless previously redeemed or purchased and cancelled, the notes will mature on November 3, 2016.

### **Redemption at the Option of the Company for Changes in Brazilian Withholding Tax**

If (i) as a result of any change in or amendment to the laws (or any regulations or rulings promulgated thereunder) of a Taxing Jurisdiction or any change in official position regarding application or interpretation of such laws, regulations or rulings (including a holding by a court of competent jurisdiction), which change or amendment becomes effective on or after the original issue date of the notes, the Company shall become obligated to pay Additional Amounts on the notes in excess of the Additional Amounts that the Company would pay if payments in respect of the notes were subject to deduction or withholding at a rate of 15%, or at a rate of 25% in case the Holder is resident in a tax haven jurisdiction for Brazilian tax purposes (i.e., countries which do not impose any income tax or which impose it at a

maximum rate lower than 20% or where the laws impose restrictions on the disclosure of ownership composition or securities ownership), and (ii) such obligation cannot be avoided by the Company taking reasonable measures available to it, the notes will be subject to redemption at the option of the Company, at any time in whole but not in part, at a redemption price equal to 100% of the principal amount thereof plus accrued and unpaid interest to the date fixed for redemption, upon the giving of notice as described below. In the event that the Company elects to redeem the notes, the Company will deliver to the Trustee an Officers' Certificate stating that (i) the obligation to pay such Additional Amounts cannot be avoided by the Company taking reasonable measures available to it and (ii) the Company is entitled to redeem the notes pursuant to their terms. The Company will also deliver to the Trustee a written opinion of an independent Brazilian counsel of recognized standing and reasonably satisfactory to the Trustee to the effect that the Company has become obligated to pay such Additional Amounts as a result of a change or amendment described above. The Company shall give notice to the Holders not less than 30 and not more than 60 days prior to the date scheduled for such redemption, provided that no such notice of redemption shall be given earlier than 90 days prior to the earliest date on which the Company would incur an obligation to pay such Additional Amounts if a payment in respect of the notes were then due. Such notice shall be signed by two executive officers of the Company and shall specify the date the notes are to be redeemed and the circumstances giving rise to the Company's entitlement to effect such redemption. Any such notice shall be irrevocable, and the delivery thereof shall oblige the Company to make the redemption therein specified.

### **Open Market Purchases**

The Company may at any time purchase notes in the open market or otherwise at any price.

### **Cancellation of Redeemed and Purchased Notes**

All unmatured notes redeemed by the Company will be cancelled and may not be reissued or resold. Notes purchased by the Company and not surrendered to the Trustee for cancellation may be reissued and resold by the Company in compliance with applicable law (including the U.S. securities laws).

### **Ranking**

The notes will constitute existing senior unsecured obligations of the Company, and will rank at least *pari passu* with each other and with all other existing and future senior unsecured indebtedness of the Company, subject to certain statutory preferences (including tax and labor claims).

The notes are not guaranteed by Brazil or the State of São Paulo, and holders of notes will not be able to rely on the resources of Brazil or the State of São Paulo for repayment of the notes.

As of the date of the offering circular, the Company had no Subsidiaries. If the Company were to form Subsidiaries, the notes would become structurally subordinated to any Indebtedness of such Subsidiaries.

### **Certain Covenants**

The indenture will contain, among others, the following covenants:

#### *Statement as to Compliance*

The Company shall deliver to the Trustee, within 120 days after the end of each fiscal year, a written statement signed by any of its Chief Executive Officer, its Chief Financial Officer, its Treasurer or its *Superintendente de Captação de Recursos*, stating, as to the signatory thereto that:

- (a) a review of the activities of the Company during such year and of performance under the indenture has been made under his or her supervision, and
- (b) to the best of his or her knowledge, based on the review the Company has fulfilled all of its obligations under the indenture throughout such year, or, if there has been a default in the fulfillment of any such obligation, specifying each such default known to him and the nature and status thereof.

#### *Certain Reporting Requirements*

The Company at all times shall keep, and, shall cause each Subsidiary to keep, true and complete books of record and account, in accordance with Brazilian GAAP, and shall furnish to the Trustee:

- (a) an English language version of its annual audited consolidated financial statements prepared in accordance with Brazilian GAAP, together with (i) a supplemental consolidated balance sheet and statement of income prepared on the basis set forth in the second sentence of the definition of "Brazilian GAAP," promptly upon such statements becoming available but not later than 120 days after the close of its fiscal year and (ii) a report and opinion of independent accountants of recognized standing selected by the Company, which report and opinion shall be based upon an examination made in accordance with Brazilian GAAP;
- (b) an English language version of its unaudited quarterly consolidated financial statements all in reasonable detail and in accordance with Brazilian GAAP on a basis consistent with the audited annual financial statements of the Company, together with a supplemental consolidated balance sheet and statement of income prepared on the basis set forth in the second sentence of the definition of "Brazilian GAAP," promptly upon such statements becoming available but not later than 60 days after the close of the relevant quarterly fiscal period (it being recognized that no quarterly financial statements need be prepared for the fourth quarter of the fiscal year); and
- (c) simultaneously with the delivery of each set of financial statements referred to in clause (a) above, a statement in English by the independent public accountants whose report and opinion accompanied such financial statements that, in making the examination necessary for such report and opinion, such accountants have obtained no knowledge of any default of the Company on the notes or in the fulfillment of any of the terms, covenants or provisions of the indenture, or under any other evidence of Indebtedness, of any event which, with notice or lapse of time, or both, would constitute an event of default on the notes or under the indenture or under any other evidence of Indebtedness or if, in the opinion of such accountants, any such event of default or other default shall exist, a statement as to the nature and status thereof shall be included; such report shall also include or be accompanied by such other reports, schedules or information as may have been delivered to the Company in connection with such examination.

The Company will furnish the Trustee such other information as the Trustee may reasonably from time to time request with respect to the Company and its Subsidiaries and will permit the Trustee and its officers, employees and agents from time to time to visit any of the properties of the Company and its Subsidiaries and inspect their records at such reasonable times as the Trustee may desire.

#### *Negative Pledge*

So long as any notes remain outstanding, the Company shall not, and shall not permit any of its Subsidiaries to, at any time create, incur or suffer to exist any Lien other than Permitted Liens with respect to any properties or assets of the Company or any such Subsidiary (as the case may be) now owned or hereafter acquired to secure any Indebtedness, unless the Company or such Subsidiary causes such Lien to secure equally and ratably the obligations of the Company under the notes.



### *Limitation on Indebtedness*

(a) The Company shall not, and shall not permit any Subsidiary to, Incur (or agree to Incur) any Indebtedness unless (i) no Event of Default shall have occurred and be continuing and (ii) after giving *pro forma* effect to the Incurrence of such Indebtedness and any other Indebtedness Incurred since the end of the most recent fiscal quarter of the Company and the receipt and application of the proceeds thereof:

(A) the ratio of Adjusted Total Debt to Adjusted EBITDA of the Company for the four most recently completed fiscal quarters of the Company, determined as of the date of Incurrence of such Indebtedness, shall not be greater than 3.65; and

(B) the Debt Service Coverage Ratio of the Company, determined as of the date of Incurrence of such Indebtedness, shall not be less than 2.35.

(b) Notwithstanding paragraph (a) above, the Company and its Subsidiaries may Incur the following Indebtedness:

(i) Indebtedness the proceeds of which are used to refinance any Indebtedness permitted by paragraph (a) above, the notes, and Indebtedness of the Company or its Subsidiaries outstanding on the date of the indenture or any Indebtedness permitted by this paragraph (b); provided, however, that (1) the principal amount of the Indebtedness so issued shall not exceed the principal amount of the Indebtedness so refinanced plus reasonable premium, fees and expenses and (2) the Indebtedness so issued (A) shall not mature prior to the final Stated Maturity of the Indebtedness so refinanced, (B) shall have a ranking no greater than the Indebtedness so refinanced, and (C) shall not be secured to any greater extent than, or by any assets or revenues other than those securing, the Indebtedness so refinanced;

(ii) Indebtedness of the Company owed to and held by a Subsidiary of the Company;

(iii) Indebtedness of a Subsidiary of the Company owed to and held by the Company or any other Subsidiary of the Company;

(iv) Indebtedness owed to, directly or indirectly, any Brazilian federal governmental lender, including, without limitation, the Caixa Econômica Federal for the performance of the transactions contemplated by Ruling (Instrução Normativa) No. 6 of the Brazilian Municipalities Ministry (Ministério das Cidades), of February 2, 2006;

(v) Indebtedness Incurred by the Company in connection with PPP Projects; and

(vi) Indebtedness which the Company would not be permitted to Incur pursuant to paragraph (a) above or clauses (i), (ii) or (iii) of this paragraph (b) provided that after the Incurrence of such Indebtedness the aggregate principal amount of all Indebtedness Incurred in reliance on this clause (iv) shall not exceed the greater of (A) U.S.\$100,000,000 (or its equivalent in other currencies) and (B) 1.00% of Adjusted Shareholders' Equity.

Notwithstanding any other provision of this covenant, a guarantee of Indebtedness permitted by the terms of the indenture at the time such Indebtedness was incurred shall not constitute a separate Incurrence of Indebtedness.

In the event that Indebtedness falls within more than one category of permitted Indebtedness as set out above, the Company shall determine the applicable category and such Indebtedness shall only be counted once. If Indebtedness is issued at less than the principal amount thereof, the amount of such Indebtedness for purposes of the above limitations shall equal the amount of the liability as determined in accordance with Brazilian GAAP.

### *Compliance with Laws, Rules and Regulations*

The Company will, and will cause its Subsidiaries to, comply with all applicable laws, rules, regulations, orders and directions of any governmental agency having jurisdiction over its business and all covenants and other obligations contained in any agreements to which it is a party; *provided, however*, that such compliance will not be required unless the failure so to comply would have a material adverse effect upon the condition (financial or other), business prospects or results of the Company's operations and of its Subsidiaries considered as one enterprise or a material adverse effect on the performance of the Company's obligations hereunder or under the notes.

### *Notification of Default*

The Company agrees as soon as reasonably practicable and in any event no later than five Business Days following its becoming aware of the occurrence of any such event to inform the Trustee of the occurrence of (i) any Event of Default, or (ii) any event that, with the passing of time or the giving of notice, will become or result in an Event of Default.

### *Limitation on Sale-Leaseback*

The Company shall not, and shall not permit any Subsidiary to, enter into, renew or extend any Sale and Leaseback Transaction, except a Sale and Leaseback Transaction that, had such Sale and Leaseback Transaction been structured as a mortgage loan rather than as a Sale and Leaseback Transaction, the Company would not have been prohibited from entering, or permitting its Subsidiary to enter, into such transaction pursuant to "—Negative Pledge."

### *Limitations on Certain Transactions with Affiliates*

The Company will not, nor will it permit any Subsidiary to, enter into or permit to exist any transaction (including the purchase, sale, lease or exchange of any property, employee compensation arrangements or the rendering of any service) with, or for the benefit of, any Affiliate, other than a wholly-owned Subsidiary (an "Affiliate Transaction") unless the terms of the Affiliate Transaction are no less favorable to the Company or such Subsidiary than those that could be obtained at the time of the Affiliate Transaction in arm's length dealings with a person who is not an Affiliate.

### *Limitations on Business Activities*

The Company will not engage in any business other than the operation of public water and sewage systems and businesses that are reasonably related or ancillary thereto.

### *Additional Covenants*

The indenture will also contain covenants with respect to, among other things, the following matters: (i) payment of principal and interest; (ii) payment of taxes and other claims; (iii) maintenance of properties; (iv) maintenance of corporate existence; (v) maintenance of insurance; and (vi) listing on the Luxembourg Stock Exchange (EuroMTF Market).

### *Merger and Consolidation*

The Company shall not consolidate with or merge with or into, or sell, assign, convey, transfer, lease or otherwise dispose of, in a single transaction or a series of transactions, all or substantially all its assets to, any Person or group of affiliated Persons, unless: (i) either the Company shall be the continuing entity, or the Person (if other than the Company) formed by such consolidation or into which the Company is merged or the Person that acquires by sale, assignment, conveyance, transfer, lease or other disposition of all or substantially all of the assets of the Company (the "surviving entity") is organized under the laws of Brazil and such surviving entity assumes by supplemental indenture, executed and

delivered to the Trustee in form and substance reasonably satisfactory to the Trustee, all obligations of the Company on the notes and under the indenture; (ii) immediately after giving effect to such transaction or series of transactions (and treating any Indebtedness that becomes an obligation of the surviving entity as a result of such transaction, as having been Incurred by such surviving entity at the time of such transaction), no Default or Event of Default shall have occurred and be continuing (iii) immediately after giving effect to such transaction or series of transactions, the net worth of the Company or the surviving entity, as the case may be, is equal to or greater than the net worth of the Company prior to such transaction or series of transactions; (iv) immediately after giving effect to such transaction or series of transactions, the Company or the surviving entity as the case may be, could Incur at least U.S.\$1.00 of additional Indebtedness without violating “—Limitation on Indebtedness” and shall otherwise be in compliance with the other covenants contained in the indenture; and (v) the Company or the surviving entity, as the case may be, shall have delivered, or caused to be delivered, to the Trustee, in form and substance reasonably satisfactory to the Trustee, an Officers’ Certificate and an Opinion of Counsel, each to the effect that such transaction and the supplemental indenture in respect thereto comply with the indenture and that all conditions precedent provided for relating to such transaction have been complied with and that such supplemental indenture is valid, binding and enforceable against the Company, in accordance with its terms.

### *Covenant Suspension*

If on any date following the Closing Date:

(a) the notes have been assigned an Investment Grade rating by any two Rating Agencies;  
and

(b) no Default shall have occurred and be continuing,

then, beginning on that day and subject to the provisions of the following two paragraphs, the covenants specifically listed under the following captions will automatically, without any notice of any kind, be suspended (and the Company and its Subsidiaries will have no obligation or liability whatsoever with respect to such covenants):

- (i) “—Limitation on Indebtedness”;
- (ii) “—Limitation on Sale-Leaseback”; and
- (iii) “—Negative Pledge”.

Clauses (i) through (iii) above are collectively referred to as the “Suspended Covenants”.

If, during any period in which the Suspended Covenants are suspended, the notes cease to have an Investment Grade rating by two Rating Agencies, the Suspended Covenants will thereafter be reinstated and be applicable pursuant to the terms of the indenture (including in connection with performing any calculation or assessment to determine compliance with the terms of the indenture), unless and until the notes subsequently attain an Investment Grade rating by any two Rating Agencies (in which event the Suspended Covenant will again be suspended for such time that the notes maintain an Investment Grade rating by any two Rating Agencies).

No Default or breach or violation of any kind will be deemed to exist under the indenture and the notes with respect to the Suspended Covenants (whether during the period when the Suspended Covenants were suspended or thereafter) based on, and none of the Company or any of its Subsidiaries will bear any liability (whether during the period when the Suspended Covenants were suspended or thereafter) for, any actions taken or events occurring after the notes attain an Investment Grade Rating by any two Rating Agencies and before any reinstatement of the Suspended Covenants as provided above, or any actions taken at any time (whether during the period when the Suspended Covenants were

suspended or thereafter) pursuant to any contractual obligation arising prior to the reinstatement of the Suspended Covenants, regardless of whether those actions or events would have been permitted if the applicable Suspended Covenants had remained in effect during such period.

### **Modification of the Indenture; Waiver of Covenants**

Modifications and amendments of the indenture may be made by the Company and the Trustee with the consent of the Holders of a majority in aggregate principal amount of the notes then outstanding *provided, however*, that no such modification or amendment may, without the consent of the Holder of each outstanding Note affected thereby: (i) change the Stated Maturity of the principal of, or any installment of principal of or interest on, any Note or reduce the principal amount thereof or the rate of interest thereon, or change the coin or currency in which any Note or any interest thereon is payable or impair the right to institute suit for the enforcement of any such payment after the Stated Maturity thereof; (ii) reduce the requirements for quorum and voting under the indenture or reduce the percentage in principal amount of the outstanding notes, the consent of whose Holders is required for any such amendment or modification, or the consent of whose Holders is required for any waiver; (iii) modify any of the provisions relating to supplemental indentures requiring the consent of Holders or relating to the waiver of past defaults or relating to the waiver of certain covenants, except to increase the percentage in principal amount of outstanding notes required for such action or to provide that certain other provisions of the indenture may not be modified or waived without the consent of the Holder of each Note affected thereby; (iv) waive a default in payment with respect to any Note (other than a default in payment that is due solely because of acceleration of the maturity of the notes); (v) alter the provisions in any manner adverse to the Holders relating to the payment of Additional Amounts; or (vi) change the obligations of the Company to maintain a Paying Agent in a Western European city.

Notwithstanding the foregoing, without the consent of the holders of the notes, the Company and the Trustee may modify or amend the indenture (i) to evidence the succession of another Person to the Company and the assumption by any such successor of the covenants of the Company in the indenture and in the notes in accordance with “—Merger and Consolidation”; (ii) to provide for uncertificated notes, in addition to or in place of, certificated notes; (iii) to add to the covenants of the Company for the benefit of the Holders of the notes, or to surrender any right or power herein conferred upon the Company in the indenture or in the notes; (iv) to cure any ambiguity, to correct or supplement any provision in the indenture which may be defective or inconsistent with any other provision in the indenture or in the notes, or to make any other provisions with respect to matters or questions arising under the indenture or the notes provided that such provisions shall not adversely affect in any material respect the interests of any Holder of any note; (v) to secure the notes pursuant to the “—Negative Pledge” covenant; (vi) to add a guarantor under the indenture; (vii) to evidence and provide the acceptance or the appointment of a successor Trustee under the indenture; or (viii) to evidence and provide for the issuance of additional notes under the indenture.

The Holders of a majority in aggregate principal amount of the notes outstanding may waive compliance with certain restrictive covenants and provisions of the indenture.

For so long as the notes are listed on the Luxembourg Stock Exchange and the rules of that exchange so require, if the indenture is modified or amended, the Company will promptly publish a notice in Luxembourg to that effect in accordance with the provisions described under “Notices”.

### **Events of Default**

The indenture will set forth the following Events of Default:

- (i) failure by the Company to pay interest (including, without limitation, Additional Amounts, if any) on any Note when due and payable, if such failure continues for a period of 30 days;

(ii) failure by the Company to pay the principal (including, without limitation, Additional Amounts, if any) on any Note when due and payable (whether at maturity or upon redemption, acceleration or otherwise), if such failure continues for a period of 5 days;

(iii) failure by the Company to comply with any other agreement or covenant contained in the indenture if such failure continues for a period of 30 days after (x) the Company becomes aware of such failure or (y) notice to the Company by the Trustee or to the Company and the Trustee by the Holders of at least 25% in principal amount of the notes then outstanding;

(iv) the Company or any of its Subsidiaries shall default in a payment of an aggregate amount of U.S.\$25,000,000 or more (or its equivalent in other currencies) beyond any grace period provided with respect thereto in respect of Indebtedness for money borrowed of the Company or any of its Subsidiaries (other than the notes), or the maturity of any Indebtedness for money borrowed of the Company or any of its Subsidiaries having an aggregate principal amount of U.S.\$25,000,000 or more (or its equivalent in other currencies) shall be accelerated;

(v) it becomes unlawful for the Company to perform its payment obligations under the indenture or the notes, or such obligations thereunder cease to be valid, binding or enforceable;

(vi) the occurrence of certain events of bankruptcy or insolvency of the Company or a Significant Subsidiary; or

(vii) existence of one or more final judgments against the Company or any of its Subsidiaries in excess of U.S.\$25,000,000, either individually or in the aggregate, which remain undischarged 60 days after all rights to directly review such judgment, whether by appeal or writ, have been exhausted or have expired.

If an Event of Default occurs and is continuing, the Trustee or the Holders of not less than 25% in principal amount of the notes then outstanding may declare all the notes to be immediately due and payable by notice to the Company (and to the Trustee if given by the Holders). Under certain circumstances, the Holders of a majority in principal amount of the notes then outstanding may rescind such a declaration.

### **Defeasance or Covenant Defeasance of the Indenture**

The Company may, at its option and at any time, elect to have its obligations with respect to the outstanding notes discharged ("defeasance"). Such defeasance means that the Company shall be deemed to have paid and discharged the entire Indebtedness represented by the outstanding notes, except for the rights of Holders of outstanding notes to receive payments in respect of the principal of and interest on such notes when such payments are due and certain provisions of the indenture with respect to the registration and transfer of the notes. In addition, the Company may, at its option and at any time, elect to have its obligations and the obligations of its subsidiaries with respect to certain covenants described in the indenture released ("covenant defeasance") and thereafter any failure to comply with such covenants shall not constitute a Default or an Event of Default. In the event of a covenant defeasance, certain other events (not including payment, bankruptcy or insolvency events) described under "Events of Default" will no longer constitute a Default or an Event of Default with respect to the notes.

In order to exercise either defeasance or covenant defeasance, (i) the Company must irrevocably deposit with the Trustee, in trust, for the benefit of the Holders of notes, cash in U.S. dollars, U.S. Government Obligations (as defined in the indenture), or a combination thereof (collectively, the "trust fund"), in such amounts as will be sufficient, in the opinion of an internationally recognized firm of independent accountants, to pay and discharge interest on the outstanding notes as it becomes due and

to pay and discharge the principal of the outstanding notes at redemption or maturity; (ii) in the case of defeasance, the Company must deliver to the Trustee an Opinion of Counsel in the United States stating that (1) the Company has received from, or there has been published by, the U.S. Internal Revenue Service a ruling or (2) since the date of the indenture, there has been a change in the applicable U.S. federal income tax law, in either case to the effect that, and based thereon such Opinion of Counsel in the United States shall confirm that, the Holders of the outstanding notes will not recognize income, gain or loss for U.S. federal income tax purposes as a result of such defeasance and will be subject to U.S. federal income tax on the same amounts, in the same manner and at the same times as would have been the case if such defeasance had not occurred; (iii) in the case of covenant defeasance, the Company must deliver to the Trustee an Opinion of Counsel in the United States to the effect that the Holders of the outstanding notes will not recognize income, gain or loss for U.S. federal income tax purposes as a result of such covenant defeasance and will be subject to U.S. federal income tax on the same amounts, in the same manner and at the same times as would have been the case if such covenant defeasance had not occurred; (iv) no Default or Event of Default may have occurred and be continuing on the date of such deposit and after giving effect thereto; (v) such defeasance or covenant defeasance may not cause the Trustee for the notes to have a conflicting interest with respect to any securities of the Company; (vi) such defeasance or covenant defeasance may not result in a breach or violation of, or constitute a Default under, the indenture or any material agreement or instrument to which the Company is a party by which it is bound; (vii) the Company must deliver to the Trustee an Officers' Certificate stating that the deposit was not made by the Company with the intent of preferring the Holders of the notes over the other creditors of the Company or with the intent of defeating, hindering, delaying or defrauding creditors of the Company; (viii) no event or condition may exist that would prevent the Company from making payments of the principal of, premium, if any, and interest on the notes, on the date of such deposit; (ix) the Company must deliver to the Trustee an Officers' Certificate and an Opinion of Counsel in the United States each stating that all conditions precedent under the indenture relating to either the defeasance or the covenant defeasance, as the case may be, have been complied with and (x) the Company must pay, including to the Trustee and Paying Agent, all other amounts due under the indenture.

### **Satisfaction and Discharge**

The indenture will cease to be of further effect (except as to surviving rights of registration of transfer or exchange of the notes, as expressly provided for in the indenture) as to all outstanding notes when (i) either (1) all the notes theretofore authenticated and delivered (except lost, stolen or destroyed notes which have been replaced or paid) have been delivered to the Trustee for cancellation or (2) all notes not theretofore delivered to the Trustee for cancellation have become due and payable, or will become due and payable or are to be called for redemption within one year, and the Company has irrevocably deposited or caused to be deposited with the Trustee funds in an amount sufficient to pay and discharge the entire Indebtedness on the notes not theretofore delivered to the Trustee for cancellation, for principal of, and premium, if any, and interest on the notes to the date of deposit together with irrevocable instructions to the Trustee from the Company directing the Trustee to apply such funds to the payment thereof at maturity or redemption, as the case may be; (ii) the Company has paid all other sums payable under the indenture by the Company; and (iii) the Company has delivered to the Trustee an Officers' Certificate and an Opinion of Counsel each stating that all conditions precedent under the indenture relating to the satisfaction and discharge of the indenture have been complied with.

### **Trustee and Registrar**

Deutsche Bank Trust Company Americas, the Trustee under the indenture, may from time to time enter into ordinary correspondent and other banking relationships with the Company. Deutsche Bank Trust Company Americas is also the Registrar for purposes of the indenture. The address of the principal corporate trust office of the Trustee and Registrar is set forth on the inside back cover page hereof.

### **Meetings of Holders**

The Company or the Trustee, upon the request of the Holders having at least 10% in aggregate principal amount of the outstanding notes, or the Company, at its discretion, may call a meeting of Holders at any time and from time to time, to make, give, or take any request, demand, authorization, notice, consent, election, waiver or other action permitted by the indenture. Any such meeting will be held in City of New York. Notice of every meeting of Holders, setting forth, in general, the time and the place of, and the agenda for, such meeting, shall be given not less than 10 days nor more than 30 days prior to the date fixed for the meeting, in the manner provided under “Notices” and publication thereof shall be at least once in each place of publication. In the absence of quorum within 45 minutes of the time appointed for any such meeting, a second call meeting (the “second call meeting”) may be called to take place. Persons holding or representing a majority of the aggregate principal amount of the notes at the time outstanding, or in the case of any second call meeting, the Holders present or represented at such meeting, shall constitute a quorum for any meeting of Holders. The unanimous affirmative vote of all of the Holders will be required to adopt any action or resolution if such action or resolution to be taken would effect any of the changes referred to in clauses (i) to (vi) of the first paragraph under “—Modification of the indenture; Waiver of Covenants.” In all other cases resolutions will be adopted by the affirmative vote of a majority of the Holders present or represented at any meeting computed on the basis of the principal amount of the outstanding notes held by such persons.

Except as provided above, any modifications, amendments, or waivers to the terms and conditions of the notes will be conclusive and binding on all Holders, whether or not they have given such consent or were present at any meeting of Holders, and whether or not notation of such modifications, amendments or waivers is made upon the notes.

## **Notices**

Notices to Holders will be deemed to be validly given if (i) mailed to the registered address of Holders as provided in the Register and (ii) published in a leading daily newspaper of general circulation in Luxembourg, which is expected to be the *Luxemburger Wort* so long as the notes are listed on the Luxembourg Stock Exchange and the rules of the Luxembourg Stock Exchange so require. Any notice so given will be deemed to have been validly given on the date of such publication (or, if published more than once, on the date of the first publication). Notices to the trustee will be deemed to be validly given upon actual receipt. The Company may choose to publish notices on the website of the Luxembourg Stock Exchange.

## **Governing Law and Submission to Jurisdiction**

THE INDENTURE AND THE NOTES WILL BE GOVERNED BY, AND WILL BE CONSTRUED IN ACCORDANCE WITH, THE LAWS OF THE STATE OF NEW YORK.

For the benefit of the Holders, the Company has irrevocably submitted to the non-exclusive jurisdiction of any New York State or U.S. federal court sitting in the Borough of Manhattan, City of New York, solely for the purposes of any suit, action or proceeding arising out of or related to the indenture or the notes and the Company has appointed NRAI-National Registered Agents, Inc. as its authorized agent upon which process may be served in any such suit, action or proceeding.

To the extent that the Company may in any jurisdiction claim for itself or its assets immunity from a suit, execution, attachment (whether in aid of execution, before judgment or otherwise) or other legal process and to the extent that in any such jurisdiction there may be attributed to itself or its assets such immunity (whether or not claimed), the Company irrevocably agrees for the benefit of the Holders not to claim, and irrevocably waives, such immunity to the full extent permitted by the laws of such jurisdiction

## **Currency Indemnity**

The Company agrees that, if a judgment or order given or made by any court for the payment of any amount in respect of any notes is expressed in a currency (the “judgment currency”) other than

U.S. dollars (the “denomination currency”), it will indemnify the relevant Holder against any deficiency arising or resulting from any variation in rates of exchange between the date as of which the denomination currency is notionally converted into the judgment currency for the purposes of such judgment or order and the date of actual payment thereof. This indemnity will constitute a separate and independent obligation from the other obligations of the Company under the indenture, will give rise to a separate and independent cause of action, will apply irrespective of any indulgence granted from time to time and will continue in full force and effect notwithstanding any judgment or order for a liquidated sum or sums in respect of amounts due in respect of the relevant Note or under any such judgment or order. Any such loss or damage will be deemed to constitute a loss suffered by the relevant Holder and no proof or evidence of loss will be required.

## **Certain Definitions**

“Adjusted EBITDA” means net income before financial expenses, net, income tax and social contribution tax (Brazilian federal taxes on income), depreciation and amortization, non-operating income (expenses) and extraordinary item(s), net of income tax and social contribution, each as set forth in the Company’s financial statements.

“Adjusted Total Debt” means, as of any date of determination, (a) our total (i) indebtedness for borrowed money or for the deferred purchase price of property or services, excluding trade payables and other accrued current liabilities arising in the ordinary course of business; (ii) obligations evidenced by bonds, notes, debentures, letters of credit or similar instruments; and (iii) guarantees of the types of indebtedness set forth in (i) and (ii) above, (b) less accrued interest and finance charges.

“Adjusted Shareholders’ Equity” means, with respect to any Person, as of any date of determination, Shareholders’ Equity of such Person less the sum of: (i) an amount equal to the aggregate amount of overdue accounts receivable from the Controlling shareholder of such Person and all Bulk Water Customer of such Person included on the consolidated balance sheet of such Person and its Subsidiaries, net of any reserve in respect of such accounts receivable and (ii) the value of any Capital Stock referred to in the proviso to clause (v) of the definition of “Indebtedness” to the extent included in the assets of such Person and its Subsidiaries, in each case determined on a consolidated basis in accordance with Brazilian GAAP as of the last day of the most recent fiscal quarter of such Person ending on or prior to such date of determination.

“Affiliate” means, with respect to any Person, any other Person directly or indirectly Controlling or Controlled by or under direct or indirect common Control with such specified Person; *provided, however*, that for purposes of this indenture, Brazil shall not be considered an Affiliate of the Company or any of its Subsidiaries.

“Brazilian Corporate Law” means Brazilian Federal Law No. 6,404, of December 15, 1976, as amended.

“Brazilian GAAP” means generally accepted accounting principles set forth in the Brazilian Corporate Law and in the regulations issued by the CVM, as in effect from time to time.

“Bulk Water Customer” means, with respect to any Person, any other Person that purchases water on a bulk basis from the first Person or any of its Subsidiaries and for which neither the first Person nor any of its Subsidiaries provides the service of distributing such water to end-users.

“Business Day” means a day other than a Saturday, a Sunday or a day on which banking institutions in the City of New York, Brazil and Luxembourg are not required to be open.

“Capital Lease Obligation” means, with respect to any Person, any obligation of such Person under any lease for real or personal property which, in accordance with Brazilian GAAP, is required to be recorded as a capitalized lease obligation; and, for the purpose of the indenture, the amount of such



obligation at any date shall be the capitalized amount thereof at such date, determined in accordance with Brazilian GAAP.

“Capital Stock” in any Person means any and all shares, interests, participations or other equivalents or interests in (however designated) capital stock in such Person, including, with respect to a corporation, common stock, Preferred Stock and other corporate stock and, with respect to a partnership, partnership interests, whether general or limited, and any rights to receive shares of the profits and losses of, or distributions of assets of, the issuing Person.

“Concession” means a concession granted to or held by the Company from a municipality in the State of São Paulo to provide water or sewage services within such municipality.

“Consolidated Interest Expense” means, with respect to any Person, as of any date of determination, the sum of the following items for the four most recent consecutive fiscal quarters ending on or prior to such date of determination, without duplication: (i) consolidated paid and accrued interest expense of such Person for such period and (ii) any other expenses related to the Adjusted Total Debt of such Person for such period.

“Control” when used with respect to any specified Person means the power to direct the management and policies of such Person directly or indirectly, whether through ownership of voting securities (or pledge of voting securities if the pledgee thereof may on the date of determination exercise or control the exercise of the voting rights of the owner of such voting securities), by contract or otherwise; and the terms “to Control,” “Controlling” and “Controlled” have meanings correlative to the foregoing.

“Debt Service Coverage Ratio” means, with respect to any person, the ratio of Adjusted EBITDA for such Person to the Consolidated Interest Expense for such Person, in each case for the four most recent consecutive fiscal quarters ending on or prior to the date of determination. In the event that such Person incurs or redeems any Indebtedness subsequent to the commencement of the period for which the Debt Service Coverage Ratio is being calculated but prior to the date of the event for which the calculation of the Debt Service Coverage Ratio is made (the “Calculation Date”), then the Debt Service Coverage Ratio shall be calculated giving *pro forma* effect to such Incurrence or redemption of Indebtedness, as if the same had occurred at the beginning of the applicable four-quarter period, including the assumption of investment returns at the rate equal to the higher of the SELIC Rate or any successor thereto or six-month LIBOR at the beginning of such four-quarter period. For the purposes of making the computation referred to above, investments in the equity of, or other acquisitions or dispositions, which constitute all or substantially all of an operating unit of a business and discontinued operations (as determined in accordance with Brazilian GAAP) that have been made by such Person or any of its Subsidiaries, including all mergers, consolidations and dispositions, during the four-quarter reference period or subsequent to such reference period and on or prior to the Calculation Date shall be calculated on a *pro forma* basis assuming that all such investments, acquisitions, dispositions, discontinued operations, mergers and consolidations (and the reduction of any associated fixed charge obligations and the change in Adjusted EBITDA resulting therefrom) had occurred on the first day of the four-quarter period. If since the beginning of such period any Person (that subsequently became a Subsidiary or was merged with or into such Person or any Subsidiary since the beginning of such period) shall have made an investment in the equity of, or other acquisition or disposition, which constitutes all or substantially all of an operating unit of a business, discontinued operation, merger or consolidation that would have required adjustment pursuant to this definition, the Debt Service Coverage Ratio shall be calculated giving *pro forma* effect thereto for such period as if such investment, acquisition, disposition, discontinued operation, merger or consolidation had occurred at the beginning of the applicable four-quarter period. For purposes of this definition, whenever *pro forma* effect is to be given to a transaction, the *pro forma* calculations shall be made in good faith by a responsible financial or accounting officer of the Company. If any Indebtedness bears a floating rate of interest and is being given *pro forma* effect, the interest on such Indebtedness shall be calculated as if the rate in effect on the Calculation date had been the applicable rate for the entire period. Interest on a Capital Lease Obligation shall be deemed to accrue at an interest rate implicit in such Capital Lease Obligation in accordance with Brazilian GAAP.

Interest on Indebtedness that may optionally be determined at an interest rate based upon a factor of a prime or similar rate, a eurocurrency interbank offered rate, or other rate, shall be deemed to have been based upon the rate actually chosen, or, if none, then based upon such optional rate as the Company shall choose.

“Default” means an event or condition the occurrence of which would, with the lapse of time or the giving of notice or both, become an Event of Default.

“Disqualified Capital Stock” means any Capital Stock which, by its terms (or by the terms of any security into which it is convertible or exchangeable), or upon the happening of any event, matures or is mandatorily redeemable, pursuant to a sinking fund obligation or otherwise, or redeemable at the option of the holder thereof, in whole or in part on, or prior to, or is exchangeable for debt securities of the Company or its Subsidiaries prior to, the final Stated Maturity of principal of the notes; *provided* that only the amount of such Capital Stock that is redeemable prior to the Stated Maturity of principal of the notes shall be deemed to be Disqualified Capital Stock.

“FEHIDRO” means the *Fundo Estadual de Recursos Hídricos*.

“FESAN” means the *Fundo Estadual de Saneamento*.

“Guaranteed Indebtedness” means, with respect to any Person, without duplication, all Indebtedness of any other Person guaranteed, directly or indirectly, in any manner by such Person, or in effect guaranteed directly or indirectly by such Person through an agreement (i) to pay or purchase such Indebtedness or to advance or supply funds for the payment or purchase of such Indebtedness, (ii) to purchase, sell or lease (as lessee or lessor) property, or to purchase or sell services, primarily for the purpose of enabling the debtor to make payment of such Indebtedness or to assure the holder of such Indebtedness against loss, (iii) to supply funds to, or in any other manner invest in, the debtor (including any agreement to pay for property or services without requiring that such property be received or such services be rendered), (iv) to maintain working capital or equity capital of the debtor, or otherwise to maintain the net worth, solvency or other financial condition of the debtor, or (v) otherwise to assure a creditor with respect to Indebtedness against loss, *provided* that such term shall not include endorsements of instruments for collection or deposit in the ordinary course of business.

“Holder” means a Person in whose name a Note is registered in the Note Register.

“Incur” means create, issue, assume, guarantee, incur or in any other manner become liable for or with respect to, directly or indirectly; *provided, however*, that any Indebtedness or Capital Stock of a Person existing at the time such Person becomes a Subsidiary (whether by merger, consolidation, acquisition or otherwise) shall be deemed to be Incurred by such Subsidiary at the time it becomes a Subsidiary. The term “Incurrence” when used as a noun shall have a correlative meaning. Notwithstanding the foregoing, a change in Brazilian GAAP that results in an obligation existing at the time of such change becoming Indebtedness shall not be deemed an Incurrence of such Indebtedness. The accretion of principal of a non-interest bearing security shall be deemed the Incurrence of Indebtedness.

“Indebtedness” means, with respect to any Person, without duplication, (i) all indebtedness of such Person for borrowed money or for the deferred purchase price of property or services, excluding any trade payables and other accrued current liabilities arising in the ordinary course of business, but including, without limitation, all obligations, contingent or otherwise, of such Person in connection with any letters of credit issued under letter of credit facilities which are outstanding for more than 30 days, and in connection with any agreement by such Person to purchase, redeem, exchange, convert or otherwise acquire for value any Capital Stock of such Person now or hereafter outstanding, (ii) all obligations of such Person evidenced by bonds, notes, debentures or other similar instruments, (iii) all indebtedness of such Person created or arising under any conditional sale or other title retention agreement with respect to property acquired by such Person, but excluding trade payables arising in the ordinary course of business, (iv) all Capital Lease Obligations of such Person, (v) all indebtedness referred to in clauses (i)

through (iv) above of other Persons and all dividends payable by other Person, the payment of which is, in each case, secured by (or for which the holder of such indebtedness has an existing right, contingent or otherwise, to be secured by) any Lien, upon or with respect to property (including, without limitation, accounts and contract rights) owned by such Person, even though such Person has not assumed or become liable for the payment of such indebtedness (the amount of such obligations being deemed to be the lesser of the value of such property or asset or the amount of the obligations so secured), *provided, however*, that Indebtedness shall not include any such indebtedness of any such other Person if the only such Lien is upon the Capital Stock of such other Person, (vi) all guarantees by such Person of Guaranteed Indebtedness, (vii) all Disqualified Capital Stock (valued at the greater of book value and voluntary or involuntary maximum fixed repurchase price plus accrued and unpaid dividends) of such Person, and (viii) any amendment, supplement, modification, deferral, renewal, extension, refunding or refinancing of any liability of the types referred to in clauses (i) through (vii) above. For purposes hereof, (x) the “maximum fixed repurchase price” of any Disqualified Capital Stock which does not have a fixed repurchase price shall be calculated in accordance with the terms of such Disqualified Capital Stock as if such Disqualified Capital Stock were purchased on any date on which Indebtedness shall be required to be determined pursuant to this indenture, and if such price is based upon, or measured by, the fair market value of such Disqualified Capital Stock, such fair market value is to be determined in good faith by the board of directors (or any duly authorized committee thereof) of the issuer of such Disqualified Capital Stock, and (y) Indebtedness is deemed to be incurred pursuant to a revolving credit facility each time an advance is made thereunder.

“Investment Grade” means BBB- or higher by S&P or Baa3 or higher by Moody’s, or the equivalent of such global ratings by S&P or Moody’s, or of another Rating Agency.

“Lien” means any mortgage, charge, pledge, lien (statutory or otherwise), security interest, hypothecation or other encumbrance upon or with respect to any property of any kind, real or personal, movable or immovable, now owned or hereafter acquired.

“Moody’s” means Moody’s Investors Service, Inc. and its successors.

“Permitted Liens” means and includes the following:

- (i) any Lien on an asset a respect of Indebtedness Incurred solely for the purpose of financing all or any part of the cost of acquiring, developing, improving or constructing such asset (including Capital Stock of any Person); *provided* that any such Lien may attach only to such asset and may not exceed the cost of acquiring, developing or constructing such asset; and *provided, further*, that such Lien will attach concurrently or within 180 days of the acquisition, development, improvement or construction of such asset or any promise to acquire such asset;
- (ii) any Lien securing Indebtedness Incurred by the Company or any of its Subsidiaries in connection with a Project Financing; *provided* that the property over which such Lien is granted consists solely of assets or revenues of the project for which the Project Financing was Incurred;
- (iii) any Lien on current and future accounts receivable due to the Company or any of its Subsidiaries securing Indebtedness owed to, directly or indirectly, (a) any multilateral development bank, (b) FEHIDRO, FESAN or any successor(s) thereto or any similar Brazilian entities that provide funds for similar purposes on similar terms and conditions or (c) any Brazilian federal governmental lender including (but not limited to) the Caixa Econômica Federal for the performance of the transactions contemplated by Ruling (*Instrução Normativa*) No. 6 of the Brazilian Municipalities Ministry (*Ministério das Cidades*), dated as of February 2, 2006;
- (iv) any Lien securing Indebtedness by the Company in connection with any PPP Project;

(v) any Lien securing current taxes, assessments or other governmental charges which are not delinquent or remain payable without any penalty, or the validity of which is contested in good faith by appropriate proceedings;

(vi) any order of attachment or similar legal process arising in connection with appropriate proceeding; *provided* that the execution or other enforcement thereof has effectively been stayed and the claims secured thereby are being contested at the time in good faith by appropriate proceedings;

(vii) any Lien securing claims of mechanics, laborers, workmen, repairmen, materialmen, suppliers, carriers, warehousemen, landlords, mortgagees of landlords or vendors or other claims provided for by mandatory provisions of the laws of Brazil which are not yet due and delinquent, or are being contested in good faith by appropriate proceedings;

(viii) any Lien existing on the date of the issuance of the notes and any Lien created in accordance with “—Negative Pledge”;

(ix) any Lien on property existing prior to the acquisition of such property by the Company or any of its Subsidiaries; *provided* that no such Lien was created in connection with or in contemplation of such acquisition;

(x) any Lien arising solely by operation of law;

(xi) any Lien on any assets or property owned by any Subsidiary which Lien existed at the time of acquisition of the interest in such Subsidiary by the Company or any of its Subsidiaries (including by way of merger or consolidation or otherwise) and which Lien was not created in connection with or in anticipation of such acquisition;

(xii) any Lien arising out of the title retention provisions in connection with the purchase of goods and equipment in the ordinary course of business;

(xiii) any Lien (x) on deposits to secure, or any Lien otherwise securing, the performance of bids, trade contracts, commercial or equipment leases, statutory obligations, surety bonds, performance bonds and other obligations of like nature Incurred in the ordinary course of business or (y) securing the performance of bids or proposals for the acquisition of assets by the Company or its Subsidiaries;

(xiv) any Lien securing reimbursement obligations under letters of credit, guarantees and other forms of credit enhancement given in connection with the purchase of goods and equipment in the ordinary course of business;

(xv) any Lien granted in respect of Indebtedness that is exchangeable or convertible into shares of the Company or any of its Subsidiaries; *provided* that such Lien is only granted over the shares into which such Indebtedness is exchangeable or convertible;

(xvi) any Lien on any property resulting solely from the granting, performance or termination of a Concession;

(xvii) easements, rights-of-way, restrictions, minor defects or irregularities in title and other similar charges or encumbrances not interfering in any material respect with the business of the Company or any of its Subsidiaries;

(xviii) any interest or title of a lessor in property subject to any Capital Lease Obligation or operating lease;

(xix) any Lien on current and future accounts receivable due to the Company or any of its Subsidiaries securing Indebtedness Incurred by the Company or any of its Subsidiaries to finance working capital;

(xx) any Lien securing an extension, renewal or financing of Indebtedness secured by the Liens described in clauses (iii), (vii), (viii) and (x) secured by a Lien in a principal amount not greater than the original principal amount thereof; and

(xxi) any other Lien not described in clauses (i) through (xx), *provided* that at the time such Lien is created, Incurred or granted, the principal amount of Indebtedness secured by all Liens created, Incurred or granted in reliance on this clause (xxi) shall not exceed the greater of (x) U.S.\$100,000,000 (or its equivalent in other currencies) and (y) 1.00% of Adjusted Shareholders' Equity.

For the purpose of the foregoing, property of a party to a merger or consolidation or to which the Company or a Subsidiary sells all or substantially all of its assets which is not the Company or a then Subsidiary, shall be deemed "acquired" by the Company or Subsidiary (even if the Company or a Subsidiary, as the case may be, is not the Surviving Entity) at time such merger or consolidation or sale occurs.

"Person" means any individual, corporation, limited liability company, partnership, joint venture, association, joint-stock company, trust, unincorporated organization or government or any agency or political subdivisions thereof.

"PPP Project" means a transaction entered under Brazilian federal law n.º11.079, of December 30, 2004 and/or state law n.º 11.688, of May 19, 2004 (so-called public-private partnerships, "PPP") that is (x) in accordance with the Company's investment budget, (y) solely for the purpose of operating assets which are closely related to the performance of the Company's main corporate purpose and investments in developing, improving or constructing, which are related to the services rendered in connection with the project; and (z) providing for economic benefits for the Company, which will be appraised by a well-known third-party appraiser and approved by the Company prior to the its commitment with the transaction.

"Preferred Stock" means, with respect to any Person, any Capital Stock of any class or classes (however designated) which is preferred as to the payment of dividends or distributions, or as to the distribution of assets upon any voluntary liquidation or dissolution of such Person, over Capital Stock of any other class in such Person.

"Project Financing" means any financing of all or part of the costs of the acquisition, construction or development of any project *provided* that the Person or Persons providing such financing expressly agree to limit their recourse to the project financed and the revenues derived from such project as the only source of repayment for the monies advanced.

"Rating Agency" means (i) S&P, (ii) Moodys or (iii) if neither S&P or Moodys is rating the notes, another internationally recognized rating agency.

"Sale and Leaseback Transaction" means any direct or indirect arrangement, or series of related arrangements, with any Person (other than the Company or a Subsidiary of the Company) or to which any Person (other than the Company or a Subsidiary of the Company) is a party, providing for the leasing to the Company or to a Subsidiary of the Company of any property for an aggregate term exceeding three years, whether owned by the Company or by any Subsidiary of the Company at the issue date or later acquired, which has been or is to be sold or transferred by the Company or such Subsidiary of the Company to such Person or to any other Person from whom funds have been or are to be advanced by such Person on the security of such property.

“S&P” means Standard & Poor’s Ratings Group, a division of McGraw Hill, Inc. and its successors.

“SELIC Rate” means the rate of interest calculated from time to time by the *Sistema Especial de Liquidação e Custódia* as the average of social market interest rate and published from time to time by the Central Bank.

“Shareholders’ Equity” of any Person means shareholders’ equity of such Person and its Subsidiaries determined on a consolidated basis in accordance with Brazilian GAAP.

“Significant Subsidiary” means, with respect to any Person, any consolidated Subsidiary of such Person for which the revenue or net income of such Subsidiary was more than 10% of the consolidated revenue of such Person in the prior fiscal years.

“Stated Maturity” when used with respect to any Indebtedness (including, without limitation, the notes) means the date specified in the instrument governing such Indebtedness as the fixed date on which any principal amount of such Indebtedness is due and payable (including, without limitation, by reason of any required redemption, purchase, defeasance or sinking fund payment) and, when used with respect to any installment of interest on Indebtedness, means the date on which such installment is due and payable.

“Subsidiary” means, with respect to any Person, any corporation, association or other business entity of which more than 50% of the voting power of Voting Stock thereof is at the time owned or controlled, directly or indirectly, by such Person or one or more of the other Subsidiaries of such Person or a combination thereof.

“Voting Stock” means Capital Stock of the class or classes of which the holders have (i) in respect of a corporation, the general voting power under ordinary circumstances to elect at least a majority of the board of directors, managers or trustees of such corporation (irrespective of whether or not at the time Capital Stock of any other class or classes shall have or might have voting power by reason of the happening of any contingency) or (ii) in respect of any other Person, the general voting power under ordinary circumstances to elect the board of directors or other governing board of such Person or other Person that controls such Person.

“Western Europe” means Austria, Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom and Northern Ireland.

## TAXATION

*The following discussion summarizes certain Brazilian and U.S. federal income tax considerations that may be relevant to you if you invest in the notes. This summary is based on laws and regulations now in effect in Brazil, and laws, regulations, rulings and decisions now in effect in the United States, in each case which may change. Any change could apply retroactively and could affect the continued validity of this summary.*

*This summary does not describe all of the tax considerations that may be relevant to you or your situation, particularly if you are subject to special tax rules. You should consult your tax advisors about the tax consequences of holding the notes, including the relevance to your particular situation of the considerations discussed below, as well as of state, local and other tax laws.*

### **Brazilian Taxation**

The following discussion is a general description of certain Brazilian tax aspects of the notes applicable to a holder that is an individual, entity, trust or organisation resident or domiciled outside Brazil for tax purposes ("non-Brazilian holder") and does not purport to be a comprehensive description of the tax aspects of the notes.

Generally, any capital gains generated outside Brazil as a result of a transaction between two non-residents of Brazil with assets not located in Brazil are not subject to tax in Brazil. On the other hand, when the assets are located in Brazil, such capital gains are subject to income tax, according to Law No. 10,833, enacted on December 29, 2003. Although the notes are expected to be registered in Luxembourg and although we believe that the notes would not fall within the definition of assets located in Brazil for the purposes of Law No. 10,833, considering the general and unclear scope of this legislation and the absence of judicial guidance in respect thereof, we cannot assure prospective investors that such interpretation of this law will prevail in the courts of Brazil. In case the notes are deemed to be located in Brazil, gains recognized by a non-Brazilian holder from the sale or other disposition of the notes to a resident or a non-resident in Brazil will be subject to income tax in Brazil at a rate of 15%, or 25%; if such non-Brazilian holder is located in a tax haven jurisdiction as defined below.

Interest payable under the notes by to a non-Brazilian holder is subject to Brazilian income tax withheld at source. The rate of withholding is 15% unless: (1) a lower rate is provided for in an applicable tax treaty between Brazil and the other country where the non-Brazilian holder of the payment has its domicile; or (2) the non-Brazilian holder of the payment is domiciled in a tax haven jurisdiction (i.e., countries which do not impose any income tax or which impose it at a maximum rate lower than 20% or where the laws impose restrictions on the disclosure of ownership composition or securities ownership), in which case the applicable rate is 15% if the a minimum amortization period of 96 months is observed for the notes or 25.0% on the other cases. In this last situation, if the referred minimum maturity period is determined for the notes but not observed, the difference between the 15% and 25% rates shall be calculated and collected, including fine for late payment of 20% and Selic interest rate (interest rate for governmental bonds).

Brazilian tax laws expressly authorize the payor to pay additional amounts in respect of Brazilian withholding tax, thereby assuming the cost of the applicable tax.

If the guarantor is required to assume the obligation to pay the principal amount of the notes to the non-Brazilian holder, Brazilian tax authorities could attempt to impose withholding income tax up to 25%. Although Brazilian legislation does not provide a specific tax rule for such cases and there is not an official position from tax authorities or precedents from the Brazilian courts regarding the matter, we believe that the remittance of funds by a Brazilian guarantor for the payment of the principal amount of the notes will not be subject to imposition of income tax. Regarding the payment of the interest by the Brazilian guarantor, despite the lack of an express legal provision concerning this payment as well as of precedents from Brazilian courts, we believe and intend to take the position for Brazilian tax purposes that

payments with respect to interest under the guaranty will be subject to Brazilian withholding income tax as described above.

All funds transfers in connection with financial transactions in Brazil are subject to the temporary contribution on financial transactions, or the CPMF, which is levied at a rate of 0.38% on any bank account withdrawals. The CPMF burden is incurred by the Brazilian payor. The CPMF expires on December 31, 2007, although the Federal Government may extend it or transform the CPMF into a permanent tax.

Pursuant to Decree No. 4,494/2002, conversion into Brazilian currency of proceeds received by a Brazilian entity and the conversion into foreign currency of proceeds received in reais are subject to taxation of foreign exchange transactions, or the IOF/Câmbio. Except in limited cases, the IOF/Câmbio is 0%, although the Federal Government may increase this rate up to 25%, but only with respect to future transactions. The same Decree determines the tax on bonds and securities transactions, or IOF/Títulos, which may be imposed on any transactions involving bonds and securities, even if these transactions are performed on Brazilian stock, futures or commodities exchanges. The rate of IOF/Títulos with respect to transactions of Notes is currently zero, although the executive branch may increase such rate up to 1.5% per day, but only with respect to future transactions.

Generally, there is no stamp, transfer or other similar tax in Brazil with respect to the transfer, assignment or sale of any debt instrument outside Brazil (including the notes) nor any inheritance, gift or succession tax applicable to the ownership, transfer or disposition of the notes, except for gift and inheritance taxes imposed in some states of Brazil on gifts and bequests by the non-Brazilian holder to individuals or entities domiciled or residing within such Brazilian states.

**THE ABOVE DESCRIPTION IS NOT INTENDED TO CONSTITUTE A COMPLETE ANALYSIS OF ALL TAX CONSEQUENCES RELATING TO THE OWNERSHIP OF NOTES. PROSPECTIVE PURCHASERS OF NOTES SHOULD CONSULT THEIR OWN TAX ADVISORS CONCERNING THE TAX CONSEQUENCES OF THEIR PARTICULAR SITUATIONS.**

#### **United States Federal Income Taxation**

TO ENSURE COMPLIANCE WITH U.S. TREASURY DEPARTMENT CIRCULAR 230, HOLDERS OF NOTES ARE HEREBY NOTIFIED THAT THE FOLLOWING DISCUSSION IS WRITTEN IN CONNECTION WITH THE PROMOTION OR MARKETING OF THE TRANSACTIONS DESCRIBED IN THIS OFFERING CIRCULAR. SUCH DISCUSSION OF TAX ISSUES WAS NOT INTENDED TO BE USED, AND IT CANNOT BE USED (BY ANY PERSON) FOR THE PURPOSE OF AVOIDING PENALTIES THAT MAY BE IMPOSED UNDER THE U.S. INTERNAL REVENUE CODE. EACH PROSPECTIVE PURCHASER OF NOTES SHOULD CONSULT ITS OWN TAX ADVISORS TO DETERMINE THE PARTICULAR TAX CONSEQUENCES TO THEM OF THE PURCHASE, OWNERSHIP AND DISPOSITION OF THE NOTES.

The following discussion summarizes the principal U.S. federal income tax consequences to beneficial owners arising from the purchase, ownership, and disposition of the notes. The discussion that follows is based on the U.S. Internal Revenue Code of 1986, as amended (the "Code"), its legislative history, judicial authority, administrative rulings and practice and U.S. Treasury regulations promulgated thereunder, all as in effect and available on the date hereof. Such authorities may be repealed, revoked or modified and could result in U.S. federal income tax consequences different from those discussed below, possibly with retroactive effect.

For purposes of this summary, the term "U.S. Holder" means a beneficial owner of a note that is, for U.S. federal income tax purposes (a) an individual citizen or resident of the United States, (b) a corporation or other entity taxable as such created or organized under the laws of the United States, a state thereof, or the District of Columbia, (c) an estate the income of which is subject to U.S. federal income tax regardless of its source, or (d) a trust if (i) a court within the United States is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority



to control all substantial decisions of the trust or (ii) the trust has a valid election in effect to be treated as a U.S. person under applicable U.S. Treasury regulations.

The term “Non-U.S. Holder” means a beneficial owner of a note that is neither a U.S. Holder nor a partnership. If a partnership holds notes, the tax treatment of a partner will depend upon the status of the partner and the activities of the partnership. Partners in partnerships holding notes should consult their tax advisors.

This discussion is intended as a summary only and is not intended as tax advice to any particular investor. This summary is not a complete analysis or listing of all potential U.S. federal income tax consequences to U.S. Holders and Non-U.S. Holders relating to the notes and does not address the effect of any U.S. gift, estate, state or local tax law or foreign tax law on a potential investor in the notes. This summary does not address the tax treatment of Holders that may be subject to special income tax rules, including, without limitation, (a) insurance companies, (b) tax-exempt organizations, (c) banks and other financial institutions, (d) U.S. Holders whose functional currency is not the U.S. dollar, (e) Holders subject to the alternative minimum tax, (f) broker-dealers in securities, (g) Holders that hold the notes as a hedge straddle, conversion transaction, constructive sale transaction, or other integrated transaction, (h) traders in securities that elect to mark to market, (i) certain former citizens and long-term residents of the United States, (j) real estate investment trusts, and (k) regulated investment companies. This summary is generally limited to investors who will hold the notes as “capital assets” within the meaning of Section 1221 of the Code and who are initial investors who purchase the notes at the issue price within the meaning of Section 1273 of the Code.

## **U.S. Holders**

### ***Taxation of Payments of Interest and Additional Amounts***

Interest paid on a note will be included in the gross income of a U.S. Holder as ordinary income at the time it is treated as received or accrued, in accordance with the U.S. Holder’s regular method of tax accounting. A U.S. Holder will also be required to include in gross income as interest any withholding tax paid and any Additional Amounts paid with respect to withholding tax on the notes, including withholding tax on payments of such Additional Amounts.

Because the stated redemption price of the notes will not exceed their issue price by more than a *de minimis* amount for U.S. federal income tax purposes, no portion of the discount on the notes generally will be reportable by a U.S. Holder as ordinary income on a current basis. Any such discount included in income is treated as gain recognized on the retirement of the note (generally, capital gain or loss).

Interest received or accrued on the notes generally will constitute foreign source income to U.S. Holders for U.S. foreign tax credit purposes. If Brazilian or other withholding taxes are imposed, U.S. Holders will be treated as having actually received an amount equal to the amount of such taxes and as having paid such amount to the relevant taxing authority. As a result, the amount of interest income included in gross income by a U.S. Holder will be greater than the amount of cash actually received by the U.S. Holder. Subject to certain limitations, a U.S. Holder generally will be entitled to a credit against its U.S. federal income tax liability for Brazilian income taxes withheld by us. Alternatively, a U.S. Holder may elect to claim a deduction for such Brazilian income taxes in computing its U.S. federal taxable income provided that the election shall apply to all foreign income taxes paid or accrued by the U.S. Holder for the taxable year. For purposes of the foreign tax credit limitation, foreign source income is classified in one of several “baskets,” and the credit for foreign taxes paid or accrued with respect to foreign source income in any basket is limited to U.S. federal income tax allocable to that income. In taxable years beginning before January 1, 2007, interest generally will constitute foreign source income in the “high withholding tax interest” basket if the notes are subject to Brazilian withholding tax at a rate of 5.0% or higher. If the notes are not subject to a withholding tax at such rate or in any taxable years beginning after December 31, 2006, interest generally will be in the “passive income” basket. The calculation of U.S. foreign tax credits and, in the case of a U.S. Holder that elects to deduct foreign taxes,

the availability of deductions involve the application of complex rules that depend on a U.S. Holder's particular circumstances. U.S. Holders should, therefore, consult their own tax advisors regarding the application of the U.S. foreign tax credit rules to interest income (including Additional Amounts) on the notes.

### ***Sale, Redemption, Retirement and Other Taxable Disposition of the Notes***

A U.S. Holder will generally recognize gain or loss on the sale, redemption, retirement or other taxable disposition of a note (including any deemed exchange of notes for "new" notes that might occur for U.S. federal income tax purposes as a result of an assumption of our obligations under the notes by any person, as described under "Description of the Notes—Certain Covenants—Merger and Consolidation," or as a result of significant modifications to the indenture as described under "Description of Notes—Modification of the Indenture; Waiver of Covenants") in an amount equal to the difference between (i) the amount of cash and the fair market value of property received by such U.S. Holder on such disposition (less any amounts attributable to accrued but unpaid interest which will be taxable as such), and (ii) the U.S. Holder's adjusted tax basis in the note. A U.S. Holder's adjusted tax basis in a note will generally equal the acquisition cost of such note to the U.S. Holder decreased by the amount of any principal payments made on the note. Such gain or loss will be capital gain or loss. Capital gains of certain non-corporate U.S. Holders, including individuals, derived with respect to capital assets held for over one year may be eligible for reduced rates of taxation. For example, the maximum rate of tax under current law for capital assets held for more than one year will generally be 15%. The deductibility of capital losses is subject to limitations.

Gain or loss recognized by a U.S. Holder on the sale, redemption, retirement or other taxable disposition of a note will generally be U.S.-source gain or loss. Accordingly, if Brazilian or other withholding tax is imposed on the sale or disposition of the notes, a U.S. Holder may not be able to fully utilize its U.S. foreign tax credits in respect of such withholding tax unless such U.S. Holder has other foreign source income. Prospective investors should consult their own tax advisors as to the U.S. tax and foreign tax credit implications of such sale, redemption, retirement or other disposition of a note.

### **Non-U.S. Holders**

Except as otherwise described below, a Non-U.S. Holder of a note will not be subject to U.S. federal income tax by withholding or otherwise on payments of interest (including Additional Amounts) on a note or gain realized in connection with the sale, redemption, retirement or other disposition of a note, unless the Non-U.S. Holder is (a) an individual present in the U.S. for 183 days or more in the taxable year of a disposition of the note in which gain was realized and certain other conditions are satisfied, or (b) engaged in a trade or business in the U.S. and the interest or gain on the note, as the case may be, is effectively connected with the conduct of such trade or business (and, if an income tax treaty applies, through a permanent establishment in the U.S.). In addition, if such Non-U.S. Holder is a foreign corporation, it may be subject to a branch profits tax equal to 30% (or such lower rate provided by an applicable treaty) of its effectively connected earnings and profits for the taxable year, subject to certain adjustments.

### **Backup Withholding and Information Reporting**

For non-corporate U.S. Holders, information reporting requirements generally will apply to (a) payments of principal and interest on a note (including any Additional Amounts) within the U.S., including payments made by wire transfer from outside the U.S. to an account such non-corporate U.S. Holder maintains within the U.S., and (b) the payment of the proceeds from the sale of a note effected at a U.S. office of a broker. Additionally, backup withholding will apply to such payments to a non-corporate U.S. Holder that (a) fails to provide an accurate taxpayer identification number, (b) is notified by the U.S. Internal Revenue Service that it has failed to report all interest required to be shown on its U.S. federal income tax returns, or (c) in certain circumstances, fails to comply with applicable certification requirements.

Backup withholding and information reporting will not apply to payments made by us or our paying agents, in their capacities as such, to a Non-U.S. Holder of a note if the Holder has provided the required certification that it is not a "U.S. person" within the meaning of the Code, provided that neither we nor our paying agent has actual knowledge that the Holder is a U.S. person. Payments of the proceeds from a disposition of a note by a Non-U.S. Holder made to or through a foreign office of a broker will not be subject to information reporting or backup withholding, except that information reporting and backup withholding may apply to those payments if the broker is:

1. a U.S. person;
2. a controlled foreign corporation for U.S. federal income tax purposes;
3. a foreign person, 50% or more of whose gross income is effectively connected with a U.S. trade or business for a specified three-year period; or
4. a foreign partnership, if at any time during its tax year, one or more of its partners are U.S. persons, as defined in U.S. Treasury regulations, who in the aggregate hold more than 50% of the income or capital interest in the partnership or if, at any time during its tax year, the foreign partnership is engaged in a U.S. trade or business.

Payment of the proceeds from a disposition by a Non-U.S. Holder of a note made to or through the U.S. office of a broker is likely subject to information reporting and backup withholding unless the Holder or beneficial owner certifies as to its taxpayer identification number or otherwise establishes an exemption from information reporting and backup withholding.

Non-U.S. Holders should consult their own tax advisors regarding application of backup withholding in their particular circumstance and the availability of, and the procedure for, obtaining an exemption from backup withholding under current U.S. Treasury regulations. Backup withholding is not an additional tax. Any amounts withheld under the backup withholding rules from a payment to a Non-U.S. Holder will be allowed as a refund or as a credit against the Non-U.S. Holder's U.S. federal income tax liability, provided the required information is timely furnished to the IRS.

## CERTAIN ERISA CONSIDERATIONS

**To ensure compliance with U.S. Treasury Department Circular 230, holders of notes are hereby notified that the following discussion is written in connection with the promotion or marketing of the transactions described in this offering circular. Such discussion of tax issues was not intended to be used, and it cannot be used (by any person) for the purpose of avoiding penalties that may be imposed under the U.S. Internal Revenue Code. Each prospective purchaser of notes should consult its own tax advisors to determine the particular tax consequences to them of the purchase, ownership and disposition of the notes.**

### General

The Employee Retirement Income Security Act of 1974, as amended ("*ERISA*"), imposes certain requirements on employee benefit plans subject to Title I of ERISA and on entities that are deemed to hold the assets of such plans ("*ERISA Plans*"), and on those persons who are fiduciaries with respect to ERISA Plans. Investments by ERISA Plans are subject to ERISA's general fiduciary requirements, including, but not limited to, the requirement of investment prudence and diversification and the requirement that an ERISA Plan's investments be made in accordance with the documents governing the plan.

Section 406 of ERISA and Section 4975 of the Internal Revenue Code of 1986, as amended (the "*Code*"), prohibit certain transactions involving the assets of an ERISA Plan (as well as those plans that are not subject to ERISA but which are subject to Section 4975 of the Code, such as individual retirement accounts (together with ERISA Plans, "*Plans*")) and certain persons (referred to as "*parties in interest*" or "*disqualified persons*") having certain relationships to such Plans, unless a statutory or administrative exemption is applicable to the transaction. A party in interest or disqualified person who engages in a prohibited transaction may be subject to excise taxes and other penalties and liabilities under ERISA and the Code.

Any Plan fiduciary which proposes to cause a Plan to purchase the notes should consult with its counsel regarding the applicability of the fiduciary responsibility and prohibited transaction provisions of ERISA and Section 4975 of the Code to such an investment, and to confirm that such purchase and holding will not constitute or result in a non-exempt prohibited transaction or any other violation of an applicable requirement of ERISA.

Governmental plans, certain church plans and certain non-U.S. plans, while not subject to the fiduciary responsibility provisions of ERISA or the prohibited transaction provisions of ERISA and Section 4975 of the Code, may nevertheless be subject to state, federal or other laws or regulations that are substantially similar to the foregoing provisions of ERISA and the Code ("*Similar Law*"). Fiduciaries of any such plans should consult with their counsel before purchasing the notes to determine the need for, and the availability, if necessary, of any exemptive relief under any such law or regulations.

### Prohibited Transaction Exemptions

The fiduciary of a Plan that proposes to purchase and hold any notes should consider, among other things, whether such purchase and holding may involve (i) the direct or indirect extension of credit to a party in interest or a disqualified person, (ii) the sale or exchange of any property between a Plan and a party in interest or a disqualified person, or (iii) the transfer to, or use by or for the benefit of, a party in interest or disqualified person, of any Plan assets. Such parties in interest or disqualified persons could include, without limitation, the Company, the initial purchaser, the trustee or any of their respective affiliates. Depending on the satisfaction of certain conditions which may include the identity of the Plan fiduciary making the decision to acquire or hold the notes on behalf of a Plan, Section 408(b)(17) of ERISA, Section 4975(d)(20) of the Code, Prohibited Transaction Class Exemption ("*PTCE*") 84-14 (relating to transactions effected by a "qualified professional asset manager"), PTCE 90-1 (relating to investments by insurance company pooled separate accounts, PTCE 91-38 (relating to investments by bank collective investment funds), PTCE 95-60 (relating to investments by an insurance company general

account) or PTCE 96-23 (relating to transactions directed by an in-house asset manager) (collectively, the “*Class Exemptions*”) could provide an exemption from the prohibited transaction provisions of ERISA and Section 4975 of the Code. However, there can be no assurance that any of these Class Exemptions or any other exemption will be available with respect to any particular transaction involving the notes.

By its purchase of any note, the purchaser thereof will be deemed to have represented and warranted either that: (i) no assets of a Plan or governmental, church or non-U.S. plan, or any trust established with respect to a Plan or governmental, church, or non-U.S. plan, have been used to acquire such notes or an interest therein or (ii) the purchase and holding of such notes or an interest therein by such person will not result in a violation of, or are exempt from the prohibited transaction restrictions of ERISA and the Code or any provisions of Similar Law, as applicable, pursuant to one or more prohibited transaction statutory or administrative exemptions, as applicable.

Each Plan fiduciary (and each fiduciary for governmental, church or non-U.S. plans subject to Similar Law) should consult with its legal advisor concerning the potential consequences to the plan under ERISA, the Code or such Similar Laws of an investment in the notes and to confirm that such investment will not constitute or result in a non-exempt prohibited transaction or any other violation of any applicable requirement of ERISA, Section 4975 of the Code or Similar Laws.

## PLAN OF DISTRIBUTION

Subject to the terms and conditions of the purchase agreement, Deutsche Bank Securities Inc., as the initial purchaser, has agreed to purchase from us the following respective principal amount of notes at the initial offering price set forth on the cover page of this offering circular less discounts and commissions:

<u>Underwriters</u>	Principal Amount of Notes
<b>Deutsche Bank Securities Inc.</b> .....	<b>\$140,000,000</b>
<b>Total</b> .....	<b>\$140,000,000</b>

The purchase agreement provides that the obligations of the initial purchaser to purchase the notes offered hereby are subject to certain conditions precedent and that the initial purchaser will purchase all of the notes offered by this offering circular if any of these notes are purchased.

After the initial offering, the initial purchaser may change the offering price and other selling terms.

We have agreed to indemnify the initial purchaser against some specified types of liabilities, including liabilities under the Securities Act, and to contribute to payments the initial purchaser may be required to make in respect of any of these liabilities.

The notes have not been registered under the Securities Act. The initial purchaser has agreed that it will offer or sell the Notes only (i) in the United States to qualified institutional buyers in reliance on Rule 144A under the Securities Act or (ii) in offshore transactions in reliance on Regulation S under the Securities Act. The notes being offered and sold pursuant to Regulation S may not be offered, sold or delivered in the United States or to, or for the account or benefit of, any U.S. person, unless the Notes are registered under the Securities Act, or an exemption from the registration requirements thereof is available. Terms used above have the meanings given to them by Regulation S and Rule 144A under the Securities Act. See "Transfer Restrictions."

Until the expiration of 40 days after the commencement of the offering, any offer or sale of notes within the United States by a broker-dealer may violate the registration requirements of the Securities Act, unless such offer or sale is made pursuant to Rule 144A under the Securities Act or another available exemption from the registration requirements thereof.

The notes are a new issue of securities with no established trading market. We do not intend to list the notes on any securities exchange or on any automated dealer quotation system other than the Luxembourg Stock Exchange and to trade on the Euro MTF. The notes are expected to be eligible for trading in the Private Offerings, Resale and Trading through Automatic Linkages (PORTAL<sup>SM</sup>) Market. The initial purchaser may make a market in the notes after completion of the offering, but will not be obligated to do so and may discontinue any market-making activities at any time without notice. No assurance can be given as to the liquidity of the trading market for the notes or that an active public market for the notes will develop. If an active public trading market for the notes does not develop, the market price and liquidity of the notes may be adversely affected.

In connection with the offering, the initial purchaser may purchase and sell the notes in the open market. These transactions may include short sales, purchases to cover positions created by short sales and stabilizing transactions.

Short sales involve the sale by the initial purchaser of a greater principal amount of notes than it is required to purchase in the offering. The initial purchaser may close out any short position by purchasing notes in the open market. A short position is more likely to be created if initial purchaser is

concerned that there may be downward pressure on the price of the notes in the open market prior to the completion of the offering.

Stabilizing transactions consist of various bids for or purchases of the notes made by the initial purchaser in the open market prior to the completion of the offering.

The initial purchaser may impose a penalty bid. This occurs when a particular underwriter repays to the initial purchaser a portion of the underwriting discount received by it because the initial purchaser has repurchased notes sold by or for the account of that underwriter in stabilizing or short covering transactions.

Purchases to cover a short position and stabilizing transactions may have the effect of preventing or slowing a decline in the market price of the notes. Additionally, these purchases, along with the imposition of the penalty bid, may stabilize, maintain or otherwise affect the market price of the notes. As a result, the price of the notes may be higher than the price that might otherwise exist in the open market. These transactions may be effected in the over-the-counter market or otherwise.

It is expected that delivery of the notes will be made against payment therefor on or about November 3, 2006, which is the tenth business day following the date hereof (this settlement cycle being referred to as "T+10"). Under Rule 15c6-1 under the U.S. Securities and Exchange Act of 1934, as amended, trades in the secondary market generally are required to settle in three business days, unless the parties to any such trade expressly agree otherwise. Accordingly, U.S. purchasers who wish to trade notes on the date hereof or any of the next six business day will be required, by virtue of the fact that the notes initially will settle in T+10, to specify an alternate settlement cycle at the time of any such trade to prevent a failed settlement. Purchasers of notes in other countries who wish to trade the notes on the date hereof or the any of the next six business day should consult their own advisor.

## **Selling Restrictions**

### ***European Economic Area***

In relation to each member state of the European Economic Area that has implemented the Prospectus Directive, (each, a Relevant Member State), with effect from and including the date on which the Prospectus Directive is implemented in that Relevant Member State (the Relevant Implementation Date) our notes will not be offered to the public in that Relevant Member State prior to the publication of a prospectus in relation to our notes that has been approved by the competent authority in that Relevant Member State and notified to the competent authority in that Relevant Member State, all in accordance with the Prospectus Directive, except that, with effect from and including the Relevant Implementation Date, our notes may be offered to the public in that Member State at any time:

- to legal entities which are authorized or regulated to operate in the financial markets, or if not so authorized or regulated, whose corporate purpose is solely to invest in securities;
- to any legal entity which has two or more of (1) an average of at least 250 employees during the last financial year; (2) a total balance sheet of more than €43,000,000 and (3) an annual net turnover of more than €50,000,000, as shown in its last annual or consolidated accounts; or
- in any other circumstances which do not require the publication by us of a prospectus pursuant to Article 3 of the Prospectus Directive.

For the purposes of this provision, the expression "our notes may be offered to the public" in relation to any of our notes in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and our notes to be offered so as to enable an investor to decide the purchase our notes as the same may be varied in that Member State by any

measure implementing the Prospectus Directive in that Member State and the expression “Prospective Directive” means Directive 2003/71/EC and includes any relevant implementing measure in each Relevant Member State.

This European Economic Area selling restriction is in addition to any other selling restrictions set out below.

### ***United Kingdom***

Our notes may not be offered or sold and will not be offered or sold to any persons in the United Kingdom other than to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or as agent) for the purposes of their businesses and in compliance with all applicable provisions of the Financial Services and Markets Act, or the FSMA, with respect to anything done in relation to our notes in, from or otherwise involving the United Kingdom. In addition, the initial purchaser has only communicated or caused to be communicated and will only communicate or cause to be communicated any invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) received by it in connection with the issue or sale of our notes in circumstances in which Section 21(1) of the FSMA does not apply to us. Without limitation to the other restrictions referred to herein, this offering circular is directed only at (1) persons outside the United Kingdom, (2) persons having professional experience in matters relating to investments who fall within the definition of “investment professionals” in Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005; or (3) high net worth bodies corporate, unincorporated associations and partnerships and trustees of high value trusts as described in Article 49(2) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005. Without limitation to the other restrictions referred to herein, any investment or investment activity to which this offering memorandum relates is available only to, and will be engaged in only with, such persons, and persons within the United Kingdom who receive this communication (other than persons who fall within (2) or (3) above) should not rely or act upon this communication.

### ***Switzerland***

The notes may not and will not be publicly offered, distributed or re-distributed on a professional basis in or from Switzerland and neither this offering circular nor any other solicitation for investments in the notes may be communicated or distributed in Switzerland in any way that could constitute a public offering within the meaning of Articles 1156 or 652a of the Swiss Code of Obligations or of Article 2 of the Federal Act on Investment Funds of March 18, 1994. This offering circular may not be copied, reproduced, distributed or passed on to others without the underwriters’ prior written consent. This offering circular is not a prospectus within the meaning of Articles 1156 and 652a of the Swiss Code of Obligations or a listing prospectus according to article 32 of the Listing Rules of the Swiss exchange and may not comply with the information standards required thereunder. We will not apply for a listing of our notes on any Swiss stock exchange or other Swiss regulated market and this offering circular may not comply with the information required under the relevant listing rules. The notes have not and will not be registered with the Swiss Federal Banking Commission and have not and will not be authorized under the Federal Act on Investment Funds of March 18, 1994. The investor protection afforded to acquirers of investment fund certificates by the Federal Act on Investment Funds of March 18, 1994, does not extend to acquirers of the notes.

### ***Hong Kong***

The notes may not be offered or sold by means of any document other than to persons whose ordinary business is to buy or sell, shares or debentures, whether as principal or agent, or in circumstances which do not constitute an offer to the public within the meaning of the Companies Ordinance (Cap. 32) of Hong Kong, and no advertisement, invitation or document relating to the notes may be issued, whether in Hong Kong or elsewhere, which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the securities laws of Hong Kong) other than with respect to the notes which are or are intended to be



disposed of only to persons outside Hong Kong or only to “professional investors” within the meaning of the Securities and Futures Ordinance (Cap. 571) of Hong Kong and any rules made thereunder.

### ***Singapore***

This offering circular has not been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, this offering circular and any other document or material in connection with the offer or sale, or invitation for purchase of the notes may not be circulated or distributed, nor may the notes be offered or sold, or be made the subject of an invitation for purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor under Section 274 of the Securities and Futures Act, Chapter 289 of Singapore, or the SFA, (ii) to a relevant person, or any person pursuant to Section 275(1A), and in accordance with the conditions, specified in Section 275 of the SFA or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

Where the notes are purchased under Section 275 by a relevant person which is: (a) a corporation (which is not an accredited investors) the sole business of which is to hold investments and the entire share capital of which is owned by one or more individuals, each of whom is an accredited investor; or (b) a trust (where the trustee is not an accredited investor) whose sole purpose is to hold investments and each beneficiary is an accredited investor, shares, debentures and units of shares and debentures of that corporation or the beneficiaries' rights and interest in that trust shall not be transferable for six months after that corporation or that trust has acquired the notes under Section 275 except: (1) to an institutional investor under Section 274 of the SFA or to a relevant person, or any person pursuant to Section 275(1A), and in accordance with the conditions, specified in Section 275 of the SPA; (2) where no consideration is given for the transfer; or (3) by operation of law.

## TRANSFER RESTRICTIONS

The notes have not been registered under the Securities Act and may not be offered or sold in the United States or to, or for the account or benefit of, U.S. persons except in accordance with an applicable exemption from the registration requirements thereof. Accordingly, the notes are being offered and sold only (1) to “qualified institutional buyers” (as defined in Rule 144A under the Securities Act) in compliance with Rule 144A, or (2) outside the United States to non-U.S. persons in reliance upon Regulation S under the Securities Act. As used in this section, the terms “United States,” “U.S. person” and “offshore transactions” have the meanings given to them in Regulation S.

Each purchaser of notes, by its acceptance thereof, will be deemed to have acknowledged, represented to and agreed with Sabesp and the initial purchaser as follows:

- It is:
  - a qualified institutional buyer, is aware that the sale of the notes to it is being made in reliance on Rule 144A and is acquiring the notes for its own account or for the account of a qualified institutional buyer; or
  - not a U.S. person and is purchasing the notes outside the United States in compliance with Regulation S.
- It understands that the notes are being offered in a transaction not involving any public offering in the United States within the meaning of the Securities Act and that the notes have not been registered under the Securities Act.
- If it is acquiring the notes in a sale made in reliance upon Rule 144A, it will not offer, resell, pledge or otherwise transfer notes prior to the date that is two years after the later of the original issue date of the notes and the last date on which Sabesp or any of its affiliates was the owner of that note (or any predecessor of that note) except:
  - to Sabesp;
  - inside the United States to a qualified institutional buyer in compliance with Rule 144A;
  - outside the United States to non-U.S. persons in offshore transactions in accordance with Rule 903 or Rule 904 of Regulation S;
  - in a transaction complying with Rule 144 under the Securities Act (if available); or
  - pursuant to an effective registration statement under the Securities Act,in each case in accordance with any applicable securities laws of any state of the United States and other jurisdictions. In addition, it will, and each subsequent holder is required to, notify any subsequent purchaser of those notes from it of the resale restrictions referred to above.
- If it is acquiring the notes in a sale being made in reliance upon Rule 144A, it understands that the notes will, until two years after the later of the original issue date of the notes and the last date on which Sabesp or any of its affiliates was the owner of that note (or any predecessor of that note), unless otherwise agreed by Sabesp and the holder of the note, bear a legend substantially to the following effect:

**“This security has not been registered under the United States Securities Act of 1933, as amended (the “Securities Act”), or the securities laws of any state or other jurisdiction. Neither this security nor any interest or participation herein may be reoffered, sold, assigned, transferred, pledged, encumbered or otherwise disposed of in the absence of such registration or unless such transaction is exempt from, or not subject to, such registration.**

**The holder of this security by its acceptance hereof (1) represents that it is a “qualified institutional buyer” (as defined in Rule 144A under the Securities Act) purchasing this security for its own account or for the account of one or more qualified institutional buyers; (2) agrees to offer, sell or otherwise transfer such security, prior to the date (the “resale restriction termination date”) which is two years after the later of the original issue date hereof and the last date on which Sabesp or any affiliate of Sabesp was the owner of this security (or any predecessor of such security), only (a) to Sabesp or any affiliate thereof, (b) pursuant to a registration statement that has been declared effective under the Securities Act, (c) for so long as the securities are eligible for resale pursuant to Rule 144A, to a person it reasonably believes is a “qualified institutional buyer,” that purchases for its own account or for the account of a qualified institutional buyer to whom notice is given that the transfer is being made in reliance on Rule 144A, (d) pursuant to offers and sales that occur outside the United States in compliance with Rule 903 or 904 under Regulation S under the Securities Act or (e) pursuant to another available exemption from the registration requirements of the Securities Act, in each case in accordance with all applicable securities laws of the states of the United States or any other applicable jurisdiction; and (3) agrees that it will deliver to each person to whom this security is transferred a notice substantially to the effect of this restrictive legend. This legend will be removed upon the request of the holder after the resale restriction termination date.”**

- If it is acquiring the notes in a sale being made in reliance upon Regulation S, it understands that the notes will, until the expiration of a 40-day “distribution compliance period” within the meaning of Rule 903 of Regulation S, bear a legend substantially to the following effect:

**“This security has not been registered under the United States Securities Act of 1933, as amended (the “Securities Act”), or the securities laws of any state or other jurisdiction, and, accordingly, may not be offered or sold within the United States or to or for the account or benefit of U.S. persons except as set forth in the following sentence. By its acquisition hereof, the holder (1) represents that it is not a U.S. person, is not acquiring this security for the account or benefit of a U.S. person and is acquiring this security in an offshore transaction, (2) by its acceptance hereof, agrees to offer, sell or otherwise transfer such security only (a) to Sabesp or any affiliate thereof, (b) pursuant to a registration statement that has been declared effective under the Securities Act, (c) for so long as the securities are eligible for resale pursuant to Rule 144A under the Securities Act (“Rule 144A”), to a person it reasonably believes is a “qualified institutional buyer” as defined in Rule 144A that purchases for its own account or for the account of a qualified institutional buyer to whom notice is given that the transfer is being made in reliance on Rule 144A in a transaction meeting the requirements of Rule 144A, (d) pursuant to offers and sales that occur outside the United States in compliance with Rule 903 or 904 under Regulation S under the Securities Act or (e) pursuant to another available exemption from the registration requirements of the Securities Act, in each case in accordance with all applicable securities laws of the states of the United States or any other applicable jurisdiction, and (3) agrees that it will deliver to each person to whom this security is transferred a notice substantially to the effect of this restrictive legend. This legend will be removed after 40 consecutive days beginning on and including the later of (x) the day on which the securities are offered to persons other than distributors (as defined in Regulation S) and (y) the date of the closing of the original offering. As used herein, the**

**terms “offshore transaction,” “United States” and “U.S. person” have the meanings given to them by Regulation S under the Securities Act.”**

- If it is a purchaser in a sale that occurs outside the United States within the meaning of Regulation S, it agrees that until the expiration of a 40-day “distribution compliance period” within the meaning of Rule 903 of Regulation S under the Securities Act, no offer or sale of the notes shall be made by it to a U.S. person or for the account or benefit of a U.S. person within the meaning of Rule 902(o) of the Securities Act except to a qualified institutional buyer and in compliance with the applicable restrictions set forth in paragraph (4) above.
- It acknowledges that the trustee will not be required to accept for registration of transfer any notes acquired by it, except upon presentation of evidence satisfactory to Sabesp and the trustee that the restrictions set forth herein have been complied with.
- It acknowledges that Sabesp and the initial purchaser will rely upon the truth and accuracy of the foregoing acknowledgments, representations and agreements and agrees that, if any of the acknowledgments, representations or warranties deemed to have been made by its purchase of notes is no longer accurate, it will promptly notify Sabesp and the initial purchaser. If it is acquiring any notes as a fiduciary or agent for one or more investor accounts, it represents that it has sole investment discretion with respect to each such account and that it has full power to make the foregoing acknowledgments, representations and agreements on behalf of each such account.
- It will be deemed to have represented and agreed either with Sabesp and the initial purchaser that (1) no assets of a Plan or governmental, church or non-U.S. plan, or any trust established with respect to a Plan or governmental, church or non-U.S. plan, have been used to acquire such notes or an interest therein or (2) the purchase and holding of such notes or an interest therein by such person will not result in a violation of, or are exempt from the prohibited transaction restrictions of ERISA and the Code or any provisions of Similar Law, as applicable, pursuant to one or more prohibited transaction statutory or administrative exemptions, as applicable.

## ENFORCEMENT OF CIVIL LIABILITIES

We are a mixed capital company organized under the laws of Brazil. Substantially all of our directors and officers and independent auditors, and some of the advisors named herein, reside in Brazil or elsewhere outside the United States, and all or a significant portion of the assets of such persons may be located outside the United States. As a result, it may not be possible for investors to effect service of process upon us and these persons within the United States or other jurisdictions outside Brazil or to enforce against us judgments predicated upon the civil liability provisions of the U.S. federal securities laws or the laws of such other jurisdictions.

In the terms and conditions of the notes, we will (i) agree that the courts of the State of New York and the federal courts of the United States, in each case sitting in the Borough of Manhattan, The City of New York, will have jurisdiction to hear and determine any suit, action or proceeding, and to settle any disputes, which may arise out of or in connection with the notes and, for such purposes, irrevocably submit to the jurisdiction of such courts and (ii) name an agent for service of process in the Borough of Manhattan, The City of New York. See "Description of Notes."

We have been advised by our Brazilian counsel, Mattos Filho, Veiga Filho, Marrey Jr. e Quiroga Advogados, that judgments of non-Brazilian courts for civil liabilities predicated upon the securities laws of countries other than Brazil in respect of the guarantees, including the U.S. securities law, may be enforced in Brazil subject to certain requirements as described below. A judgment against either us or any of our directors, officers, independent auditors or advisors obtained outside Brazil would be enforceable in Brazil against us or any such person without retrial or reexamination of the merits, upon confirmation of that judgment by the Brazilian Superior Court of Justice. That confirmation, generally, will occur if the foreign judgment:

- fulfills all formalities required for its enforceability under the laws of the country where the foreign judgment is granted;
- is issued by a competent court after proper service of process is made in accordance with Brazilian legislation, or after sufficient evidence of the parties' absence has been given;
- is not subject to appeal;
- is for a sum certain;
- is authenticated by a Brazilian consular office in the country where the foreign judgment is issued and is accompanied by a sworn translation into Portuguese; and
- is not contrary to Brazilian national sovereignty, public policy or public morality.

The confirmation process may be time-consuming and may also give rise to difficulties in enforcing the foreign judgment in Brazil. Accordingly, we cannot assure you that confirmation would be obtained, that the confirmation process would be conducted in a timely manner or that a Brazilian court would enforce a monetary judgment for violation of the securities laws of countries other than Brazil, including the U.S. securities laws.

We have also been advised that:

- the ability of a judgment creditor to satisfy a judgment against us is limited by Brazilian bankruptcy, insolvency, liquidation, reorganization and similar laws; and
- civil actions may be brought before Brazilian courts based on the federal securities laws of the United States and that, subject to applicable law, Brazilian courts may enforce such liabilities in such actions against us (provided that the provisions of the federal securities

laws of the United States do not contravene Brazilian public policy, good morals or national sovereignty and provided further that Brazilian courts can assert jurisdiction over the particular action).

A plaintiff (whether Brazilian or non-Brazilian) who resides outside Brazil during the course of litigation in Brazil must provide a note to guarantee court costs and legal fees if the plaintiff owns no real property in Brazil that may ensure such payment. This note must have a value sufficient to satisfy the payment of court fees and defendant's attorneys' fees, as determined by the Brazilian judge, except in the case of the enforcement of foreign judgments that have been duly confirmed by the Brazilian Superior Court of Justice. In addition, Brazilian law limits the ability of our judgment creditors to satisfy a judgment against us by attaching certain of our concession-related assets.

### **VALIDITY OF THE NOTES**

The validity of the notes offered and sold in this offering will be passed upon for the Company by Shearman & Sterling LLP, and for the initial purchaser by White & Case LLP. Certain matters of Brazilian law relating to the notes will be passed upon for the Company by Mattos Filho, Veiga Filho, Marrey Jr. e Quiroga Advogados, our Brazilian counsel. Souza, Cescon Avedissian, Barrieu e Flesch Advogados will pass upon certain matters of Brazilian law relating to the notes for the initial purchaser.

### **INDEPENDENT AUDITORS**

Our annual financial statements as of and for the years ended December 31, 2003, 2004 and 2005, included elsewhere in this offering circular, have been audited by Deloitte Touche Tohmatsu Auditores Independentes, an independent registered public accounting firm, as stated in their report appearing therein.

## LISTING AND GENERAL INFORMATION

1. The notes have been accepted for clearance through DTC, Euroclear and Clearstream. The CUSIP and ISIN numbers for the notes are as follows:

	<u>Restricted Global Note</u>	<u>Regulation S Global Note</u>
CUSIP .....	20441AAG7	P3058WAB3
ISIN .....	US20441AAG76	USP3058WAB39
Common Code .....	027310354	027310443

2. Copies of our latest and future audited annual financial statements and unaudited interim financial statements may be obtained at the offices of the principal paying agent and any other paying agent, including the Luxembourg paying agent. Our annual and quarterly financial statements will be available in English. Copies of our by-laws (*estatuto social*), as well as the indenture (including forms of notes), will be available for inspection at the offices of the principal paying agent and any other paying agent, including the Luxembourg paying agent.

3. Except as disclosed in this offering circular, there has been no material adverse change in our financial position since June 30, 2006, the date of the latest financial statements included in this offering circular.

4. Except as disclosed in this offering circular, we are not involved in any litigation or arbitration proceedings relating to claims or amounts that are material in the context of this offering, nor so far as we are aware is any such litigation or arbitration pending or threatened.

5. The notes are expected to be listed on the Luxembourg Stock Exchange and traded on the Euro MTF.

6. So long as the notes are listed on the Official List of the Luxembourg Stock Exchange and admitted to trading on the Euro MTF market of the Luxembourg Stock Exchange and the rules of this exchange so require, we shall appoint and maintain a paying agent in Luxembourg, where the notes may be presented or surrendered for payment or redemption, in the event that the global notes are exchanged for definitive certificated notes. In addition, in the event that the global notes are exchanged for definitive certificated notes, announcement of such exchange shall be made through the Luxembourg Stock Exchange and such announcement will include all material information with respect to the delivery of the definitive certificated notes.

7. If the listing of the notes on the Luxembourg Stock Exchange would, in the future, require us to publish financial information either more regularly than we otherwise would be required to, or according to accounting principles which are materially different from the accounting principles which we would otherwise use to prepare our published financial information, we may seek an alternative admission to listing, trading and/or quotation for the notes by another listing authority, stock exchange and/or quotation system.

8. The issuance of the notes was authorized by the Company's board of directors on July 20, 2006. In addition, the following governmental approvals were obtained by Sabesp: (A) the pre-registration (*credenciamento*) with the Central Bank; (B) the registration with the Central Bank relating to the remittances from Brazil in U.S. dollars of payments of principal and interests on the notes; (C) the prior approval of the National Treasury Secretariat of the Ministry of Finance in Brazil; and (D) the prior approval of the External Financing Committee of Secretariat of Finance of the State of São Paulo.

9. The Company's registered office is at Rua Costa Carvalho, 300, 05429-900, São Paulo, SP, Brazil and its statutory documents can be inspected at its headquarter at the same address. The Company is authorized to increase its capital up to a maximum of R\$4,100,000 registered common



shares without par value, upon resolution of the board of directors. The Company's subscribed and paid-up capital as of June 30, 2006 consisted of 28,479,577,827 registered common shares without par value.

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Companhia de Saneamento  
Básico do Estado de São Paulo –  
SABESP

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Management of  
Companhia de Saneamento Básico do Estado de São Paulo - SABESP  
São Paulo – SP

1. We have performed limited reviews of the accompanying balance sheets of Companhia de Saneamento Básico do Estado de São Paulo - SABESP, as of June 30, 2006 and 2005, and the related statements of income, changes in shareholders' equity, and changes in the financial position for the six-month periods then ended, all expressed in Brazilian reais and prepared in accordance with Brazilian accounting practices under the responsibility of the Company's management.
2. Our reviews were conducted in accordance with specific standards established by the Brazilian Institute of Independent Auditors (IBRACON) and consisted principally of applying analytical procedures to financial data and making inquiries of persons responsible for financial and accounting matters as to the criteria adopted in the preparation of the financial statements. Since the scope of these reviews do not represent an audit in accordance with auditing standards generally accepted in Brazil, we do not express an opinion on the aforementioned financial statements.
3. Based on our limited reviews, we are not aware of any material modifications that should be made to the financial statements referred to in paragraph 1 for them to be in conformity with Brazilian accounting practices.
4. The statements of cash flows for the six-month periods ended June 30, 2006 and 2005, are presented for purposes of additional analysis and are not a required part of the financial statements. This information has been subjected to the limited reviews procedures mentioned in paragraph 2 and, based on our reviews, we are not aware of any material modifications that should be made to the cash flows.
5. As mentioned in Note 5 to the financial statements, the Company is negotiating with the State of São Paulo Government the reimbursement of the amounts for supplementary retirement and pensions paid by the Company and the future flow of these payments to be reimbursed by the State of São Paulo Government.

São Paulo, August 14, 2006 (except for note 20, dated October 2, 2006)

DELOITTE TOUCHE TOHMATSU  
Auditores Independentes

Marco Antonio Brandão Simurro  
Engagement Partner

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****BALANCE SHEETS AS OF JUNE 30, 2006 AND 2005**

(In thousands of Brazilian reais – R\$)

<b>Assets</b>	<b>June 30, 2006</b>	<b>June 30, 2005</b>
<b>Current assets</b>		
Cash and cash equivalents	336,012	877,949
Customer accounts receivable, net (note 4)	1,214,648	1,115,441
Receivable from shareholder, net (note 5)	225,612	174,742
Inventories	32,035	25,040
Deferred taxes (note 9)	22,161	30,421
Other current assets	43,904	47,830
	<u>1,874,372</u>	<u>2,271,423</u>
<b>Long-term assets</b>		
Customer accounts receivable, net (note 4)	297,250	278,687
Receivable from shareholder, net (note 5)	823,558	757,727
Indemnities receivable (note 6)	148,794	148,794
Escrow deposits	30,723	5,490
Deferred taxes (note 9)	310,827	272,293
Other assets	48,879	31,064
	<u>1,660,031</u>	<u>1,494,055</u>
<b>Permanent assets</b>		
Investments	740	5,100
Intangible assets (note 7)	499,274	509,027
Property, plant and equipment, net (note 7)	13,666,428	13,472,223
Deferred charges	15,389	35,277
	<u>14,181,831</u>	<u>14,021,627</u>
<b>Total Assets</b>	<b><u>17,716,234</u></b>	<b><u>17,787,105</u></b>

The accompanying notes are an integral part of these financial statements.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****BALANCE SHEETS AS OF JUNE 30, 2006 AND 2005**

(In thousands of Brazilian reais – R\$)

	<b>June 30, 2006</b>	<b>June 30, 2005</b>
<b>Liabilities and Shareholders' Equity</b>		
<b>Current liabilities</b>		
Accounts payable to suppliers and contractors	88,032	46,553
Loans and financing (note 8)	642,461	1,420,176
Accrued payroll and related charges	224,208	169,579
Provisions for contingencies (note 13)	10,921	21,074
Interest on shareholders' equity (notes 5 and 14 (c))	381,158	183,526
Taxes payable (note 10)	145,150	129,115
Deferred taxes (note 9)	72,348	69,980
Other current liabilities	98,612	86,110
	<u>1,662,890</u>	<u>2,126,113</u>
<b>Long-term liabilities</b>		
Loans and financing (note 8)	5,778,076	6,041,965
Taxes payable (note 10)	244,567	264,998
Deferred taxes (note 9)	139,454	131,615
Provisions for contingencies (note 13)	602,964	528,084
Accrued pension obligation (note 11)	299,118	249,736
Other liabilities	110,777	103,362
	<u>7,174,956</u>	<u>7,319,760</u>
<b>Shareholders' equity (note 14)</b>		
Paid-in capital	3,403,688	3,403,688
Capital reserve	100,760	72,824
Revaluation reserve	2,483,566	2,574,594
Profit reserves	2,470,269	1,863,389
Retained earnings non appropriated	420,105	426,737
	<u>8,878,388</u>	<u>8,341,232</u>
<b>Total Liabilities &amp; Shareholders' Equity</b>	<b><u>17,716,234</u></b>	<b><u>17,787,105</u></b>

The accompanying notes are an integral part of these financial statements.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****STATEMENTS OF INCOME**

FOR THE PERIODS ENDED JUNE 30, 2006 AND 2005

(In thousands of Brazilian reais – R\$, except for earnings per share)

	<u>June 30, 2006</u>	<u>June 30, 2005</u>
<b>GROSS REVENUE FROM SALES AND SERVICES</b>	2,878,821	2,582,244
Taxes on sales and services - COFINS and PASEP	(220,819)	(192,230)
Net revenue from sales and services	2,658,002	2,390,014
Cost of sales and services	(1,266,150)	(1,152,098)
<b>GROSS PROFIT</b>	1,391,852	1,237,916
<b>OPERATING EXPENSES</b>		
Selling expenses	(267,920)	(244,561)
Administrative expenses	(135,200)	(168,916)
Financial expenses, net	(238,182)	(98,716)
<b>Total operating expenses</b>	(641,302)	(512,193)
<b>INCOME FROM OPERATIONS</b>	750,550	725,723
<b>NONOPERATING INCOME (EXPENSES)</b>		
Loss on disposal of property, plant and equipment (note 7(a))	(2,321)	(2,332)
Others	2,367	3,242
	46	910
<b>INCOME BEFORE TAXES ON INCOME</b>	750,596	726,633
Income and social contribution taxes (note 9)	(229,553)	(221,961)
<b>INCOME BEFORE EXTRAORDINARY ITEM</b>	521,043	504,672
Extraordinary item, net of income and social contribution taxes	(17,561)	(17,561)
<b>NET INCOME</b>	<b>503,482</b>	<b>487,111</b>
Earnings per thousand shares in R\$	17.68	17.10

The accompanying notes are an integral part of these financial statements.



**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**

**STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

FOR THE PERIOD ENDED JUNE 30, 2006 AND 2005

(In thousands of Brazilian reais – R\$)

	Paid in capital	Capital reserve	Revaluation reserve	Profit reserves		Retained earnings	Total
				Legal	Investment		
<b>BALANCES AS OF JANUARY 1, 2005</b>	3,403,688	65,291	2,619,220	171,991	1,691,398	—	7,951,588
Donations		7,533					7,533
Realization of revaluation reserve			(44,626)			44,626	-
Net income						487,111	487,111
<b>Allocation of income:</b>							
Interest on shareholders' equity						(105,000)	(105,000)
<b>BALANCES AS OF JUNE 30, 2005</b>	<b>3,403,688</b>	<b>72,824</b>	<b>2,574,594</b>	<b>171,991</b>	<b>1,691,398</b>	<b>426,737</b>	<b>8,341,232</b>
<b>BALANCES AS OF JANUARY 1, 2006</b>	<b>3,403,688</b>	<b>78,820</b>	<b>2,529,771</b>	<b>215,273</b>	<b>2,254,996</b>	<b>—</b>	<b>8,482,548</b>
Donations (note 14 (d))		21,940					21,940
Realization of revaluation reserve			(46,205)			46,205	-
Net income						503,482	503,482
<b>Allocation of income:</b>							-
Interest on shareholders' equity (note 14 (c))						(129,582)	(129,582)
<b>BALANCES AS OF JUNE 30, 2006</b>	<b>3,403,688</b>	<b>100,760</b>	<b>2,483,566</b>	<b>215,273</b>	<b>2,254,996</b>	<b>420,105</b>	<b>8,878,388</b>

The accompanying notes are an integral part of these financial statements.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****STATEMENTS OF CHANGES IN FINANCIAL POSITION**

FOR THE PERIODS ENDED JUNE 30, 2006 AND 2005

(In thousands of Brazilian reais – R\$)

	June 30, 2006	June 30, 2005
<b>SOURCES OF FUNDS</b>		
<b>From operations:</b>		
<b>Net income</b>	<b>503,482</b>	<b>487,111</b>
<b>Items not affecting working capital</b>		
Bad debt expense	41,950	59,606
Depreciation and amortization	297,846	294,999
Reversal of escrow deposits provision	(6,595)	-
Loss on disposal of property, plant and equipment	3,502	2,332
Write-off of deferred charges	863	-
Provisions for contingencies	33,377	67,853
Accrued pension obligation	22,560	27,560
<b>Interest and monetary and exchange variations on long-term assets and liabilities:</b>		
Assets	(7,431)	1,452
Loans and financing	(34,981)	(159,991)
Taxes payable	8,559	11,267
Deferred income and social contribution taxes:		
In long-term assets	(12,008)	(15,022)
In long-term liabilities	6,010	1,559
<b>Total from operations</b>	<b>857,134</b>	<b>778,726</b>
<b>From third parties:</b>		
Decrease in long-term assets	1,288	10,699
Increase in long-term liabilities	2,288	10,673
Loans and financing, long-term	320,528	1,061,414
Increase in property, plant and equipment - donations	21,940	7,533
<b>Total from third parties</b>	<b>346,044</b>	<b>1,090,319</b>
<b>Total sources</b>	<b>1,203,178</b>	<b>1,869,045</b>
<b>USES OF FUNDS</b>		
Increase in long-term assets	119,115	81,891
<b>Permanent assets</b>		
Property, plant and equipment	365,160	261,669
Deferred charges	55	53
<b>Transfer from long-term to current liabilities</b>		
Loans and financing	394,136	385,417
Interest on shareholders' equity	129,582	105,000
Taxes and contributions	20,105	18,606
<b>Increase in working capital</b>	<b>175,025</b>	<b>1,016,409</b>
<b>Total uses</b>	<b>1,203,178</b>	<b>1,869,045</b>
<b>Increase (decrease) in working capital</b>		
<b>Represented by:</b>		
<b>Current assets</b>		
At end of year	1,874,372	2,271,423
At beginning of year	1,725,386	1,229,790
<b>Variation in current assets</b>	<b>148,986</b>	<b>1,041,633</b>
<b>Current liabilities</b>		
At end of year	1,662,890	2,126,113
At beginning of year	1,688,929	2,100,889
<b>Variation in current liabilities</b>	<b>(26,039)</b>	<b>25,224</b>
<b>Increase (decrease) in working capital</b>	<b>175,025</b>	<b>1,016,409</b>

The accompanying notes are an integral part of these financial statements.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**

**STATEMENTS OF CHANGES IN FINANCIAL POSITION**

FOR THE PERIODS ENDED JUNE 30, 2006 AND 2005

(In thousands of Brazilian reais – R\$)

	<u>June 30, 2006</u>	<u>June 30, 2005</u>
<b><u>SUMMARY</u></b>		
SOURCES		
From operations	857,134	778,726
From third parties	346,044	1,090,319
<b>TOTAL SOURCES</b>	<b>1,203,178</b>	<b>1,869,045</b>
USES		
Increase in long-term assets	119,115	81,891
Permanent assets	365,215	261,722
Transfer from long-term to current liabilities	414,241	404,023
Interest on shareholders' equity	129,582	105,000
<b>Increase in working capital</b>	<b>175,025</b>	<b>1,016,409</b>
<b>TOTAL USES</b>	<b>1,203,178</b>	<b>1,869,045</b>

The accompanying notes are an integral part of these financial statements.

## **COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**

### **NOTES TO THE FINANCIAL STATEMENTS**

FOR THE PERIODS ENDED JUNE 30, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

#### **1. OPERATIONS**

Companhia de Saneamento Básico do Estado de São Paulo - SABESP (the "Company") is engaged in the operation of public water and sewage systems in the State of São Paulo, Brazil, providing water and sewage services to a broad range of residential, commercial, industrial and government customers. The Company also provides water on a wholesale basis to certain municipalities in the São Paulo Metropolitan Region that do not have water production systems.

With the enactment of Law 12,292 on March 2, 2006 we became authorized to provide water and sewage services outside the State of São Paulo, including in other countries, either directly or through national or international consortia. We may also have equity participation in other state or mixed-capital companies, and establish subsidiaries.

The Company's shares are listed on the São Paulo Stock Exchange (BOVESPA) in the "New Market" segment since April 2002, and on the New York Stock Exchange (NYSE), in the form of ADRs (American Depositary Receipts) since May 2002.

The Company provides water and sewage services in 367 municipalities in the State of São Paulo, nearly all of which are through concessions granted by the municipalities and most of them with 30-year term. The 17 (seventeen) concession contracts that expired in 2005 have been extended or are under negotiation. Up to December 31, 2006, 135 contracts are going to expire and the rest between 2007 and 2034. Management expects that the referred concessions will be renewed or extended, thus there will not be a discontinuity of the water supply and sewage collection. Up to June 30, 2006, the net book value of property, plant and equipment items relating to the municipalities where the concessions are under negotiation or will expire in 2006 totals R\$ 1,62 billion, and net revenue totals R\$ 358 million related to these concessions.

The Company does not hold a formal concession to provide water and sewage services in the City of São Paulo, which accounts for a substantial portion of the sales and services rendered. In Santos, a municipality located in the Santos Coastal Area, which also has a large population, the Company operates under a public deed of authorization, like in some other municipalities in the Santos Coastal Area and in the Ribeira Valley, where the Company started operating after the merger of the companies that formed SABESP. Management believes that the Company has a vested right to provide water and sewage services to these municipalities based upon, among other things, its ownership of the related water and sewage systems serving the City of São Paulo and these other municipalities and certain succession rights resulting from the merger which formed the Company.

In general, the Company does not face any competition in the municipalities in which it provides water and sewage services, and management understands that in those municipalities the Company has an exclusive right to provide such services.

All information regarding concession areas, number of municipalities, volumes of water and sewage and other related data disclosed in this report that do not arise from the accounting and/or financial statements are unaudited.

#### **2. PRESENTATION OF FINANCIAL STATEMENTS**

The Company's statutory financial statements, which are used as the basis for determining income taxes and mandatory minimum dividend calculations, have been prepared in accordance with accounting practices adopted in Brazil, which are based on the Brazilian Corporate Law (Law No. 6,404/76, as amended), the rules and regulations of the Brazilian Securities Commission ("CVM") and the accounting standards issued by the Brazilian Institute of Independent Auditors ("IBRACON").

To facilitate an understanding of Brazilian accounting practices, the presentation of the financial statements has been adapted from the financial statements filed for Brazilian legal and regulatory purposes. In addition, certain terminology changes have been made and the notes to the financial statements have been

**NOTES TO THE FINANCIAL STATEMENTS**

FOR THE PERIODS ENDED JUNE 30, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

expanded to conform them more closely to reporting practices prevailing in the United States of America. All amounts are presented in Brazilian currency ("*real*" or "*reais*"), unless otherwise indicated.

3. SIGNIFICANT ACCOUNTING PRACTICES

The Company's accounting practices, which are based on the accrual concept, comply with the Corporate Law.

(a) Revenue from sales and services

Revenue for water and sewer services is recognized as water is consumed or as services are provided. Revenue from water and sewer services rendered but not billed is recorded as unbilled customer accounts receivable based on monthly estimates in order to match such revenue with costs incurred.

(b) Marketing costs

Marketing costs are generally expensed as incurred and reported in administrative expenses. Marketing costs were R\$ 5,819 and R\$ 5,538 for the six-months period ended June 30, 2006 and 2005, respectively. No marketing costs were deferred in the six-months period June 30, 2006 and 2005.

(c) Financial income and expenses

Financial income and expenses are primarily comprised of interest and monetary and exchange variations on loans and financing and financial investments, and are calculated and reported on the accrual basis of accounting.

(d) Income and social contribution taxes

Income and social contribution taxes (a federally mandated tax based on income) are accrued on taxable results.

Income tax is calculated at the rate of 15%, plus a 10% surtax, and social contribution tax is calculated at the rate of 9%. These taxes are reported on an accrual basis.

Deferred taxes related to tax loss carryforwards and temporary differences are calculated and recorded based on future taxable or deductible amounts and are recognized to the extent that realization is believed to be probable.

As permitted by the CVM, the Company opted not to recognize the deferred tax liability (non-cash) on the revaluation reserve of property, plant and equipment recorded up to 1991.

(e) Other income and expenses

Other income and expenses are recorded on an accrual basis.

(f) Cash and cash equivalents

Cash and cash equivalents are comprised primarily of bank deposits and financial investments and are carried at cost, plus accrued interest, if applicable. Financial investments denominated in reais have a ready market and an original maturity after 30 days from the date of investment, and are comprised mainly of Bank Deposit Certificates – CDB's. Foreign currency deposits, if any, are translated at balance sheets date

**NOTES TO THE FINANCIAL STATEMENTS**

FOR THE PERIODS ENDED JUNE 30, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

exchange rates. The Company is required by law to invest excess cash with financial institutions controlled by the State Government (see Note 5).

(g) Customer accounts receivable and allowance for doubtful accounts

Customer accounts receivable generally do not accrue interest or indexation charges or penalties, except for refinanced agreements.

The Company records an allowance for doubtful accounts for receivable balances in an amount that is deemed by management to be sufficient to cover probable losses in accounts receivable, based on an aging analysis of receipts, taking into consideration the expected recovery in the different categories of customers accounts. Amounts in excess of R\$ 5 and overdue for more than 360 days and in excess of R\$ 30 and overdue for more than 360 days, which are under judicial collection proceedings, are provisioned. Accounts receivable balances under R\$ 5 and overdue more than 180 days are written off through a direct charge to income.

(h) Inventories

Inventories of materials used in operations and in the maintenance of the Company's water and sewage systems are stated at the lower of average acquisition cost or realizable value and are classified in current assets. Inventories for capital projects are classified under property, plant and equipment and are stated at the average acquisition cost.

(i) Other current assets and long-term receivables

Other current assets and long-term receivables are stated at the lower of acquisition cost or realization value, plus accrued interest, when applicable.

(j) Property, plant and equipment

Property, plant and equipment are generally stated at amounts established by independent technical appraisals, plus price-level restatements from the date of the appraisals to 1995. Revaluation increments arising from revaluing assets to appraised values are recorded in the revaluation reserve component of shareholders' equity and subsequently transferred from the reserve to retained earnings as the related assets are depreciated, sold or upon disposal. The price-level restatement adjustments were based on official inflation indices published by the federal government. The Company believes that the distortion caused by indices which understated the independently measured inflation rate have been mitigated by recording revaluation increments.

The revaluation of property, plant & equipment items, carried out in two separate stages in 1990 and 1991, was based on an appraisal report issued by independent experts. The referred revaluation was recorded with a corresponding credit to the "Revaluation Reserve" account in Shareholder's Equity, and is realized through depreciation, sale, and disposal of the respective assets, with a corresponding entry to "Retained Earnings".

Contributions of property, plant and equipment by third parties and from government entities (such as property owners) to allow the Company to supply water and sewage services are recorded as a capital reserve.

Construction-in-progress is recorded at cost and is primarily related to construction projects under contract with third parties. For long-term projects, the Company capitalizes these projects once the Company's engineering department approves that the project milestones have been achieved and the Company takes delivery of the assets.

**NOTES TO THE FINANCIAL STATEMENTS**

FOR THE PERIODS ENDED JUNE 30, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

**Depreciation**

Depreciation of property, plant and equipment, is recorded using the straight-line method based on the estimated useful lives of the underlying assets. The principal depreciation rates are detailed in Note 7.

**Capitalization of interest**

Consistent with the requirements of accounting regulations for Brazilian utilities, up to 1985, interest was capitalized at 12% per annum on construction-in-progress. Interest capitalized which exceeded interest expense on loans obtained to finance construction-in-progress was recorded in a capital reserve directly in shareholders' equity. Up to 1995, BR CL did not require the capitalization of interest costs incurred during the construction period as part of the cost of the related property, plant and equipment. However, as permitted by the Brazilian Water and Sewage Plan (*Plano Nacional de Saneamento Básico - PLANASA*), the Company capitalized interest on construction in progress through 1988. No interest was capitalized from 1989 to 1995. Interest was again capitalized beginning in 1996, following changes in the CVM requirements in 1996. Beginning in 1999, the Company has capitalized indexation charges on the *real* - denominated loans and financing and the foreign exchange effects on foreign currency loans and financing. The Company capitalizes interest incurred on borrowings to the extent that borrowings do not exceed construction-in-progress, which is recorded as a reduction of interest expense.

Interest capitalized is depreciated with the cost of the asset, once the related asset becomes operational. Through December 31, 1998, but not thereafter, such depreciation of capitalized interest was deductible for purposes of determining taxes on income.

**Repairs and maintenance**

Improvements to existing property are capitalized, while costs of general maintenance and repairs are expensed as incurred. Materials allocated to specific projects are added to construction-in-progress.

**Concession assets acquired**

Beginning in 1999, acquisitions of concession assets and concession rights from third parties have been accounted for at fair values, as determined in technical appraisal reports. Accordingly, the purchase price, plus direct costs of acquisition, is allocated to assets acquired and liabilities assumed based upon their estimated fair values at the date of acquisition. These concessions are recorded as concession assets acquired, included as intangible assets in the balance sheets.

Concession rights are amortized on a straight-line basis over the estimated future periods to be benefited, not to exceed the contractual term of the concession. The straight-line method of depreciation is modified, when applicable, to avoid the backloading of charges in later years by estimating future disbursement commitments to meet the Company's concession obligations.

**Impairment**

The Company reviews long-lived assets, primarily buildings and water and sewage systems, including property, plant and equipment and concession assets, to be held and used in the business, for the purpose of determining and measuring impairment on a recurring basis or when events or changes in circumstances indicate that the carrying value of an asset or group of assets may not be recoverable. The Company assesses impairment on the basis of the projected recovery of depreciation charges through results of operations. The carrying value of assets or groups of assets is written down to realizable value if and when appropriate.

**NOTES TO THE FINANCIAL STATEMENTS**

FOR THE PERIODS ENDED JUNE 30, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

(k) Deferred charges

Deferred charges are comprised primarily of deferred project costs and technical studies, which are being amortized using the straight-line method over 5 years from the date when benefits start to be generated.

(l) Loans and financing

Loans and financing are adjusted by indexation charges and foreign exchange variations and include accruals for related interest expense. Loans and financing denominated in foreign currencies are translated to reais using the exchange rate in effect at the balance sheet date. The resulting foreign currency exchange adjustments are recognized as incurred in financial income (expense), net.

(m) Salaries and payroll charges

Salaries and other payroll charges, including provisions for vacation pay, 13th salary and complementary payments agreed upon through collective bargaining agreements, added by the corresponding payroll charges, are recorded on an accrual basis.

(n) Provisions for contingencies

Provisions for contingencies are recorded at the estimated amounts to cover potential losses related on labor, tax, civil, commercial, environmental and other claims and lawsuits, at administrative and court levels, when such losses are considered probable and are estimateable by management.

(o) Environmental costs

Costs relating to ongoing environmental programs are expensed as incurred. Ongoing programs are designed to minimize the environmental impact of operations and to manage the environmental risks inherent to the Company's activities. Provisions for contingent losses related to environmental claims are recorded when they are considered to be probable and reasonably estimatable by Management.

(p) Pension and postretirement benefits

The Company sponsors a private defined benefit pension plan, which is operated and administered by Fundação SABESP de Seguridade Social ("SABESPREV"). CVM resolution 371 of December 13, 2000 determines the recognition of actuarial liabilities exceeding to the plan assets. As permitted, the Company has elected to recognize the transition obligation as of the date of adoption in earnings on a straight-line basis over five years beginning January 1, 2002.

(q) Interest on shareholders' equity

Brazilian corporations are permitted to deduct for tax purposes interest on shareholders' equity, which is a distribution similar to a dividend. For financial reporting purposes, interest on shareholders' equity is recorded as a deduction directly from unappropriated retained earnings. This interest has been recorded in accordance with Law 9249/95, for tax deductibility purposes, limited to the daily pro-rata variation of the Long-Term Interest Rate ("TJLP"). Withholding taxes with respect to the payment of interest on shareholders' equity is generally withheld and paid by the Company on behalf of shareholders (see note 14).



**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

FOR THE PERIODS ENDED JUNE 30, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

- (r) Use of estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the reported amounts of revenues and expenses for the reporting periods. Actual results could differ from those estimates.

- (s) Earnings per share

Earnings per share is calculated based on the number of shares outstanding at the balance sheet date.

## 4. CUSTOMER ACCOUNTS RECEIVABLE

The following summarizes customer accounts receivable balances at June 30:

- (a) Customer accounts receivable

	<b>2006</b>	<b>2005</b>
Customer accounts receivable	2,503,776	2,225,958
Allowance for doubtful accounts	(991,878)	(831,830)
Total	<u>1,511,898</u>	<u>1,394,128</u>
Current portion	1,214,648	1,115,441
Long-term portion (i)	297,250	278,687

(i) The long-term portion of customer accounts receivable consists of the long-term portion of renegotiated past-due private sector customer accounts receivable and past-due balances of wholesale customers-municipal authorities for which management believes collection is not likely within the next year. A number of wholesale customers have been contesting certain tariffs since mid-1998 and are not paying the amounts disputed. While such amounts are currently due and payable, management believes that based on the historical settlement and payment history, that such amounts are better classified as long-term. The long-term portion is recorded net of an allowance for doubtful accounts of R\$ 561,582 and R\$ 454,175 at June 30, 2006 and 2005, respectively.

- (b) Customer accounts receivable aging summary

	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Current (including unbilled amounts)	754,595	634,072
Past due:		
Up to 30 days	195,571	175,554
From 31 to 60 days	76,042	67,586
From 61 to 90 days	59,566	57,591
From 91 to 120 days	49,718	46,717
From 121 to 180 days	99,976	96,776
From 181 to 360 days	195,703	212,023
For more than 360 days	1,072,605	935,639
Total aged customer accounts receivable	<u>2,503,776</u>	<u>2,225,958</u>

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

FOR THE PERIODS ENDED JUNE 30, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

(c) Allowance for doubtful accounts

(i) Changes in the allowance for doubtful accounts are as follows:

	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Balance at beginning of period	920,736	759,640
Private-sector customers/government entities	18,854	12,585
Wholesale customers	52,288	59,605
Bad debt expense-net of recoveries	71,142	72,190
Balance	991,878	831,830
Current portion	430,296	377,655
Long-term portion	561,582	454,175

Bad debt included as part of selling expenses for the periods ended June 30 was as follows:

	<b>2006</b>	<b>2005</b>
Provisions (over five thousand reais)	(96,097)	(87,562)
Recoveries (over five thousand reais)	24,955	15,371
Direct write-offs (less than five thousand reais)	(89,432)	(73,013)
Recoveries (less than five thousand reais)	36,456	38,947
Total bad debt expenses	(124,118)	(106,257)

A number of wholesale customers have been contesting certain tariffs since mid-1998. As a result, some municipalities are currently not paying the Company's invoices in full or on a timely basis. In addition, some governmental entities located in municipalities the Company serves are also not paying on a regular basis. While the Company continues to enter into negotiations with municipalities to reschedule the related accounts receivable and continues to file legal proceedings against municipalities to collect overdue amounts, in some cases, the Brazilian courts have required that the Company continue to provide water on a wholesale basis to municipalities, even if they fail to pay the Company's invoices.

Management believes that the allowance for doubtful accounts is sufficient to absorb probable losses in customer accounts receivable

(e) Unbilled amounts

Unbilled amounts represent water and sewage services provided but not yet billed, which are estimated from the last measurement date to month-end based on prior month's billings.

**5. RELATED-PARTY TRANSACTIONS**

The Company is a party to a number of transactions with its majority shareholder, the State Government, and its related agencies.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

FOR THE PERIODS ENDED JUNE 30, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## (a) Receivable from shareholder

	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Current:		
Water and sewage services (i)	168,626	126,072
GESP Agreement	56,986	48,670
Total current	225,612	174,742
Long-term:		
Water and sewage services –GESP Agreement	104,601	137,898
Reimbursement for pension benefits paid (ii)	718,957	619,829
Total long-term	823,558	757,727
Total receivable from shareholder	1,049,170	932,469
Water and sewage services	330,213	312,640
Reimbursement for pension benefits	718,957	619,829
	1,049,170	932,469

(b) Less amounts due to shareholder – interest on shareholders' equity	325,366	138,003
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## (c) Operating Revenues

	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Gross revenue from sales and services		
Water sales	85,162	79,005
Sewage services	70,754	63,759
Collections	(98,840)	(65,170)

The Company does not record an allowance for doubtful accounts for any amounts due from the State Government or entities controlled by the State Government, since it does not expect losses on such receivables.

## (i) Water and sewage services

The Company provides water and sewage services to the State Government and its related agencies under terms and conditions that management believes are equal to those with third parties, except for the settlement of amounts outstanding, as described further below in items (iii) and (iv).

## (ii) Reimbursement for pension and benefits paid.

Reimbursement for pension and benefits paid represents supplementary pension and leave benefit paid by the Company on behalf of the State Government to former employees of State Government-owned companies which merged to form SABESP. These amounts should be reimbursed to the Company by the State Government, as the primary obligor, in conformity with Law No. 200/74. At June 30, 2006 and 2005, 2,699 and 2,745 retirees, respectively, received supplementary pension payments, for which the Company paid R\$ 46,242 and R\$ 43,503 in the six-months period ended June 30, 2006 and 2005, respectively. There

## **COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**

### **NOTES TO THE FINANCIAL STATEMENTS**

FOR THE PERIODS ENDED JUNE 30, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

were 182 active employees at June 30, 2006, who will be entitled to these benefits once they retire, as compared to 205 at June 30, 2005.

(iii) GESP Agreement

On December 11, 2001, the Company entered into an agreement with the State of São Paulo Government (the GESP Agreement), through the State Department of Finance and the State Department of Water and Energy (DAEE), having the State Department of Water Resources, Sanitation and Works as intervening party. Pursuant to the GESP Agreement, the State Government, by force of Law No. 200/74, acknowledged to be responsible for the supplemental retirement and pension benefits and agreed to pay amounts it owed to the Company in respect of water and sewage services. The value at the date of the Agreement was R\$ 678,830, of which R\$ 320,623 referred to supplemental retirement and pension benefits in the period from March 1986 until November 2001, and R\$ 358,207 referred to water supply and sewage collection services invoiced and due from 1985 until December 1, 2001.

Considering the strategic importance of Taiacupeba, Jundiá, Biritiba, Paraitinga and Ponte Nova reservoirs, for ensuring the volume of water of the Alto Tietê System to be maintained, it was agreed that DAEE would transfer these properties to the Company, with the fair value of these transferred assets used to reduce the amounts owed to the Company.

Under the December 2001 agreement, in July and August 2002, a State Government -owned construction company (Companhia Paulista de Obras e Serviços—CPOS), on behalf of the State, and an independent appraisal firm (ENGEVAL—Engenharia de Avaliações), on the Company's 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 the Company had already made investments in these reservoirs by then, the arithmetic average of the appraisals submitted to the Company's Board of Directors for approval in August 2002 of 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 Government is to make payments in 114 consecutive monthly installments, with the first payment to be made upon the latest of (1) 210 days after the date of the agreement, (2) agreement by the parties on the fair value of the reservoirs and (3) conclusion of the audit by a State-appointed auditor of amounts owed. The nominal amount owed by the State Government 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, plus 6.0% per year, starting on the date the first installment becomes due. The original first payment was to be made in July 2002.

On October 29, 2003, the Public Attorney of the State (Ministério Público do Estado de São Paulo), on behalf of the people of the State, brought a civil public action in a Trial Court of the state of São Paulo (12a Vara da Fazenda Pública do Estado de São Paulo) alleging that a transfer to the Company of ownership of the Alto Tietê System reservoirs from 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 Attorney of the State, which the Company believes relates only to the illegality of the transfer of the reservoirs. In response, the Company filed an appeal which is pending final decision and the State Government successfully filed an action suspending the lower Court's decision until final judgment is reached by the Court of Appeals of the state of São Paulo (Tribunal de Justiça do Estado de São Paulo). The Company is unable to predict whether it will succeed in appealing such decision. Management currently does not expect that an eventual unfavorable decision would have material adverse effect on the Company's business and financial condition.

The December 2001 agreement also provided that the legal advisors of the State Government 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 Government. Management does not expect these analyses to differ significantly from the amounts

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recorded in respect of these amounts. The commencement of payments with respect to pension amounts owed by the State Government has been postponed until such analyses are completed, the appraisal report is approved and the credit assignments relating to the transfer of the reservoirs described above are formalized. In addition, the transfer of these reservoirs is currently being disputed and we are not certain whether such transfer will be legally allowed, as discussed above.

Based on Official Notice No. 53/2005 of the State Capital Defense Council (CODEC), dated March 21, 2005, negotiations are still ongoing between the Company and the State Government with a view to restatement of the debt for supplemental retirement and pension benefits, under the terms defined in the December 2001 agreement, including amounts due after November 2001. These negotiations are expected to be consolidated in a second amendment to the December 2001 agreement, including criteria for recovery of future amounts to be disbursed by the Company. The Company has retained Fundação Instituto de Pesquisas Contábeis, Atuariais e Financeiras, USP – “FIPCAFI” to validate the actual values to be reimbursed by the State Government, taking into account the legal advice provided by the General Office of the State Attorney provided by the Office of the State Attorney General.

As these negotiations are still in the early stages, it is not possible to determine the net effects on the balance sheet resulting from such negotiation. Management does not expect to incur significant net losses relating to any differences between the amounts recorded as due from the State Government and the amounts expected to be received by Sabesp.

The following summarizes activity with respect to amounts due from the State Government related to the reimbursement of pension and retirement benefits:

	June 30,	
	2006	2005
Receivable from shareholder – reimbursement for pension benefits paid:		
Balance at beginning of the period	672,715	576,326
Payments made on behalf of State Government	46,242	43,503
Balance at end of the period	718,957	619,829

Management continues to believe that the amounts due from the State Government are collectible and does not expect to incur losses on these accounts receivable.

The balances for water and sewage services were included in the 1st amendment, as described below (iv).

(iv) First Amendment to GESP Agreement

On March 22, 2004, the Company and the State Government amended the terms of the original GESP Agreement, thereby (1) consolidating and acknowledging amounts due from the State Government for water and sewage services through February 2004, monetarily adjusted through February 2004; (2) formally providing for the offset of amounts due from the State Government against interest on shareholders' equity declared by the Company and any other debt owed to the State Government at December 31, 2003, which were monetarily adjusted through February 2004; and (3) defining the payment terms of the remaining obligations of the State Government for water and sewage services.

Under the terms of the Amendment, the State Government acknowledged amounts due to the Company for water and sewage services provided through February 2004, of R\$ 581,779, including monetary adjustments based on the Referential Rate (TR) at the end of each fiscal year through February 2004. In addition, the Company acknowledged amounts due to the State Government with respect to interest on shareholders' equity of R\$ 518,732, including (1) amounts declared and payable relating to years prior to 2003 (R\$ 126,967), (2) monetary adjustments on these amounts based on the annual change in the

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Consumer Prices Index (IPC/FIPE) through February 2004 (R\$ 31,098); and (3) amounts declared and payable relating to 2003 (R\$ 360,667).

The Company and the State Government agreed to the reciprocal offset of R\$ 404,889 (monetarily adjusted through February 2004). The remaining obligation of R\$ 176,890 at February 29, 2004 is being paid in monthly installments from May 2005 through April 2009, which is subject to monthly monetary adjustment at the Expanded Consumer Price Index (IPCA/IBGE), plus 0.5%.

As the right of offset was contemplated in the original terms of the GESP Agreement, the Company recorded the applicable effects of such Amendment as of and through December 31, 2003, including the monetary adjustments of both amounts payable to and receivable from the State Government. In addition, the amounts payable to the State Government for interest on shareholders' equity specifically identified in the agreement for reciprocal offset through 2004 have been reclassified as a reduction of amounts receivable at December 31, 2004.

The Amendment to the GESP Agreement does not provide for amounts owed by the State Government for supplementary retirement and pension plan benefits, paid by the Company on behalf of the State Government. Such amounts continue to be subject to the terms of the original GESP Agreement. Part of such amounts may be netted upon the transfer of the reservoirs that make up the Alto Tietê System. As discussed above, the Company and the State Government are negotiating the transfer and netting of the additional amounts owed.

Management believes that the amounts owed by the State Government shall be received and it is not estimated that losses will be incurred with such accounts receivable.

The following summarizes the movement of the related accounts receivable from shareholder related to water and sewage services and the related amounts due to shareholder related to interest on shareholders' equity reflecting the Amendment as of and for the periods ended June 30, 2006 and 2005:

	<b>June 30,</b>	
	<b>2006</b>	<b>2005</b>
Receivable from shareholder – water and sewage services:		
Balance at beginning of the year	294,235	351,137
Services provided and billed	155,916	142,764
Collections	(98,840)	(21,270)
Collections – GESP Amendment	(28,010)	(51,065)
Amounts offset in accordance with GESP Amendment	-	(105,520)
Monetary restatement	6,912	(3,406)
Balance at end of the year	330,213	312,640
Receivable from shareholder – water and sewage services net	330,213	312,640
Amounts due to shareholder – interest on shareholders' equity (State Government only):		
Balance at beginning of the year	260,240	190,751
Amounts offset in accordance with GESP Amendment	-	(105,520)
Interest on shareholders' equity declared and payable for the year	65,126	52,772
Balance at end of the year	325,366	138,003
Amounts due to shareholder – interest on equity (State Government) net	325,366	138,003

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(d) Cash and cash equivalents

The Company's balance of cash and financial investment accounts with financial institutions controlled by the State Government was R\$ 303,758 and R\$ 169,434 at June 30, 2006 and 2005, respectively. The financial income from such financial investments was R\$ 27,645 and R\$ 15,466 at June 30, 2006 and 2005, respectively.

(e) Arrangements to use certain reservoirs

The Company uses the Guarapiranga and Billings reservoirs and a portion of some of the reservoirs of the Alto Tietê System, which are owned by the State Department of Water and Energy (DAEE). The Company does not pay any fees with respect to the use of these reservoirs, but is responsible for maintaining and funding the operating costs of these reservoirs. The State of São Paulo does not incur such costs on behalf of the Company. In the event these facilities had not been made available to the Company, it would have had to obtain water from more distant sources which would have been more costly.

As part of these arrangements, the Company funded approximately R\$ 97,115 of costs for the 1992 and 1997 projects. A portion of these project costs were funded by the State Government, through DAEE. The agreements included the construction of ducts, tunnels and other facilities to interconnect the Tietê River with the Biritiba and Jundiaí reservoirs and other bodies of water in exchange for the Company's use of the reservoirs during a 30-year period.

The Company has the right to draw water from and release emissions into the reservoirs during a 30-year period which began in 1997. The Company capitalizes expenditures on the facilities constructed. The assets relating to the original reservoir project were placed in service in 1994 and 2002 and are being depreciated over the remaining term of the original 30 year period. The Company had recorded as part of property, plant and equipment R\$ 57,029 and R\$ 59,766 of amounts capitalized with respect to these agreements, net of accumulated depreciation, in the six-months period ended June 30, 2006 and 2005, respectively.

(f) Contracts with reduced Fare for State and Municipal Public Entities that adhere to the Program of Rational Use of Water

The Company has entered into contracts with public entities related to the State Government and other municipalities involving approximately 6,800 properties that are benefited with a 25% tariff reduction for water and sewage services. The contract provides for the implantation of the program of rational use of water, which considers the reduction in water consumption.

(g) Guarantees

The State Government and the Brazilian Federal Government, in some cases, provide guarantees of, or security for, the Company's loans and financing. The Company does not pay any fees with respect to these guarantees.

6. INDEMNITIES RECEIVABLE

Indemnifications receivable is a long term asset representing amounts receivable from the municipalities of Diadema and Mauá as indemnification for the unilateral withdraw of the Company's water and sewage services concessions in 1995. At June 30, 2006 this asset amounted to R\$ 148,794.

Under these concession agreements, the Company invested in the construction of water and sewage systems in these municipalities to meet its concession service commitments. Upon the unilateral termination of the Diadema and Mauá concessions, the municipalities took on the responsibility of providing water and sewage services in these areas. At that time, the Company reclassified from property, plant and equipment balances relating to the impounded assets to long-term assets (indemnities receivable) and recorded

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impairment charges to reduce the carrying value of the assets to the estimated recoverable amounts for which the Company had contractually agreed as fair compensation with the relevant authorities. The net book value of property, plant and equipment items relating to the municipality of Diadema, written-off in December 1996, was R\$ 75,231, and the balance of indemnity and other receivables from this municipality was R\$ 62,876 at June 30, 2006. The net book value of the property, plant and equipment items relating to the municipality of Mauá, written-off in fiscal year 1999, was R\$ 103,763, and the balance of indemnity receivable from the municipality was R\$ 85,918 at June 30, 2006

The Company's rights to the recovery of these amounts are being disputed by the municipalities and no amount has been received to date.

In December 1996, SABESP filed a claim seeking compensation for the amounts due by the municipality of Diadema. In the first instance the judge pronounced a sentence against SABESP. The Company filed an appeal in November 2000 and on December 1, 2005, it was given partial acceptance to the appeal in order to void the sentence and determine the performance of a new first instance judgment.

With respect to Mauá, a decision has been issued by the lower court requiring Mauá to pay an amount of R\$ 153,2 million as compensation for the loss of profits. This decision was appealed by Mauá and is pending appeal court decision.

Based on the advice of legal counsel, management continues to affirm that the Company has the legal right to receive such amounts and it continues to monitor the status of the legal proceedings. However, the ultimate amounts to be received, if any, will most likely be subject to a final court decision. As such, actual amounts received could differ from those recorded.

**7. PROPERTY, PLANT AND EQUIPMENT**

	Annual Depreciation rates - %	June 30,	
		2006	2005
In use:			
Water systems:			
Land	-	941,584	934,924
Buildings	4%	2,678,453	2,634,446
Connections	5%	808,106	793,795
Water meters	10%	272,786	266,265
Networks	2%	3,256,376	3,232,370
Equipment	10%	251,150	247,964
Other	2 to 20%	520,125	487,210
		8,728,580	8,596,974
Accumulated depreciation		(3,210,320)	(2,942,354)
Total water systems		5,518,260	5,654,620
Sewage system:			
Land	-	354,114	351,913
Buildings	4%	1,485,318	1,445,357
Connections	5%	858,397	836,004
Networks	2%	4,680,432	4,609,133
Equipment	10%	501,676	497,708
Other	2 to 20%	27,263	13,637
		7,907,200	7,753,752
Accumulated depreciation		(2,341,613)	(2,104,727)
Total sewage systems		5,565,587	5,649,025



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	Annual Depreciation rates - %	June 30,	
		2006	2005
General use:			
Land	-	107,707	102,953
Buildings	4%	122,529	120,622
Transportation equipment	20%	134,103	131,942
Furniture, fixtures and equipment	10%	278,608	294,162
		642,947	649,679
Accumulated depreciation		(381,314)	(351,268)
Total general use		261,633	298,411
Non operational assets, net of accumulated depreciation		26,482	31,903
Subtotal		11,371,962	11,633,959
Construction in progress:			
Water systems		745,328	555,964
Sewage systems		1,529,090	1,263,358
Other		20,048	18,942
		2,294,466	1,838,264
		13,666,428	13,472,223

**(a) Disposals of property, plant and equipment**

The Company wrote off property, plant and equipment items in the amount R\$ 3,502 and R\$ 2,332 in the six-months period June 30, 2006 and 2005, respectively. Of these losses, R\$ 2,321 and R\$ 2,332 in June 30, 2006 and 2005, respectively, related to the disposal, theft and obsolescence of assets in use.

Studies supporting the write-offs for obsolescence and construction-in-progress were concluded by the Company in the accounting period of the write-off, based on undiscounted cash flow projections, and have been approved by Management. The carrying value of property, plant and equipment is monitored on an ongoing basis and is adjusted, when appropriate, to assure future projected operating revenue is sufficient to recover the carrying value of the assets. When applicable, depreciation rates are adjusted to take into account changes in estimated remaining economic lives as assets are replaced.

**(b) Capitalization of interest and financial charges**

The Company capitalized interests and monetary variation, including foreign currency exchange variation, to property, plant and equipment in the amount of R\$ (6,829) and R\$ (14,411) for the six-months period ended on June 30, 2006 and 2005, respectively during the period in which the related assets were under construction.

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## (c) Construction in progress

Construction in progress primarily related to new projects and operating improvements is as follows:

	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Water systems:		
Networks and connections	249,120	202,495
Transmission	35,322	34,581
Water treatment	96,384	97,230
Sub-transmission	196,522	114,258
Production and storage	122,227	81,230
Other	45,753	26,170
Total water systems	<u>745,328</u>	<u>555,964</u>
Sewage systems:		
Collection	1,246,831	1,009,289
Treatment	179,691	175,664
Others	102,568	78,404
Total sewage systems	<u>1,529,090</u>	<u>1,263,358</u>
Others	<u>20,048</u>	<u>18,942</u>
Total	<u><u>2,294,466</u></u>	<u><u>1,838,264</u></u>

Estimated disbursements related to construction works already contracted are estimated to be approximately R\$ 976,000 for fiscal years from 2006 to 2011 (unaudited).

## (d) Expropriations

Development of major water and sewage systems frequently requires the expropriation or establishment of rights of way through third-party properties. The owners of these properties are generally compensated either through negotiated settlements or judicial arbitration in conformity with applicable legislation.

Disbursements to be effected as from fiscal year 2006 are estimated to be approximately R\$ 280,245 (unaudited), which will be paid out of Company funds. The related assets acquired as a result of these negotiations are recorded as property, plant and equipment when the expropriation is complete. The total amount paid relating to expropriations of property, plant and equipment in June 30, 2006 and 2005 was R\$ 3,041 and R\$ 4,434, respectively.

## (e) Assets in guarantee

At June 30, 2006 and 2005, the Company had assets in the amount of R\$ 249,034 provided as guarantee under the Special Tax Debt Refinancing Program - PAES (Note 10).

Three of the Company's properties in the amount of R\$ 60,539 were pledged as collateral for the financing with the International Bank for Reconstruction and Development.

## (f) Non-operating assets

The Company had R\$ 26,482 at June 30, 2006 (June 30, 2005 – R\$ 31,903) referring to other non-operating assets, comprised primarily of land surrounding reservoirs.

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## (g) Revaluation

Property, plant and equipment items were revaluated in 1990 and 1991 and have been depreciated at annual rates which take into consideration the estimated remaining economic useful lives of the assets as determined in the respective valuation reports that, as a rule, fall within the ranges of the above presented rates.

## (h) Totally depreciated assets

On June 30, 2006 and 2005 the gross accounting value of the totally depreciated assets which are still in use is R\$ 347.234 and R\$ 322,495, respectively.

## (i) Concessions

## (i) Intangible Assets

Beginning in 1999, negotiations and acquisition of new concessions considers the financial economic value of the business, defined in an appraisal report, issued by independent experts.

The terms of these concessions are generally for a period of 30 years and generally include the corresponding right to operate the related concession assets for which the Company does not have title. The purchase price for these concessions is generally the fair value of the concession, based on appraisal reports which take into consideration the projected cash flows and the remaining concession period at the date of acquisition. The cost of the concession assets acquired is amortized over the concession period using the straight-line method.

Municipalities

	Periods Ended June 30,	
	2006	2005
Agudos	7,425	7,301
Bom Sucesso do Itararé	134	81
Campo Limpo Paulista	11,545	11,375
Conchas	2,178	2,144
Duartina	1,460	1,450
Estância de Serra Negra	12,075	11,298
Itapira	14,709	14,512
Itararé	5,528	5,488
Marabá Paulista	359	358
Miguelópolis	3,984	3,938
Osasco	265,575	257,511
Paraguaçu Paulista	14,135	13,942
Paulistânia	150	149
Sandovalina	215	211
Santa Maria da Serra	1,079	874
São Bernardo do Campo	237,459	237,459
Várzea Paulista	11,668	11,571
Total	589,678	579,662
Less accumulated amortization	(90,404)	(70,635)

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Concession assets, net	<u>499,274</u>	<u>509,027</u>
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Amortization expense related to intangible concession rights was R\$ 9,941 and R\$ 9,789 for the period ended June 30, 2006 and 2005, respectively. Estimated amortization expense for the next five years is estimated to be approximately R\$ 10,000 per half-year.

(ii) Fixed Assets in operation

The fixed assets in operation represent the assets involved in the service providing of supply of water and collection of sewage in 352 municipalities the other municipalities were negotiated by financial economic appraisal, as described in the item above. In the case of Sao Bernardo do Campo, the negotiation that occurred in December 2003 was based on a financial economic appraisal amounting to R\$ 415,471 and there was the transfer of services, as well as the ownership of the assets. In December, 2004 the property evaluation of the assets has been completed for the Municipality. The amount arrived at of R\$ 175,858 was reclassified in December 31, 2004 from "intangible assets" to "operating assets".

The concession contracts foresee that the assets shall be transferred to the conceding power at the end of the term.

The 17 (seventeen) concession contracts that expired in 2005 have been extended or are under negotiation. Up to December 31, 2006, 135 contracts are going to expire and the rest between 2007 and 2034. The net accounting value of the fixed assets in the Municipalities where the concessions are under negotiation (2005) or that will expire in 2006, amount to R\$ 1.62 billion.

On June 30, there was no amount pending of payments to the municipalities.

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### 8. LOANS AND FINANCING

In local currency:

Banco do Brasil  
Debentures 4<sup>th</sup> Issue  
Debentures 5<sup>th</sup> Issue  
Debentures 6<sup>th</sup> Issue  
Debentures 7<sup>th</sup> Issue  
Debentures 8<sup>th</sup> Issue  
Caixa Econômica Federal  
FIDC – SABESP I  
Brazilian Economic and Social Development Bank – BNDES  
Other  
Accrued Interest and financial charges

In foreign currency:  
Eurobonus: US\$ 225,000 thousand (June 2005 - US\$ 500,000 thousand)

Interamerican Development Bank (IDB): US\$ 440,674 thousand (June 2005 - US\$ 443,919 thousand)  
International Bank for Reconstruction and Development - BIRD ("World Bank"): US\$ 4,391 thousand (June 2005 - US\$ 8,820 thousand)  
Deutsche Bank Luxembourg: ( June 2005 - US\$ 10,000 thousand)  
Société Générale: € 524 thousand (June 2005 - € 1,489 thousand)  
JBIC: Yen 465,726 thousand  
Accrued Interest and financial charges

#### Total loans and financing

Exchange rate at June 30, 2006: US\$ 2.1643 (June 30, 2005 - US\$ 2.3504) ; EUR 2.76814 (June 30, 2005 - EUR 2.84586) ; Yen 0.018920

June 30, 2006				June 30, 2005				Guarantees	Final Maturity Date	Annual interest rate	Adjustment to inflation
Short Term	Long Term	Total	Short Term	Long Term	Total						
204,639	1,943,908	2,148,547	183,406	2,096,020	2,279,426	State of S.Paulo Government and Own Funds					
49,998	—	49,998	100,001	49,998	149,999						
44,955	—	44,955	149,155	149,155	298,310						
—	619,618	619,618	—	616,509	616,509						
—	301,891	301,891	—	301,085	301,085						
—	701,336	701,336	—	698,520	698,520						
45,601	458,124	503,725	40,232	451,554	491,786	Own Funds					
41,667	208,333	250,000	—	—	—	Own Funds					
31,107	169,156	200,263	16,273	164,730	181,003	Own Funds					
2,706	23,496	26,202	2,386	24,645	27,031						
102,028	—	102,028	111,442	—	111,442						
522,701	4,425,862	4,948,563	602,895	4,552,216	5,155,111						
—	486,968	486,968	646,360	528,840	1,175,200	-					
97,317	856,434	953,751	94,333	949,054	1,043,387	Federal Government					
9,503	—	9,503	10,365	10,365	20,730	Federal Government					
—	—	—	23,504	—	23,504						
1,449	—	1,449	2,747	1,490	4,237	Federal Government					
—	8,812	8,812	—	—	—	Federal Government					
11,491	—	11,491	39,972	—	39,972						
119,760	1,352,214	1,471,974	817,281	1,489,749	2,307,030						
642,461	5,778,076	6,420,537	1,420,176	6,041,965	7,462,141						

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## (a) Banco do Brasil

In March 1994, existing loan agreements with Caixa Econômica Federal were refinanced and the loan rights were transferred by that financial institution to the Federal Government, with Banco do Brasil acting as an agent. Under the terms of the agreement signed with the Federal Government, charges and payments are made on the "Price" amortization system, indexed monthly to the Standard Reference Unit (UPR), which is equal to the Government's benchmark Interest Rate (TR), plus 8.5% per year. Interest and principal are payable monthly, with final maturity in 2014. This financing is guaranteed by the State of São Paulo Government's revenue and by the Company's own revenues.

## (b) Debentures

(i) 4<sup>th</sup> Issue

On April 1, 2001 the Company made a public placement of 30,000 non-convertible, registered, book-entry type, single series debentures, at the unit value of R\$ 10, in an aggregate amount of R\$ 300,000. The placement of these debentures in the local market occurred through an auction held on June 8, 2001.

Principal amortization is being made in 12 quarterly installments, beginning on March 15, 2004, with a final scheduled redemption date on December 15, 2006.

These debentures bear interest at the daily interbank deposit rate (CDI), as calculated and disclosed by the CETIP (Securities Custody and Financial Settlement Agency), plus 1.20% per annum spread. Interest is paid quarterly, beginning on June 15, 2001.

Proceeds from the issue were used to settle debt obligation that came due in the funding year.

Interest expense was R\$ 6,919 and R\$ 17,056 in the six-months period June 30, 2006 and 2005, respectively. Accrued and unpaid interest at June 30, 2006 of R\$ 304, is recorded under "Loans and financing" in the current liabilities.

(ii) 5<sup>th</sup> Issue

On April 1, 2002 the Company made a public placement for the 5<sup>th</sup> issue of simple, book-entry, registered, unsecured, non-convertible debentures, with face value of R\$ 10.

Proceeds from the issue were used for settling debt obligations that came due during fiscal year 2002.

40,000 debentures were issued, distributed in two series, as follows:

	1 <sup>st</sup> Series	2 <sup>nd</sup> Series
Placement date	05/16/2002	05/16/2002
Number	31,372	8,628
Face value of Issue	R\$ 313,720	R\$ 86,280
Original yield	CDI + 1.85% per year	IGP-M + 13.25% per year
Interest payments	Quarterly, except for last installment on 03/01/2007	Annual, except for last installment in 03/01/2007
Amortization	3 installments on 04/01/2005, 04/01/2006 and 03/01/2007	3 installments on 04/01/2005, 04/01/2006 and 03/01/2007

The interest rates for the two series were renegotiated for the last time in April 2005, whereby the rate for the 1st Series was changed from CDI + 2.0% per year to CDI + 1.1% per year, and the rate for the 2nd

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Series was changed from IGPM + 12.7% per year to IGPM + 10.7% per year, which will be in effect until maturity.

Interest expense was R\$ 10,991 and R\$ 24,884 for the six-months period ended June 30, 2006 and 2005, respectively relating to the 1<sup>st</sup> Series and R\$ 3,615 and R\$ 6,812, respectively relating to the 2<sup>nd</sup> Series. The remaining balances of R\$ 9,971 in June 30, 2005 for the 1<sup>st</sup> Series and R\$ 1,096 and R\$ 2,260 in June 30, 2006 and 2005, respectively for the 2<sup>nd</sup> Series are recorded under "Loans and financing", in current liabilities.

**(iii) 6<sup>th</sup> Issue**

On September 17, 2004, the Company registered with the CVM a securities program under which it has been able to offer debt securities, including non-convertible debentures and commercial papers, up to a total amount of R\$ 1,500,000 during the subsequent two years. As part of such program, on September 1, 2004 the Company issued 600,000 debentures, distributed in three series, with face value of R\$ 1, totaling R\$ 600,000. The date of the financial settlement of the transaction was September 21, 2004 for the 1<sup>st</sup> series, and September 22, 2004, for the 2<sup>nd</sup> and 3<sup>rd</sup> series.

The debentures were placed in the market as follows:

	Amount	Adjustment	Interest	Interest payment	Amortization	Maturity date
1 <sup>st</sup> Series	231,813	-	CDI+1.75% p.a.	Semiannual	Single payment	Sep/2007
2 <sup>nd</sup> Series	188,267	IGP-M	11%	Annual	Single payment	Sep/2009
3 <sup>rd</sup> Series	179,920	IGP-M	11%	Annual	Single payment	Sep/2010

Proceeds from the issue was used for final settlement of the 3<sup>rd</sup> Issue of debentures and promissory notes issued in June 2004 in the amount of R\$ 130,000.

Interest expense was R\$ 20,207 and R\$ 22,785 for the six-months period ended June 30, 2006 and 2005, respectively, relating to the 1st Series; R\$ 10,902 –and R\$ 10,850 for the six-months period ended June 30, 2006 and 2005, respectively, relating to the 2nd Series and R\$ 10,419 for the six-months period ended June 30, 2006 (for the six-months period ended June 30, 2005 – R\$ 10,369) relating to the 3rd Series, which will be paid annually. Remaining balances to be paid in the amount of R\$ 12,957 (June 30, 2005 – R\$ 15,511) of the 1st Series; R\$ 17,659 (June 30, 2005 - R\$ 17,607) of the 2nd Series and R\$ 16,876 (June 30, 2005 – R\$ 16,826) of the 3rd Series. Such amounts are recorded under "Loans and financing" in current liabilities.

**(iv) 7<sup>th</sup> Issue**

Within the program registered together with the CVM on September 17, 2004, the Company issued, in March 1, 2005, 300,000 debentures distributed into two series, without renegotiation, with face value of R\$ 1, totaling R\$ 300,000. The date of the financial settlement was March 14, 2005.

The debentures were placed in the market as follows:

	Amount	Adjustment	Interests	Interest Payment	Amortization	Maturity Date
1 <sup>st</sup> series	200,000	-	CDI + 1.5%p.a.	Semiannual	Single payment	Mar/2009
2 <sup>nd</sup> series	100,000	IGP-M	10.80%	Annual	Single payment	Mar/2010

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Proceeds from the issuance were used to settle obligations due under the 4<sup>th</sup> and 5<sup>th</sup> issues of debentures and for payment of other loan installments.

Interest expenses totaled R\$ 17,170 and R\$ 13,207 for the six-months period ended June 30, 2006 and 2005, respectively, referring to the 1st series, and R\$ 5,445 and R\$ 3,515 for the six-months period ended June 30, 2006 and 2005, respectively, referring to the 2nd Series, that will be paid annually. The remaining balances of R\$ 11,008 and R\$ 13,207 in June 30, 2006 and 2005, respectively, relating to the 1st series, and R\$ 3,501 and R\$ 3,515 in June 30, 2006 and 2005, respectively, relating to the 2nd Series are registered under the line item "Loans and financing" in current liabilities.

(v) 8<sup>th</sup> Issue

In completion to the program registered at the CVM on September 17, 2004 the Company issued, on June 1st, 2005, 700,000 debentures, using the option to increase the quantity of debentures allowed up to 20%, according to the paragraph 2 of article 14 of the CVM inscription nr. 400/03. The debentures were distributed in two series, at par value of R\$ 1, amounting to R\$ 700,000. The settlement date of the financial operation was June 24, 2005.

The debentures were placed in the market as follows:

	Amount	Adjustment	Interests	Interest Payment	Amortization	Maturity Date
1 <sup>st</sup> series	350,000	-	CDI+1.5% p.a.	Semiannual	Single payment	Jun/2009
2 <sup>nd</sup> series	350,000	IGP-M	10.75% p.a.	Annual	Single payment	Jun/2011

Proceeds were used to settle obligations due under the Euro Bonds contract (note 8 (f) (i)).

Interest expenses totaled R\$ 29,937 and R\$ 5,733 for the six-months period ended June 30, 2006 and 2005, respectively, referring to the 1st series, R\$ 19,039 and R\$ 2,978 for the six-months period ended June 30, 2006 and 2005, respectively, referring to the 2nd series. Remaining balances to be paid in the amount of R\$ 4,358 and R\$ 5,733 in June 30, 2006 and 2005, respectively, referring to the 1st series, and R\$ 2,859 and R\$ 2,978 in June 30, 2006 and 2005, respectively, referring to the 2nd series, are registered under "Loans and Financing" in current liabilities.

(c) Caixa Econômica Federal

Pro-Sanitation Program

(i) Water and sewage agreements

During 1996 through 1998, the Company entered into several loan agreements under the Federal Government Pro-Sanitation Program, with a view to expanding and improving the water supply and sewage systems of several municipalities of the State of São Paulo and of the City of São Paulo. The loans are collateralized by collections of the daily billings from water supply and sewage services up to the total amount of the debt.

Contractually established repayment terms range from 120 to 180 months, from the date the related projects become operational.

The balances as of June 30, 2006 and 2005 were R\$ 456,353 and R\$ 481,598, respectively.



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Contract charges are as follows:

	Contract executed in:		
	1996	1997	1998 - 2004
Interest rates	9.5% p.a.	6.5% to 8.0% p.a.	6.5% to 8.0% p.a.
In the grace period:			
Risk fee	1.0% on disbursed amount	1.0% on disbursed amount	0.6% p.a. or 2% p.a. on outstanding balance
Management fee	0.12% p.m. on contract value	2.0% p.a. on disbursed value	1.0% p.a. on disbursed value or 2% p.a. on outstanding balance por agreements executed in 2003-2004.
In the operational stage:			
Management fee	Difference between calculation of installment at the rate of 10.5% p.a. less rate of 9.5% p.a.	1.0% p.a. on outstanding balance	1.0% p.a. on outstanding balance

## (ii) Pro-sanitation Program - "Pró-Sanear"

In 1997 and 1998 contracts were signed under the Pro-Sanitation – "Pró-Sanear" program for the improvement of water and sewage services in several municipalities of the Metropolitan Region of São Paulo, with the participation of the communities receiving the services. The loans are collateralized by collections of the daily billings from water supply and sewage services up to the total amount of the debt. Contractually established repayment terms are 180 months from the date the related projects become operational. Outstanding loan balances under this program at June 30, 2006 and 2005 were R\$ 47,372 and R\$ 10,188, respectively.

Applicable financial charges:

Interest rate – 5.0% p.a.

Management fee (Grace period) – 2.0% p.a. on outstanding balance

Management fee (amortization stage) – 1.0% p.a. on outstanding balance

Risk fee (grace period) – 1.0% on disbursement

## (d) BNDES

Agreement 01.2.619.3.1 – This agreement was executed in August 2002 in the total amount of up to R\$ 60,000 to partially finance the second stage of the Tietê River Clean-up Project, which is also the project object of loan agreement No. 1212/OC – BR with the Interamerican Development Bank (IDB). The related project is in the execution. The outstanding loan balances at June 30, 2006 and 2005 were R\$ 50,032 and R\$ 45,230, respectively.

In addition, the Company has an onlending agreement (10/669.748-6) for a total amount of up to R\$ 180,000. The onlending agreement has the same purpose as the agreement above with BNDES. The onlending agreement funds are passed on from BNDES to the agents, and by the agents to the

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Company, distributed among the financial agents as follows:

Agent	Amount
Unibanco – União de Bancos Brasileiros S.A.	60,000
Banco BBA Creditanstalt S.A.	51,000
Banco Alfa de Investimento S.A.	39,000
Banco Itaú S.A.	30,000
Total	180,000

The related project is in the execution stage, aggregate borrowings under the onlending agreements were R\$ 24,280 in June 30, 2006. Outstanding loan balances at June 30, 2006 and 2005 were R\$ 150,231 and R\$ 135,773, respectively.

Applicable interest and charges and amortization for theses BNDES loans are equal for both. Interest is charged at the Long-Term Interest Rate ("TJLP") limited to 6.0% plus a spread of 3.0% per annum, which is payable quarterly during the grace period and monthly in the repayment period. The portion of the TJLP in excess of 6.0% p.a. is added to the outstanding principal balance. Principal is payable in 84 monthly installments and started on September 2005, with final maturity in February 2013. The agreements are collateralized by part of the revenue from water and sewage services.

(e) Investment Fund in Credit Rights SABESP I – FIDC

On March 23, it was issued a single series of senior quotas and 26 (twenty six) subordinated quotas, kept in a deposit account in the name of their respective holders, with unit value at the issue date corresponding to R\$ 500,000.00 (five hundred thousand reais). Senior quotas will be amortized in 54 (fifty four) monthly installments. Subordinated quotas have been underwritten and paid up exclusively by SABESP. The Fund will have a parameter of profitability corresponding to 100% (one hundred per cent) over the DI Rate, added by a pre-fixed coupon of 0.70% (seventy centesimal points per cent) interest per year based on 252 working days, observed the terms of its Regulation

The Fund is managed by Caixa Econômica Federal and has as custody and underwriting agent the Banco do Brasil S.A.

The resources obtained in the amount of R\$ 250 million will be used by the Company for settling debts maturing during fiscal year 2006.

(f) Eurobonds

(i) A foreign credit transaction was entered into in July 1997, having "UBS - Securities LLC" as lead arranger and "Deutsche Morgan Grenfell" and "BB Securities" as co-lead arrangers, in the amount of US\$ 275 million. The credit facility bore interest at 10%, which was payable semiannually. The outstanding loan matured in July 28, 2005, and was settled with the funds obtained from the 8<sup>th</sup> issue of debentures.

(ii) In June 2003, the Company issued US\$ 225 million 12% Notes due 2008. Interest is payable semiannually with final maturity in June 2008. "The Bank of New York" acted as lead arranger and "The Bank of Tokyo Mitsubishi Ltd." as principal paying agent. Proceeds were used for settlement of obligations under the Eurobond issue of US\$ 200 million that matured in July 2003.

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(g) Inter-American Development Bank (IDB)

Agreement 229 – In June 1987, the Company signed a loan agreement with the IDB for US\$ 163 million to finance improvements and expansion of the sewage systems in the São Paulo Metropolitan Region. Semiannual principal repayments began in January 1994, with final maturity in July 2007. The loan bears interest of 7.7% per annum. A guarantee agreement between the Federative Republic of Brazil and the IDB was executed in June 1987, to warrant the provision of funds to meet the obligations set forth in the financing agreement. Outstanding loan balances under the agreement on June 30, 2006 were US\$ 19.8 million (R\$ 42,852 and R\$ 77,067 at June 30, 2006 and 2005, respectively).

Agreement 713 – In December 1992, the Company signed a loan agreement with the IDB for US\$ 400 million to finance the Tietê River Clean-up Project – Stage I. Semiannual principal repayments began in June 1999, with final maturity in December 2017. The loan bears interest at a variable rate based on the cost of funding to the IDB. A guarantee agreement between the Federative Republic of Brazil and the IDB was executed in December 1992, to warrant the provision of funds to meet the obligations set forth in the financing agreement. The outstanding balance of such agreement at June 30, 2006 was US\$ 249.5 million (R\$ 539,920 and R\$ 634,261 at June 30, 2006 and 2005, respectively).

Agreement 896 – In December 1992, the Company signed an additional loan agreement with the IDB for US\$ 50 million for the Tietê River Clean-up Project – Stage I. This loan bears interest at 3.0% per annum. Semiannual principal repayments began in June 1999, with final maturity in December 2016. A guarantee agreement between the Federative Republic of Brazil and the IDB was executed in December 1992, to warrant the provision of funds to meet the obligations set forth in the financing agreement. The outstanding balance of such agreement at June 30, 2006 was US\$ 29.2 million (R\$ 63,125 and R\$ 75,082, at June 30, 2006 and 2005, respectively).

Agreement 1.212 – In July 2000, the Company signed a loan agreement with the IDB for US\$ 200 million to finance the Tietê River Clean-up Project – Stage II. The related project is in the execution stage, and aggregate borrowings under such agreement in the 1<sup>st</sup> semester of 2006 were US\$ 20.1 million. A guarantee agreement between the Federative Republic of Brazil and the IDB was executed in July 2000, to warrant the provision of funds to meet the obligations set forth in the financing agreement. The balance available under this facility was US\$ 54.8 million at June 30, 2006.

The loan will be repaid in semiannual installments, beginning in January 2006 with scheduled maturity in July 2025. The loan bears interest at a variable rate, payable semiannually, on the daily outstanding balance, based on the cost of funding to the IDB. The outstanding balance of such agreement at June 30, 2006 was US\$ 142.2 million (R\$ 307,854 and R\$ 256,977 at June 30, 2006 and 2005, respectively).

(h) International Bank for Reconstruction and Development – BIRD (World Bank)

Agreement 3.504 – In March 1993, the Company signed an agreement with the State Government for the transfer of the funds received by the State Government from the World Bank in December 1992. The proceeds from this loan were designated to finance the environmental clean-up of the Guarapiranga Basin. In December 1992, a guarantee agreement was executed between the Federative Republic of Brazil and the BIRD, to warrant the provision of funds to meet the obligations set forth in the financing agreement. Semiannual principal repayments began in October 1997, with final maturity in April 2007. The loan bears interest at 0.5% above the World Bank cost of funding. The outstanding balance at June 30, 2006 was US\$ 4.4 million (R\$ 9,503 and R\$ 20,729, at June 30, 2006 and 2005, respectively).

(i) Syndicated loans

Deutsche Bank Luxembourg

In October 2000, the Company signed a loan agreement for US\$ 100 million having the Deutsche Trust

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Bank Limited as paying agent and the Brazilian American Merchant Bank as arranger, for the purpose of refinancing the Company's financial obligations. The loan born interest at 11.125% per year, and was repaid in 10 semiannual installments, comprising principal and interest for the period, with final maturity in October 2005.

(j) Japan Bank for International Cooperation ("JBIC")

On August 6, 2004, the Company executed a financing agreement with the JBIC - Japan Bank for International Cooperation, guaranteed by the Federal Government, in the amount of 21,320 million Japanese Yens, equivalent to approximately R\$ 422,840, which is intended for the Environment Recovery Program for the Metropolitan Region of Santos Coastal Area. The first disbursements under this loan were made in January 2006. In addition to the amount received under the JBIC credit agreement, the Company intends to invest up to R\$ 355,000 million in this program. The total term of the financing agreement is 25 years, comprising 18 years for amortization in semiannual installments and 7 years for grace period. Interest will be paid semiannually at the rate of 2.5% p.a. for the sewage network and 1.8% p.a. for sewage treatment facilities. Total disbursement in the 1st semester of 2006 was 465.7 million Japanese Yenes and the agreement's outstanding balance at June 30, 2006 was R\$ 8,812.

(k) Financial Covenants

The above loans generally include certain financial and operating covenants that require the Company to maintain certain operating and financial ratios, including but not limited to current ratio, debt-to-equity ratios, certain EBITDA and debt service coverage ratios, as well as other operating, profit and productivity ratios, each as specifically defined in the respective loan agreements.

In addition, certain agreements, including but not limited to those relating to the IDB and the Eurobonds, contain, among other provisions, limitations on the Company's ability to incur debt. The indenture relating to the 12.0% Notes due 2008 is the most stringent of these debt agreements.

Brazilian regulations provide that a state-owned company, such as the Company, must, subject to some exceptions, use the proceeds of "external credit operations" (i.e., foreign currency borrowings) to refinance outstanding financial obligations. 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 Japan Bank for

Financial covenants of the 6<sup>th</sup>, 7<sup>th</sup> and 8<sup>th</sup> issue of Debentures

- Adjusted current ratio over 1.0; current assets divided by current liabilities, excluding from the current liabilities the short-term portion of the long-term debts undertaken by the Company.
- EBITDA/Financial Expenses equal to or over than 1.5.
- Non-compliance with these obligations will not be evidenced unless if recorded in quarterly financial statements, for at least two consecutive quarters, or for two non-consecutive quarters within a period of twelve months.

Financial covenants of Caixa Econômica Federal – Pro-Sanitation

- The loans under the Pro-Sanitation program are subject to the Company meeting certain financial and operating covenants (including operating margin, personnel expense margin, and revenue versus collection index, as defined). Such indexes, based on the previous 2 years, are semiannually projected for the next 2 years.

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## Financial covenants of BNDES

- Adjusted current ratio: over 1.0;
- Ratio of EBITDA to operating revenue: equal or higher than 38%;
- Ratio of connections (water and sewage) to employees: equal or higher than 520;
- Ratio of EBITDA to debt service: equal or higher than 1.5;
- Ratio of shareholders' equity to total liabilities: equal or higher than 0.8.

## Covenants of Eurobonds (In the constant currency method):

- No incurrence of additional indebtedness if the debt/adjusted capitalization (\*) ratio is greater than 0.42;
- Debt Service Coverage Ratio cannot be less than 2.5 (adjusted EBITDA(\*\*)/financial expenses);
- Loans to controlling shareholder must be limited to the respective amount of accounts receivable.

(\*) Adjusted capitalization excludes from the Shareholders' Equity overdue accounts receivable, both from the State of São Paulo Government and from self-operated wholesale water distribution companies

(\*\*) Adjusted EBITDA is calculated by excluding unpaid sales of water and sewage services to the State of São Paulo Government and unpaid sales of water on a wholesale basis to self-operated systems in the Metropolitan Region of São Paulo – RMSP (non-accounting information).

## Financial covenants of IDB

- Agreement 229 – Long-term debt must not exceed 1.5 times the shareholders' equity.
- Agreements 713, 896 and 1212 – Tariffs must: a) produce enough revenue to cover the system operating expenses, including those related to management, operation, maintenance and depreciation; b) ensure profitability on property, plant and equipment of not less than 7%. During the performance of the project the outstanding balances of short-term loans must not exceed 8.5% of the Company's shareholders' equity.

At June 30, 2006 the Company was in compliance with all such covenants.

## (I) Maturity dates of loans and financing

	2006	2007	2008	2009	2010	2011	2012 onward	TOTAL
In domestic currency	285,164	649,453	376,783	1,148,663	718,102	765,214	1,005,184	4,948,563
In foreign currency	66,351	102,068	555,717	68,749	68,749	69,213	541,127	1,471,974
Total	351,515	751,521	932,500	1,217,412	786,851	834,427	1,546,311	6,420,537

## 9. TAXES AND CONTRIBUTIONS

Income tax and social contribution (a federally mandated tax based on income) are accrued on taxable results at the applicable tax rates, generally 25% for income tax and 9% for social contribution tax (34% composite rate).

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## (a) Reconciliation of the effective tax rate

The amount recorded as income tax and social contribution expenses in the financial statements is reconciled from the nominal rates provided by law, as shown below:

	June 30, 2006	June 30, 2005
Income before taxes on income	750,596	726,633
Statutory rate	34%	34%
Tax expense at statutory rate	(255,203)	(247,055)
Permanent differences		
Realization of revaluation reserve	(15,710)	(15,173)
Interest on shareholders' equity	44,058	35,700
Other differences	(2,698)	4,567
Income and social contribution taxes	(229,553)	(221,961)
Current	(230,963)	(233,733)
Deferred	1,410	11,772
Effective rate	31%	31%

## (b) Composition of deferred taxes and social contributions

	June 30, 2006	June 30, 2005
In current assets:		
Provision for contingencies	8,278	7,856
Provision for bonus	13,883	—
Tax loss carryforwards	—	22,565
	22,161	30,421
In long-term assets:		
Provision for contingencies and pension obligations	304,460	259,283
Tax loss carryforwards	—	532
Other	6,367	12,478
	310,827	272,293
Total deferred tax assets	332,988	302,714
In current liabilities:		
Deferred PASEP	21,866	21,876
Deferred COFINS	50,462	48,104
	72,348	69,980
Tax loss carry forward:		
Income tax	—	31,662
Social contribution	—	8,294
	—	39,956
In long-term liabilities:		
Profit for governmental agencies	80,215	84,734
Revenue for governmental agencies	59,239	46,881
	139,454	131,615
Total deferred tax liabilities	211,802	241,551

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## (i) In Current Assets

Mainly calculated on temporary differences related to currently non-deductible provisions for contingencies in the amounts of R\$ 65,180 and R\$ 23,107 at June 30, 2006 and 2005. The tax loss carryforwards basis of social contribution has been totally realized in 2006, and in June 30, 2005 amounted to R\$ 250,719.

## (ii) In Long-Term Assets

Mainly calculated on temporary differences in the amount of R\$ 908,193 (june 2005 – R\$ 795,353) related to income tax and R\$ 930,874 (june 2005 – R\$ 810,257) related to social contribution.

The loss carry forward basis of social contribution has been transferred to short-term in 2005, at June 30, 2005 the amount was R\$ 5,906.

## (iii) In current liabilities

Substantially calculated on amounts invoiced to government agencies, with taxes being deducted upon receipt of the invoices.

## (iv) In long-term liabilities

Income tax and social contribution

Substantially calculated based on temporary differences in the amount of R\$ 249,190 (june 2005 - R\$ 262,481) relating to income tax and R\$ 199,083 (june 2005 - R\$ 212,374) relating to social contribution.

## PASEP and COFINS

Substantially calculated on amounts invoiced to government agencies, wich are accrued for when services are rendered and wich are paid when the related amounts are effectively received by the Company.

## (c) Tax effects on the revaluation of assets

As permitted by CVM Instruction 197/93, the Company did not record a provision for the tax effects (deferred taxes) on the surplus of the revaluation of property, plant and equipment carried out in 1990 and 1991. Had the income tax and social contribution on the revaluation reserve been accounted for, the unrealized amount at June 30, 2006 and 2005 would have been R\$ 445,755 and R\$ 476,314, respectively. In the six-months period ended on June 30, 2006 and 2005, the realized revaluation reserve amounts were R\$ 46,205 and R\$ 44,626.

## 10. TAXES PAYABLE

	Current		Long-term	
	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
Income tax	33,856	31,662	-	-
Social contribution	12,908	8,294	-	-
COFINS and PASEP	34,499	30,438	-	-
PAES	40,760	37,856	244,567	264,998

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INSS	18,591	17,241	-	-
Other	4,536	3,624	—	—
Total	145,150	129,115	244,567	264,998

The Company applied for enrollment in the Special Tax Debt Refinancing Program ("PAES") on July 15, 2003 in accordance with Law No. 10,684 of May 30, 2003, in which the Company included certain tax liabilities related to COFINS and PASEP, which had previously been the subject of a legal action by the Company challenging the application of Law No. 9718/98, and consolidated the previously outstanding balance of tax liabilities included under the previous Tax Recovery Program ("REFIS"). The total amount of tax liabilities included in the PAES was R\$ 316,953, as follows:

Tax	Principal	Fine	Interest	Total
COFINS	132,499	13,250	50,994	196,743
PASEP	5,001	509	2,061	7,571
REFIS	112,639	-	-	112,639
Total	250,139	13,759	53,055	316,953

The PAES obligation is being paid in 120 months. After enrolling in the PAES Program, the Company paid R\$ 20,105 and R\$ 18,607 during the six-months period ended June 30, 2006 and 2005, respectively; financial charges in the amount of R\$ 9,917 and R\$ 12,812 were recorded for the six-months period ended June 30, 2006 and 2005, respectively. Assets pledged as guarantee under the previous REFIS Program, in the amount of R\$ 249,034 continue to secure amounts under the PAES Program.

**11. PENSION AND HEALTH BENEFIT PLANS****(a) Health benefit plan**

The Company sponsors the Fundação SABESP de Seguridade Social - SABESPREV, an entity organized in August 1990 with the main purpose of managing SABESP's complementary pension and health benefit plans.

The monthly contribution to the retirement plan – defined benefit corresponds to 2.10% from the Company and 2.27% from the participating employees.

The contributions made by participating employees presented above is an average, as discount amount depends on salary level, between 1% and 8.5%.

The health benefit program, which is comprised of optional health benefit plans, free-election, is also funded by contributions from the sponsor and the participating employers, which were the following in the period:

Company: average of 6.96% on the payroll;

Participating employees: 3.21% of base salary and bonus, corresponding to 2.31% of the gross payroll, on average.



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## (b) Pension benefits

In order to meet the provisions of CVM Resolution No. 371, of December 13, 2000, below is a description of the amounts of pension and retirement benefits granted and payable to which the employees will be entitled after service time.

At December 31, 2005, based on independent actuarial reports, SABESP had a net actuarial liability of R\$ 329,772, representing the difference between the present value of the Company's benefit obligations to the participating employees, retired employees and pensioners, and the assets in guarantee.

The Company has elected to recognize the liability over five years beginning in 2002. The actuarial liability as of June 30, 2006, in the amount of R\$ 299,118 (June 30, 2005 – R\$ 249,736), has been recorded in long-term liabilities.

For the fiscal year 2006 the expense estimate is R\$ 56,045, and it has been charged to income in the period from January to June, 2006, as follows:

	<b>June 30, 2006</b>	<b>June 30, 2005</b>
Transfer to Sabesprev	7,416	6,695
Actuarial liability recorded	22,560	27,560
Total recorded	29,976	34,255

The amount related to past service cost is recorded as an "extraordinary item", net of tax effects, in the statement of income.

**12. PROFIT SHARING**

Based on negotiations held by the Company with the entities representing the employees, a Profit Sharing Program was implemented with the payment of an amount corresponding to up to one month's payroll.

In the semesters ended June 30, 2006 and 2005 the amounts of R\$ 24,951 and R\$ 24,913, respectively, have been accrued.

On December 2005 an advance payment of R\$ 22,906 was made, equivalent to 50% of one month's payroll, and the remainder payment is estimated to be paid at the end of August 2006.

**13. PROVISIONS FOR CONTINGENCES**

## (a) Provisions for contingencies

The Company is party to a number of claims and legal proceedings arising in the normal course of business, including civil, labor, environmental, tax and other matters. The Company has recorded provisions for those claims and assessments whose risk of loss has been determined by management, based on the advice of the Company's legal and tax advisors, as probable and for which amounts are estimable. These recorded provisions, by nature of the related cases, are summarized below as of June 30:

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	<b>2006</b>	<b>2005</b>
Customer claims (i)	283,216	246,643
Contractor claims (ii)	198,078	193,032
Civil and tax claims (iii)	93,624	68,926
Labor claims (iv)	30,170	27,731
Environmental claims (v)	23,257	22,731
Total	628,345	559,063
Escrow Deposits	(14,460)	(9,905)
Total	613,885	549,158
Current portion	10,921	21,074
Long-term portion	602,964	528,084

## (b) Lawsuits with possible risk of loss

In addition to those claims and assessments above whose risk of loss has been determined as probable and for which related provisions have been recorded, the following summarizes the estimated amounts related to other claims and assessments for which management, based on the advice of the Company's legal and tax advisors, has assessed the likelihood of loss as possible and for which no provision has been recorded in the financial statements.

	<b>2006</b>	<b>2005</b>
Customers claims(i)	815,500	631,100
Contractor claims (ii)	190,600	180,900
Civil and tax claims(iii)	334,200	341,200
Labor claims (iv)	14,800	9,000
Environmental claims (v)	520,900	201,600
Total	1,876,000	1,363,800

## (c) Escrow Deposits

The Company had made escrow deposits in the amount of R\$ 14,460 and R\$ 9,905 at June 30, 2006 and 2005, related to pending litigation. Such deposits are restricted and held by the court, pending final resolution of the matters.

## (d) Summary of claims and assessments

## (i) Customer claims

The Company is party to a number of proceedings with the Public Prosecution Office and several municipalities which have contested our right to charge a tariff for sewage services provided as opposed to charging a fixed fee for these services. In most of these proceedings, we have received decisions in

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our favor. In addition, the Supreme Court has confirmed the understanding that we have the right to charge a tariff for the sewage services we provide.

Approximately 960 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 charged and collected and those tariffs. We cannot predict, however, the amounts we would have to pay to these customers if they were to prevail in their lawsuits, nor can we provide assurance that new lawsuits will not be brought by other customers on similar grounds.

(ii) Contractor claims

Certain contractors have filed claims in court against us alleging underpayment of inflation indexation adjustments and monetary losses incurred in connection with introduction of the real. Based on advice from our legal counsel, as of June 30, 2006, we established a provision for these claims in the amount of R\$ 198,078 to meet probable losses arising from unfavorable decisions in these actions.

(iii) Civil and Tax claims

The Company is party to a number of civil claims related to indemnifications for material damages, pain and suffering and loss of profits allegedly caused to third parties and which have been brought before different court levels. In addition, the Company is party to a number of tax proceedings. At June 30, 2006, provisions have been recorded in the amount of R\$ 93,624 for civil and tax claims for which the risk of loss has been assessed as probable.

The Company is party to a series of lawsuits initiated by the municipality of Ferraz de Vasconcelos in 1997, seeking payment of penalties in the aggregate amount of R\$ 70.1 million, which we allegedly owe for damages caused during construction in the municipality. Several of these lawsuits have already been rejected by lower courts but are still subject to appeal. The Company has not made any provisions for these proceedings.

In November 2004, the Company took legal action against the municipality of Bragança Paulista against the imposition of a new charge 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, the Company was granted an injunction suspending the imposition of this charge and preventing the municipality from collection of any current or future amounts due in respect of this charge until there is a final decision on the merits. In June 2005, the lower court ruled in favor of the Company and the injunction was maintained. The municipality appealed the decision and, as of the date of this offering circular, a trial decision was still pending. The Company has not made any provisions for this proceeding.

The Company initiated legal action in July 1999 to challenge the creation by the municipality of the City of São Paulo of a tax on the use of public areas. The tax would apply to our water and sewage mains and other installations located in public areas. Based on the advice of its internal legal counsel, the Company believes that this municipal tax is unlawful because it was established by a municipal decree instead of a municipal statute. The Company is currently disputing the creation of this tax and any related tax assessment. On May 11, 2000, the trial court of the State of São Paulo (12a. Vara da Fazenda Pública do Estado de São Paulo) issued a decision upholding this municipal tax. The Company has appealed the trial court decision to the Court of Appeals of the State of São Paulo (Tribunal de Justiça do Estado de São Paulo). A recently approved law enacted the tax on the use of public areas in the City of São Paulo. In April 2004, the Company filed a request for an injunction seeking the suspension of the tax assessment by the municipality. The injunction was granted on first instance and maintained in the decision of the lower courts. The municipality has appealed this decision to the court of appeals of the State of São Paulo and the decision is still pending. The Company currently cannot estimate the potential increase in its expenses if it is were required to pay this tax or if any future assessment of this tax will be

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retroactive to 1999. To date, the Company not established a provision for any potential expense arising from this municipal tax.

The Company has also taken legal action to challenge a City of São Paulo municipal law enacted in December 2002 that revoked its blanket exemption from municipal taxes. As a result of the loss of its exemption from municipal taxes, the Company may be subject to a tax on services charged at a rate of 5.0% on its gross revenue from water and sewage services. The Company's request for an injunction against the municipality was granted by the tax court of the State of São Paulo (11a. Vara da Fazenda Pública do Estado de São Paulo), and such injunction was maintained after the filing of an appeal by the municipality. However, on May 5, 2005, the lower court issued a decision against the Company and revoked the injunction granted in its favor. The Company appealed the decision to maintain the effects of the injunction until a trial decision in this legal proceeding is issued, but its appeal was denied. To date, despite its efforts to obtain a decision from the Superior Court of Justice to maintain the effects of the injunction until a final judgment, The Company has not been able to revert the lower court decision. The Company intend to challenge the loss of the exemptions to the fullest extent permitted by law. This legal action, for which potential expenses amount to approximately R\$ 112.3 million, was assessed by the Company's tax advisors as being a possible loss; accordingly, no provision has been recorded.

#### **(iv) Labor claims**

The Company is party to a number of labor claims and proceedings, at various legal stages and in a number of courts, brought by São Paulo Water, Sewage and Environment Service Workers Union (Sindicato dos Trabalhadores em Água Esgoto e Meio Ambiente de São Paulo—SINTAEMA) and the Company's current and former employees related to overtime pay, health hazard, premium claims, prior notice period, job deviation, salary parity, and other benefits among others. As of June 30, 2006, the Company had recorded provisions totaling R\$ 30,170 with respect to potential damages in lawsuits and administrative proceedings whose risk of loss has been determined as probable.

On January 9, 1990, SINTAEMA initiated a lawsuit against the Company, alleging that it had failed to pay certain employee benefits and was required to make a penalty payment to SINTAEMA under a then existing collective bargaining agreement. On July 31, 1992, the Labor Court issued a ruling against the Company, but did not award damages to SINTAEMA at that time. The Company and SINTAEMA are currently engaged in negotiations concerning the amount to be paid by the former. The Company also filed a writ of mandamus seeking a court decision establishing that the penalty imposed against it, which amounts to approximately R\$ 5,558, is excessive since it exceeds the principal amount by a large margin. The Company's request was denied by the courts and the lawsuit is now awaiting a final decision at Superior Labor Court (Tribunal Superior do Trabalho). The Company currently cannot predict the amount that it will be required to pay to SINTAEMA.

The Company is also a defendant in 2,688 labor proceedings and in one civil public action initiated by and on behalf of some of its current and former employees relating to certain benefits awarded by Law No. 4,819, of August 26, 1958. In all cases, the Company claims that the State, and not it, is responsible for the payments due to the plaintiffs. As of the date of this offering circular, The Company and the State have not agreed on the amounts to be reimbursed. The civil public action is now awaiting decision on the merits. Some labor and civil proceedings have been ruled upon by the lower courts, but no final decision has been issued in any of the legal proceedings as of the date of this offering circular. An injunction was granted at the first instance in the civil public action to compel the Company to pay the benefits awarded by Law No. 4,819 to all plaintiffs in that lawsuit.

#### **(v) Environment claims**

Environmental claims refer to several administrative proceedings brought by municipalities and other public agencies, including Companhia de Tecnologia de Saneamento Ambiental – “CETESB” (Environment Sanitation Technology Company), seeking to impose fines and penalties for alleged environmental damages. However, the Company does not believe that the final determination in these

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proceedings will, individually or in the aggregate, have a material adverse effect on its business, results of operations, financial condition or prospects.

The Company is party to civil public actions brought by municipalities that seek cessation of the collection of fees relating to sewage services, alleging that the Company does not treat the sewage in these municipalities and that we failed to make certain investments in sewage treatment systems as provided in the relevant concession agreements.

In addition, the Company is being sued by the Public Prosecution Office of the State of São Paulo as well as some non-governmental organizations through a number of environmental civil public actions: (1) aiming to enjoin the Company from releasing untreated sewage into certain local water courses; (2) in some cases seeking remedies for environmental damages, which have not yet been specified and evaluated by technical experts of the courts; and (3) aiming to require us to install and operate sewage treatment facilities in those locations. In each case, the Company is subject to daily fines for noncompliance therewith. The Company disputes these decisions to try to revert them. In its response to these lawsuits the Company emphasizes that the installation and operation of sewage treatment facilities in those locations is included in its business plan and that the immediate cessation of the release of untreated sewage into the relevant local water courses would hinder the Company from collecting sewage – a primary necessity – in those locations, causing much more damages against the environment and public health. In most of these lawsuits, no final judicial decision has yet been reached by local judges. Although the Company is not able to predict the final outcome of these lawsuits, it believes that such outcome, if unfavorable to it, may have a material adverse effect on it.

The civil public lawsuits to which the Company is party include the following:

(1) The Public Prosecution Office of the State has brought a civil public action before the São Bernardo do Campo Court (5a. Vara Cível de São Bernardo do Campo) which seeks reparation for environmental damage caused by the Company dumping sludge from its water treatment facilities into certain receiving waters, the immediate cessation of this practice and the implementation of an environmental recovery project. A court in the second instance ruled against the Company and ordered that it stops dumping sludge within a year from the date the decision is considered final, or to pay a daily penalty of R\$10,000, in addition to repair the environmental damage. This decision is not yet final. The Company is currently unable to evaluate the extent or cost of any remedy that it may be held responsible for in connection with this matter. The Company not made any provisions for this proceeding.

(2) The Public Prosecution Office of the State of São Paulo has brought a civil public action before the Paraguaçu Paulista Courts of Law (1a. Vara de Paraguaçu Paulista) which seeks reparation for and cessation of environmental damage allegedly caused by the Company's release of raw sewage into the Alegre river, situated in the municipality of Paraguaçu Paulista. The lower court has issued a decision against the Company, requiring that it (a) ceases the release of raw sewage into the Alegre river; (b) invests in a water and sewage treatment facility in the municipality of Paraguaçu Paulista; and (c) pays an administrative penalty in the amount of R\$116.9 million for environmental damage. The decision also imposes a daily penalty if the Company fails to comply with (a) and (b) above. The Company has appealed this decision and the decision will not be effective until a final ruling is issued on this appeal. A panel of judges of the Court of Justice of the State of São Paulo has indicated that it may not decide the appeal in favor of the Company, but a final decision has not yet been issued. While unlikely, the panel could revert this indication of its position and issue a final decision in favor of the Company. The Company has not made any provisions for this proceeding.

(3) A civil public action was brought against the Company by the Coordination Council for the Civil Entities of Piracicaba (Conselho Coordenador das Entidades Cíveis de Piracicaba) concerning the limits for water collection from the Piracicaba river and the operation of the Cantareira water distribution system. The plaintiff requests, among other things, a prohibitory injunction in order to restrict the amount of water the Company collects, the reduction of the Piracicaba river's collection limit and the payment of damages to the riparian cities in order to cover the direct and indirect environmental damages caused by

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the installation and operation of the Cantareira water distribution system. After the Company's defense, the injunction was not granted, and this action is now awaiting judgment on the first instance. This proceeding is still at an initial stage and no amount so far has been determined for the alleged damage. The Company has not made any provisions for this proceeding.

(4) On February 25, 2003, a request for a preliminary injunction was filed against the Company, aiming at restricting it from disposing of sewage without due treatment, in the municipality of Lutécia. The injunction was granted in order to determine that payments for water and sewage services by users be deposited with the court until the Company has made the necessary investment in the water and sewage system of the municipality, in addition to paying a daily fine in the amount equivalent to 1,000 minimum salaries (approximately R\$ 350,000) in the event it does not cease to dispose of the untreated sewage. The injunction was suspended at the Company's request until a final ruling is issued. After submission of an expert report, the Public Prosecution Office requested that the Company be sentenced to pay an amount of R\$82.8 million which is additional to the daily fines. The Company and the Prosecution Office are engaged in negotiations in order to settle this legal proceeding. The Company has not made any provisions for this proceeding.

(vi) Other proceedings relating to concessions

The Company is also party to a number of proceedings related to its concessions.

In December 1997, the municipality of Santos enacted a law expropriating the Company's water and sewage systems in Santos. In response, the Company filed an action seeking an injunction against this expropriation, which was denied by the lower court. This decision was later reversed by the Court of Appeals of the State of São Paulo, which issued a preliminary order suspending that law. On August 2, 2002, a decision on this matter was rendered in favor of the Company by a lower court, but that decision remains subject to appeal. Despite the pending lawsuit, the Company continues to provide water and sewage services to Santos.

In connection with discussions held with the municipality of Presidente Prudente, the Company filed a claim against the municipality seeking a court decision determining a continuation of the concession agreement that it has with that municipality until the indemnification payment owed to the Company in connection with the return of water and sewage system of Presidente Prudente is made. The lower court issued a decision in favor of the Company to the effect that it still continue to provide services in the municipality until the indemnification provided for in the concession agreement is paid to it.

On March 25, 2004, the Public Attorney's Office filed a civil action against the municipality of Itapira, its mayor, the Municipal House of Representatives and the Company, claiming that Municipal Law No. 3,593/04 is unconstitutional and seeking termination of the the Company's concession agreement with the municipality of Itapira. Although an injunction was granted, the São Paulo State Court of Appeals has stayed the injunction. On March 23, 2005, the House of Representatives of Itapira approved a decree revoking the concession agreement. In addition, Municipal Law No. 3,730/05 was enacted revoking an earlier law which authorized the municipality to enter into the concession agreement with the Company. The municipality of Itapira has further filed an action against the Company seeking to repossess the assets related to its water and sewage services and has obtained an injunction which was later confirmed by a court decision. The Company has appealed against this ruling but has not been able to suspend the effects of the decision until final judgment. Accordingly, the Company is currently not rendering water and sewage services at Itapira. As of the date of this offering circular, a trial decision on this litigation was pending. The Company has not made any provisions for this proceeding.

On October 10, 2003, the municipality of Monte Mor filed a lawsuit against the Company, seeking the additional issuance and delivery of shares by it, as consideration for its concession to render basic water and sewage services. The lawsuit was dismissed without judgment on the merits of the case, but it is still subject to appeal. The Company has not made any provisions for this proceeding.

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The municipality of Sandovalina has brought a legal action against the Company seeking to (1) obtain the termination of the concession entered into with it and (2) obtain remedies for environmental damage and alleged losses caused to the municipality due to its failure to provide sewage treatment, as well as other damage caused to public property. The Company has responded with a counterclaim against the municipality for payment of R\$ 115 related to the supply of water from December 1999 to August 2003. The Company is also seeking the payment of a contractual indemnification based on the early termination of the contract. The Company is currently operating the water and sewage systems of Sandovalina, and the lawsuit is still in the fact-finding phase. The Company has not made any provisions for this proceeding.

The Company is also defendant in legal proceedings initiated by municipalities seeking to require it to produce documents and information in connection with its concessions. These legal proceedings include the following: (1) a preliminary proceeding (*ação cautelar*) started by the municipality of Guariba seeking a court order requiring the Company to produce documents in order to inform an account revision proceeding; (2) the municipality of Ribeirão Pires has proposed preliminary proceedings seeking the production of documents to inspect the services which the Company provides; (3) the municipalities of Itupeva and Monte Mor have proposed proceedings seeking to obtain a court order to require the Company to produce documents and information in order to evaluate the possibility of renewal of its concession agreement.

**14. SHAREHOLDERS' EQUITY****(a) Authorized capital**

The Company is authorized to increase its capital up to a maximum of R\$ 4,100,000 registered common shares without par value, upon resolution of the board of directors.

The Company has from time to time issued shares to purchase assets from third parties, usually municipal authorities. These shares are issued at market value, which correspond to the fair value of the assets acquired.

**(b) Subscribed and paid-in capital**

Subscribed and paid-in capital is represented by 28,479,577,827 registered common shares without par value as follows:

Shareholders	June 30, 2006		June 30, 2005	
	Number of shares	%	Number of shares	%
State of São Paulo Department of Finance	14,313,511,867	50.26	14,313,511,871	50.26
Companhia Brasileira de Liquidação e Custódia	7,376,565,344	25.90	8,226,984,435	28.88
The Bank of New York ADR Department (Equivalent to stock) (*)	6,761,267,000	23.74	5,911,848,250	20.76
Other	28,233,616	0.10	27,233,271	0.10
	<u>28,479,577,827</u>	<u>100.00</u>	<u>28,479,577,827</u>	<u>100.00</u>

(\*) each ADR equals 250 shares

In October 2004, the State of São Paulo Government sold 5.27 billion of its common shares, of which 1.43 billion were sold in Brazil and 3.84 billion were sold as 15.36 million American Depositary Shares ("ADSS") on the New York Stock Exchange - NYSE.

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**(c) Distribution of earnings**

Shareholders are entitled to a mandatory minimum dividend distribution of 25% of adjusted net income, calculated in conformity with Brazilian Corporate Law. This requirement can be met through payments made in the form of dividends and interest on shareholders' equity (net of withholding tax), to the extent amounts are available for distribution. Dividend distributions are limited to retained earnings as determined in accordance with BR CL.

Interest on shareholders' equity declared in the 1st semester 2005, in the amount of R\$ 105,000, had their payment beginning in June 27, 2006.

Interest on shareholders' equity declared on April 20, 2006, in the amount of R\$ 129,582, will be paid up to 60 days after 2007 Shareholders' Meeting, net of withholding tax.

**(d) Capital reserve**

Capital reserve comprises of tax incentives and donations from government agencies and private entities.

The tax incentive reserve results from an option to invest in the capital stock of companies undertaking specified government-approved projects. In lieu of paying part of the income tax due, the amount is credited to income tax and subsequently appropriated from retained earnings to this reserve.

The donations reserve reflects the value of assets received from government entities, principally enabling the Company to provide service access to properties. No shares are issued in exchange nor other remuneration provided in connection with assets received. These donations are recorded as a direct benefit to shareholders' equity.

**15. INSURANCE COVERAGE**

Insurance policies held by the Company provide the following coverage, taking into account the risks and nature of the related assets:

Type of insurance	Insured amount – R\$
Engineering risk	266,020
Fire	290,079
Civil liability – officers and employees	80,000
Civil liability – construction in progress	6,144
Civil liability – operations	1,500

The Company does not have insurance coverage for business interruption risks nor for liabilities arising from contamination or other problems involving the supply of water to customers. In addition, the Company does not have insurance coverage for liabilities relating to non-compliance with environmental laws and regulations.

**16. FINANCIAL INSTRUMENTS AND RISK****(a) Market value of financial instruments**

The determination of the market value of financial instruments is performed on an annual basis by



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Company Management.

## (b) Credit risk concentration

A significant portion of sales is made to a geographically dispersed customer base. In relation to those clients, credit risk is mitigated due to the large portfolio and to the control procedures which monitor this risk.

The allowance for doubtful accounts is sufficient to cover eventual losses.

## (c) Exchange rate risk

Transactions in foreign currency consist of borrowings to specific improvement works and expansion of the Company's water supply and sewage collection and treatment services.

## 17. MANAGEMENT COMPENSATION

Compensation paid by the Company to the members of its board of directors and management totaled R\$ 1,578 and R\$ 1,203 for the six-months period ended June 30, 2006 and 2005, respectively.

## 18. COMMITMENTS

## (i) Operating leases

Administrative operating leases and property leases already contracted require the following minimum, noncancellable payments:

2006	10,106
2007	2,766
2008	556
2009	24
Total	13,452

Lease expenses for the six-months period ended June 30, 2006 and 2005 were R\$ 5,139 and R\$ 4,586, respectively.

## (ii) Take-or-pay contracts

The Company has entered into long-term take-or-pay-contracts with electric power providers. The minimum amounts payable under such arrangements are as follows:

2006	192,274
2007	167,994
2008	155,890
2009	159,623
2010	161,725
2011	166,968

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2012	139,530
Total	1,144,004

Electric power expenses for the six-months period ended June 30, 2006 and 2005 were R\$ 214,997 and R\$ 207,228, respectively.

**19. STATEMENT OF CASH FLOW**

The statement of cash flows reflects the Company's operating, investing and financing activities derived from accounting records prepared in accordance with BR CL and has been presented in accordance with International Accounting Standards (IAS) No. 7 - "Cash Flow Statements".

	<b>Periods Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
Cash flows from operating activities:		
Net income for the year	503,482	487,111
Adjustments to reconcile net income:		
Deferred taxes	(3,187)	(15,590)
Loss on disposal of property, plant and equipment	2,321	2,332
Provisions for contingencies	25,556	58,110
Pension obligation	29,977	34,255
Loss on write-off of deferred assets	863	-
Gain on sale of property, plant and equipment	(1,007)	
Depreciation and Amortization	297,846	294,999
Interest calculated on loans and credit facilities payable	321,369	334,763
Foreign exchange and indexation	(36,783)	(253,004)
Bad debt expense – net of recoveries	124,118	106,257
Variation in assets:		
Accounts receivable, net	(177,410)	(272,530)
Inventories	4,035	4,564
Accounts receivable from shareholder	(75,310)	(108,763)
Other assets	(42,700)	(6,931)
Variation in liabilities:		
Accounts payable to suppliers and contractors	10,251	(5,025)
Accrued payroll and related charges	106,919	62,351
Taxes payable	17,555	(6,157)
Contingencies	(20,000)	444
Other liabilities	(26,093)	6,287
Net cash provided by operating activities	1,061,802	723,473
Cash flows from investing activities:		
Purchase of property, plant and equipment	(331,506)	(240,663)
Proceeds from the sale of property, plant and equipment	2,188	0
Increase in deferred assets	(55)	(53)
Net cash used in investing activities	(329,373)	(240,716)
Cash flows from financing activities:		
Loans and financing		
Funds raised	320,528	1,061,414
Repayments	(838,963)	(706,227)
Payment of interest on shareholder's equity	(158,155)	(65,552)
Net cash used in financing activities	(676,590)	289,635
Increase (decrease) in cash / cash equivalents	55,839	772,392

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	<b>Periods Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
Cash and cash equivalents at the beginning of year	280,173	105,557
Cash and cash equivalents at the end of year	336,012	877,949
	<b>2006</b>	<b>2005</b>
Supplementary cash flow information:		
Interest paid on loans and financing	346,245	320,422
Income tax and social contribution paid	221,150	183,405
Non - cash transactions		
Property, plant & equipment received as donations and/or paid for with shares	21,940	7,533

**20. SUBSEQUENT EVENT**

The Public Prosecution Office of the State of São Paulo brought a civil public action against us before the Paraguaçu Paulista Courts of Law (1a. Vara de Paraguaçu Paulista), which seeks reparation for and cessation of environmental damage allegedly caused by the release of raw sewage into the Alegre River, situated in the municipality of Paraguaçu Paulista. The court ruled against the Company in the first instance, requiring that we (a) cease the release of raw sewage into the Alegre River; (b) invest in a water and sewage treatment facility in the municipality of Paraguaçu Paulista; and (c) pay an administrative penalty in the amount of R\$116.9 million for environmental damages (the adjusted amount, as of June 30, 2006, was approximately R\$160 million). The decision imposes an additional daily penalty on us if we fail to comply with (a) and (b) above. We have appealed this decision and we have begun construction of projects necessary to enable our compliance with items (a) and (b), which we expect to be concluded by October 2007. As of June 30, 2006, we had not recorded any provisions for this legal proceeding as we considered the probability of loss relating to this matter not probable.

On September 21, 2006, the Court of Justice of the State of São Paulo ruled against our appeal. While we maintain our legal right to appeal the decision issued by the Court of Justice of the State of São Paulo, we are currently negotiating with the Public Prosecution Office of the State of São Paulo relating to the terms and conditions of a possible settlement agreement, which, if entered into, will result in the effective settlement and termination of this legal proceeding. While the exact amounts payable under any such settlement have not yet been quantified and the terms of any such settlement remain subject to further negotiation, our management believes that the total estimated disbursements will be reasonably less than the aggregate amount of the administrative penalties required by the court's decision as described above.

As a result of these developments, management is evaluating the amount to be recorded in the financial statements as of September 30, 2006 in connection with the estimated future payments relating to this matter. The amount to be recorded will consider the settlement negotiations which continue in progress.

Companhia de Saneamento  
Básico do Estado de São Paulo –  
SABESP

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The accompanying notes are an integral part of these financial statements.

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Management of  
Companhia de Saneamento Básico do Estado de São Paulo - SABESP  
São Paulo - SP

1. We have audited the accompanying balance sheets of Companhia de Saneamento Básico do Estado de São Paulo - SABESP (a Brazilian Corporation hereinafter referred to as the "Company") as of December 31, 2005 and 2004, and the related statements of income, changes in shareholders' equity and changes in financial position for each of the three years in the year ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.
2. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation. We believe that our audits provide a reasonable basis for our opinion.
3. In our opinion, such financial statements present fairly, in all material respects, the financial position of Companhia de Saneamento Básico do Estado de São Paulo - SABESP as of December 31, 2005 and 2004, and the results of its operations, changes in shareholders' equity and changes in financial position for each of the three years in the year ended December 31, 2005, in conformity with accounting practices adopted in Brazil.
4. As mentioned in Note 6, the Company is negotiating with the State of São Paulo Government the reimbursement of the amounts for supplementary retirement and pension paid by the Company and the future flow of these payments to be reimbursed by the State of São Paulo Government.
5. Accounting practices adopted in Brazil vary in certain respects from accounting principles generally accepted in the United States of America. The application of the latter would have affected results of operations for each of the three years in the year ended December 31, 2005 and the determination of shareholders' equity as of December 31, 2005 and 2004, to the extent summarized in Note 22 to the financial statements.

DELOITTE TOUCHE TOHMATSU  
Auditores Independentes

São Paulo, Brazil  
June 26, 2006

The accompanying notes are an integral part of these financial statements.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****BALANCE SHEETS AS OF DECEMBER 31, 2005 AND 2004**

(In thousands of Brazilian reais – R\$)

<b>Assets</b>	<b>2005</b>	<b>2004</b>
<b>Current assets</b>		
Cash and cash equivalents (note 4)	280,173	105,557
Customer accounts receivable, net (note 5)	1,195,249	949,792
Receivable from shareholder, net (note 6)	166,356	81,334
Inventories	36,070	29,604
Deferred taxes (note 10)	23,515	30,215
Other current assets	24,023	33,288
	<u>1,725,386</u>	<u>1,229,790</u>
<b>Long-term assets</b>		
Customer accounts receivable, net (note 5)	263,356	278,060
Receivable from shareholder, net (note 6)	800,594	740,609
Indemnities receivable (note 7)	148,794	148,794
Escrow deposits	27,926	16,189
Deferred taxes (note 10)	298,820	257,271
Other assets	32,920	27,976
	<u>1,572,410</u>	<u>1,468,899</u>
<b>Permanent assets</b>		
Investments	740	5,100
Intangible assets (note 8)	502,518	517,386
Property, plant and equipment, net (note 8)	13,613,581	13,523,536
Deferred charges	20,531	39,097
	<u>14,137,370</u>	<u>14,085,119</u>
<b>Total Assets</b>	<b><u>17,435,166</u></b>	<b><u>16,783,808</u></b>

The accompanying notes are an integral part of these financial statements.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****BALANCE SHEETS AS OF DECEMBER 31, 2005 AND 2004**

(In thousands of Brazilian reais – R\$)

<b>Liabilities and Shareholders' Equity</b>	<b><u>2005</u></b>	<b><u>2004</u></b>
<b>Current liabilities</b>		
Accounts payable to suppliers and contractors	77,781	51,578
Loans and financing (note 9)	759,013	1,496,810
Accrued payroll and related charges	117,289	107,228
Provisions for contingencies (note 14)	31,557	30,373
Interest on shareholders' equity (notes 6 and 15 (c))	409,725	144,078
Taxes payable (note 11)	106,131	115,119
Deferred taxes (note 10)	70,893	71,902
Other current liabilities	<u>119,577</u>	<u>83,801</u>
	1,691,966	2,100,889
<b>Long-term liabilities</b>		
Loans and financing (note 9)	5,905,208	5,553,843
Taxes payable (note 11)	256,114	272,338
Deferred taxes (note 10)	133,443	130,055
Provisions for contingencies (note 14)	580,840	460,231
Accrued pension obligation (note 12)	276,558	222,176
Other liabilities	<u>108,489</u>	<u>92,688</u>
	7,260,652	6,731,331
<b>Shareholders' equity (note 15)</b>		
Paid-in capital	3,403,688	3,403,688
Capital reserve	78,820	65,291
Revaluation reserve	2,529,771	2,619,220
Profit reserves	<u>2,470,269</u>	<u>1,863,389</u>
	8,482,548	7,951,588
<b>Total Liabilities &amp; Shareholders' Equity</b>	<b><u>17,435,166</u></b>	<b><u>16,783,808</u></b>

The accompanying notes are an integral part of these financial statements.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****STATEMENTS OF INCOME**

FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003

(In thousands of Brazilian reais – R\$, except for earnings per share)

	<u>2005</u>	<u>2004</u>	<u>2003</u>
<b>GROSS REVENUE FROM SALES AND SERVICES (Note 18)</b>	5,356,326	4,642,491	4,307,534
Taxes on sales and services - COFINS and PASEP	<u>(402,963)</u>	<u>(245,419)</u>	<u>(176,782)</u>
Net revenue from sales and services	4,953,363	4,397,072	4,130,752
Cost of sales and services (note 19)	<u>(2,390,421)</u>	<u>(2,253,380)</u>	<u>(2,067,148)</u>
<b>GROSS PROFIT</b>	2,562,942	2,143,692	2,063,604
 <b>OPERATING EXPENSES (Note 19)</b>			
Selling expenses	(537,864)	(502,520)	(297,534)
Administrative expenses	(335,505)	(313,557)	(254,060)
Financial expenses, net	<u>(447,004)</u>	<u>(503,706)</u>	<u>(346,477)</u>
<b>Total operating expenses</b>	<u>(1,320,373)</u>	<u>(1,319,783)</u>	<u>(898,071)</u>
<b>INCOME (LOSS) FROM OPERATIONS</b>	<u>1,242,569</u>	<u>823,909</u>	<u>1,165,533</u>
 <b>NONOPERATING INCOME (EXPENSES)</b>			
Loss on disposal of property, plant and equipment (note 8(a))	(19,051)	(34,440)	(61,654)
Others	<u>(6,370)</u>	<u>518</u>	<u>7,199</u>
	<u>(25,421)</u>	<u>(33,922)</u>	<u>(54,455)</u>
 <b>INCOME (LOSS) BEFORE TAXES ON INCOME</b>	1,217,148	789,987	1,111,078
Income and social contribution taxes (note 10)	(316,379)	(241,837)	(242,636)
<b>INCOME (LOSS) BEFORE EXTRAORDINARY ITEM</b>	<u>900,769</u>	<u>548,150</u>	<u>868,442</u>
 Extraordinary item, net of income and social contribution taxes (note 12)	<u>(35,122)</u>	<u>(35,122)</u>	<u>(35,122)</u>
 <b>NET INCOME (LOSS)</b>	<u><b>865,647</b></u>	<u><b>513,028</b></u>	<u><b>833,320</b></u>
 Earnings (loss) per thousand shares in R\$	30.40	18.01	29.26

The accompanying notes are an integral part of these financial statements.



# COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP

## STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003

(In thousands of Brazilian reais – R\$)

	<u>Paid in capital</u>	<u>Capital reserve</u>	<u>Revaluation reserve</u>	<u>Profit reserves</u> <u>Legal</u>	<u>Investment</u>	<u>Retained earnings</u>	<u>Total</u>
<b>BALANCES AS OF JANUARY 1, 2003</b>	<u>3,403,688</u>	<u>49,503</u>	<u>2,857,965</u>	<u>104,674</u>	<u>830,646</u>	<u>-</u>	<u>7,246,476</u>
Donations		1,236					1,236
Realization of revaluation reserve			(134,245)			134,245	-
Net income						833,320	833,320
<b>Allocation of income:</b>							
Legal reserve				41,666		(41,666)	-
Interest on shareholders' equity						(504,089)	(504,089)
Investment reserve					<u>421,810</u>	<u>(421,810)</u>	<u>-</u>
<b>BALANCES AS OF DECEMBER 31, 2003</b>	<u>3,403,688</u>	<u>50,739</u>	<u>2,723,720</u>	<u>146,340</u>	<u>1,252,456</u>	<u>-</u>	<u>7,576,943</u>
Donations		14,552					14,552
Realization of revaluation reserve			(104,500)			104,500	-
Net income						513,028	513,028
<b>Allocation of income: (note 15 )</b>							
Legal reserve				25,651		(25,651)	-
Interest on shareholders' equity						(152,935)	(152,935)
Investment reserve					<u>438,942</u>	<u>(438,942)</u>	<u>-</u>
<b>BALANCES AS OF DECEMBER 31, 2004</b>	<u>3,403,688</u>	<u>65,291</u>	<u>2,619,220</u>	<u>171,991</u>	<u>1,691,398</u>	<u>-</u>	<u>7,951,588</u>
Donations (note 15 (d))		13,529					13,529
Realization of revaluation reserve			(89,449)			89,449	-
Net income						865,647	865,647
<b>Allocation of income: (note 15 (e))</b>							
Legal reserve (note 15 (c))				43,282		(43,282)	-
Interest on shareholders' equity (note 15 (c))						(348,216)	(348,216)
Investment reserve (note 15 (e))					<u>563,598</u>	<u>(563,598)</u>	<u>-</u>
<b>BALANCES AS OF DECEMBER 31, 2005</b>	<u>3,403,688</u>	<u>78,820</u>	<u>2,529,771</u>	<u>215,273</u>	<u>2,254,996</u>	<u>-</u>	<u>8,482,548</u>

The accompanying notes are an integral part of these financial statements.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**

**STATEMENTS OF CHANGES IN FINANCIAL POSITION**

FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003

(In thousands of Brazilian reais – R\$)

	2005	2004	2003
<b>SOURCES OF FUNDS</b>			
<b>From operations:</b>			
<b>Net income</b>	<b>865,647</b>	<b>513,028</b>	<b>833,320</b>
<b>Items not affecting working capital</b>			
Bad debt expense	137,639	76,870	-
Depreciation and amortization	595,981	598,911	564,455
Investments write-off	4,360		
Loss on disposal of property, plant and equipment	19,051	34,616	61,654
Write-off of deferred charges	6,700	-	984
Provisions for contingencies	120,609	75,660	147,201
Accrued pension obligation	54,382	76,636	77,204
<b>Interest and monetary and exchange variations on long-term assets and liabilities:</b>			
Assets	(19,597)	(38,548)	(9,434)
Loans and financing	(143,210)	(9,569)	(248,796)
Taxes payable	21,761	25,018	17,165
Deferred income and social contribution taxes:			
In long-term assets	(41,549)	(34,467)	(16,771)
In long-term liabilities	3,388	8,938	45,237
<b>Total from operations</b>	<b>1,625,162</b>	<b>1,327,093</b>	<b>1,472,219</b>
<b>From third parties:</b>			
Loans and financing, long-term	1,153,479	780,722	860,323
Changes in long-term liabilities		-	196,134
Increase in property, plant and equipment - donations	13,529	14,552	1,236
<b>Total from third parties</b>	<b>1,167,008</b>	<b>795,274</b>	<b>1,057,693</b>
<b>Decrease in working capital</b>	<b>-</b>	<b>356,265</b>	<b>38,268</b>
<b>Total sources</b>	<b>2,792,170</b>	<b>2,478,632</b>	<b>2,568,180</b>
<b>USES OF FUNDS</b>			
Increase in long-term assets	180,003	217,107	6,048
Transfer to long-term assets		-	149,760
Decrease in long-term liabilities	46,602	22,668	-
<b>Permanent assets</b>			
Property, plant and equipment	678,237	600,903	1,009,365
Deferred charges	106	444	9,469
<b>Transfer from long-term to current liabilities</b>			
Loans and financing	634,487	1,484,575	889,449
<b>Interest on shareholders' equity</b>	<b>348,216</b>	<b>152,935</b>	<b>504,089</b>
<b>Increase in working capital</b>	<b>904,519</b>	<b>-</b>	<b>-</b>
<b>Total uses</b>	<b>2,792,170</b>	<b>2,478,632</b>	<b>2,568,180</b>
<b>Increase (decrease) in working capital</b>			
<b>Represented by:</b>			
<b>Current assets</b>			
At end of year	1,725,386	1,229,790	1,217,165
At beginning of year	1,229,790	1,217,165	1,608,900
<b>Variation in current assets</b>	<b>495,596</b>	<b>12,625</b>	<b>(391,735)</b>
<b>Current liabilities</b>			
At end of year	1,691,966	2,100,889	1,731,999
At beginning of year	2,100,889	1,731,999	2,085,466
<b>Variation in current liabilities</b>	<b>(408,923)</b>	<b>368,890</b>	<b>(353,467)</b>
<b>Increase (decrease) in working capital</b>	<b>904,519</b>	<b>(356,265)</b>	<b>(38,268)</b>

The accompanying notes are an integral part of these financial statements.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**

**STATEMENTS OF CHANGES IN FINANCIAL POSITION**

FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003

(In thousands of Brazilian reais – R\$)

**SUMMARY**

	<u>2005</u>	<u>2004</u>	<u>2003</u>
SOURCES			
From operations	1,625,162	1,327,093	1,472,219
From third parties	1,167,008	795,274	1,057,693
<b>Decrease in working capital</b>	<b>-</b>	<b>356,265</b>	<b>38,268</b>
<b>TOTAL SOURCES</b>	<b>2,792,170</b>	<b>2,478,632</b>	<b>2,568,180</b>
USES			
Increase in long-term assets	180,003	217,107	6,048
Transfer to long-term assets			149,760
Decrease in long-term liabilities	46,602	22,668	
Permanent assets	678,343	601,347	1,018,834
Transfer from long-term to current liabilities	634,487	1,484,575	889,449
Interest on shareholders' equity	348,216	152,935	504,089
<b>Increase in working capital</b>	<b>904,519</b>	<b>-</b>	<b>-</b>
<b>TOTAL USES</b>	<b>2,792,170</b>	<b>2,478,632</b>	<b>2,568,180</b>

For 2005, the Company has chosen to enhance the model of its Statements of Changes in Financial Position, presenting the Increase in working capital as uses and the decrease in working capital as sources.

The accompanying notes are an integral part of these financial statements.

**NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003  
(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

1. OPERATIONS

Companhia de Saneamento Básico do Estado de São Paulo - SABESP (the "Company") is engaged in the operation of public water and sewage systems in the State of São Paulo, Brazil, providing water and sewage services to a broad range of residential, commercial, industrial and government customers. The Company also provides water on a wholesale basis to certain municipalities in the São Paulo Metropolitan Region that do not have water production systems.

With the enactment of Law 12,292 on March 2, 2006 we became authorized to provide water and sewage services outside the State of São Paulo, including in other countries, either directly or through national or international consortia. We may also have equity participation in other state or mixed-capital companies, and establish subsidiaries.

The Company's shares are listed on the São Paulo Stock Exchange (BOVESPA) in the "New Market" segment since April 2002, and on the New York Stock Exchange (NYSE), in the form of ADRs (American Depositary Receipts) since May 2002.

The Company provides water and sewage services in 368 municipalities in the State of São Paulo, nearly all of which are through concessions granted by the municipalities and most of them with 30-year term. Out of the 17 (seventeen) concession contracts that expired in 2005, 8 (eight) have been extended for a period from 3 (three) months to 1 (one) year and 9 (nine) are under negotiation with the respective Municipalities. In 2006, 135 contracts will expire and the rest between 2007 and 2034. Management expects that the referred concessions will be renewed or extended, thus there will not be an interruption of the water supply and sewage collection. The net book value of property, plant and equipment items relating to the municipalities where the concessions which were under negotiation at December 31, 2005 or that will expire in 2006, totals R\$ 1.57 billion and net revenue totals R\$ 700,0 million related to these concessions..

The Company does not hold a formal concession to provide water and sewage services in the City of São Paulo, which accounts for a substantial portion of the sales and services rendered. In Santos, a municipality located in the Santos Coastal Area, which also has a large population, the Company operates under a public authorization, like in some other municipalities in the Santos Coastal Area and the Ribeira Valley, where the Company started operating after the merger of the companies that formed SABESP. Management believes that the Company has a vested right to provide water and sewage services in these municipalities based upon, among other things, its ownership of the related water and sewage systems serving the City of São Paulo and these other municipalities and certain succession rights resulting from the merger which formed the Company.

In general, the Company does not face any competition in the municipalities in which it provides water and sewage services, and management believes that in those municipalities the Company has an exclusive right to provide such services.

All information regarding concession areas, number of municipalities, volumes of water and sewage and other related data disclosed in this report that do not arise from the accounting and/or financial statements are unaudited.

**NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003  
(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

2. PRESENTATION OF FINANCIAL STATEMENTS

The Company's statutory financial statements, which are used as the basis for determining income taxes and mandatory minimum dividend calculations, have been prepared in accordance with accounting practices adopted in Brazil, which are based on the Brazilian Corporate Law (Law No. 6,404/76, as amended), the rules and regulations of the Brazilian Securities Commission ("CVM") and the accounting standards issued by the Brazilian Institute of Independent Auditors ("IBRACON"), collectively referred to hereinafter as "Corporate Law" or "BR CL". The financial statements prepared in accordance with Corporate Law have not been indexed for inflation after 1995.

(a) Inflation accounting under BR CL

BR CL provided a simplified methodology for accounting for the effects of inflation through 1995. This method consisted of restating permanent assets (property, plant and equipment, investments and deferred charges) and shareholders' equity accounts using indices mandated by the Brazilian Federal Government. The net effect of these restatements was credited or charged to the statement of operations.

(b) Presentation of financial statements

To facilitate an understanding of Brazilian accounting practices, the presentation of the financial statements has been adapted from the financial statements filed for Brazilian legal and regulatory purposes. In addition, certain terminology changes have been made and the notes to the financial statements have been expanded to conform them more closely to reporting practices prevailing in the United States of America. All amounts are presented in Brazilian currency ("*real*" or "*reais*"), unless otherwise indicated.

3. SIGNIFICANT ACCOUNTING PRACTICES

The Company's accounting practices, which are based on the accrual concept, comply with the Corporate Law but differ in certain significant respects from accounting principles generally accepted in the United States of America ("US GAAP"). See Note 22 for further discussion of the differences between BR CL and US GAAP and the reconciliation of shareholders' equity and net income (loss) between BR CL and US GAAP. Additional disclosure has been included in the notes to the financial statements to comply with the regulations of the U.S. Securities and Exchange Commission (the "SEC") for foreign registrants.

(a) Revenue from sales and services

Revenue for water and sewer services is recognized as water is consumed or as services are provided. Revenue from water and sewer services rendered but not billed is recorded as unbilled customer accounts receivable based on monthly estimates in order to match such revenue with costs incurred.

In the fiscal year ended December 31, 2004, revenue was recorded net of customer discounts relating to the Program for Consumption Reduction Incentive Program (see Note 18).

(b) Marketing costs

Marketing costs are generally expensed as incurred and reported in administrative expenses. Marketing costs were R\$ 17,861, R\$ 31,615 and R\$ 4,206 for the years ended December 31, 2005, 2004 and 2003, respectively. No marketing costs were deferred at December 31, 2005 and 2004.

(c) Financial income and expenses

Financial income and expenses are primarily comprised of interest and monetary and exchange variations on loans and financing and financial investments, and are calculated and reported on the accrual basis of accounting.

**NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2005, 2004 AND 2003  
(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

(d) Income and social contribution taxes

Income and social contribution taxes (a federally mandated tax based on income) are accrued on taxable results.

Income tax is calculated at the rate of 15%, plus a 10% surtax, and social contribution tax is calculated at the rate of 9%. These taxes are reported on an accrual basis.

Deferred taxes related to tax loss carryforwards and temporary differences are calculated and recorded based on future taxable or deductible amounts and are recognized to the extent that realization is believed to be probable.

As permitted by the CVM, the Company opted not to recognize the deferred tax liability (non-cash) on the revaluation reserve of property, plant and equipment recorded up to 1991.

(e) Other income and expenses

Other income and expenses are recorded on an accrual basis.

(f) Cash and cash equivalents

Cash and cash equivalents are comprised primarily of bank deposits and financial investments and are carried at cost plus accrued interest, if applicable. Financial investments denominated in reais have a ready market and an original maturity of 90 days or less. These comprise mainly Financial Investment Funds (FIF's). Foreign currency deposits, if any, are translated at balance sheet date exchange rates. The Company is required by law to invest excess cash with financial institutions controlled by the State Government (see Note 5).

(g) Customer accounts receivable and allowance for doubtful accounts

Customer accounts receivable generally do not accrue interest or indexation charges or penalties, except for refinanced agreements.

The Company records an allowance for doubtful accounts for receivable balances in an amount that is deemed by management to be sufficient to cover probable losses in accounts receivable, based on an aging analysis of receipts, taking into consideration the expected recovery in the different categories of customers accounts. Amounts in excess of R\$ 5 and overdue for more than 360 days and in excess of R\$ 30 and overdue for more than 360 days, which are under judicial collection proceedings, are provisioned. Accounts receivable balances under R\$ 5 and overdue more than 180 days are written off through a direct charge to income.

(h) Inventories

Inventories of materials used in operations and in the maintenance of the Company's water and sewage systems are stated at the lower of average acquisition cost or realizable value and are classified in current assets. Inventories for capital projects are classified under property, plant and equipment and are stated at the average acquisition cost.

(i) Other current assets and long-term receivables

Other current assets and long-term receivables are stated at the lower of acquisition cost or realization value, plus accrued interest, when applicable.

(j) Property, plant and equipment

Property, plant and equipment are generally stated at amounts established by independent technical appraisals, plus price-level restatements from the date of the appraisals to 1995. Revaluation increments arising from revaluing assets to appraised values are recorded in the revaluation reserve component of

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shareholders' equity and subsequently transferred from the reserve to retained earnings as the related assets are depreciated, sold or upon disposal. The price-level restatement adjustments were based on official inflation indices published by the federal government. The Company believes that the distortion caused by indices which understated the independently measured inflation rate have been mitigated by recording revaluation increments.

The revaluation of property, plant & equipment items, carried out in two separate stages in 1990 and 1991, was based on an appraisal report issued by independent experts. The referred revaluation was recorded with a corresponding credit to the "Revaluation Reserve" account in Shareholder's Equity, and is realized through depreciation, sale, and disposal of the respective assets, with a corresponding entry to "Retained Earnings".

Contributions of property, plant and equipment by third parties and from government entities (such as property owners) to allow the Company to supply water and sewage services are recorded as a capital reserve.

Construction-in-progress is recorded at cost and is primarily related to construction projects under contract with third parties. For long-term projects, the Company capitalizes these projects once the Company's engineering department approves that the project milestones have been achieved and the Company takes delivery of the assets.

**Depreciation**

Depreciation of property, plant and equipment, is recorded using the straight-line method based on the estimated useful lives of the underlying assets. The principal depreciation rates are detailed in Note 8.

**Capitalization of interest**

Consistent with the requirements of accounting regulations for Brazilian utilities, up to 1985, interest was capitalized at 12% per annum on construction-in-progress. Interest capitalized which exceeded interest expense on loans obtained to finance construction-in-progress was recorded in a capital reserve directly in shareholders' equity. Up to 1995, BR CL did not require the capitalization of interest costs incurred during the construction period as part of the cost of the related property, plant and equipment. However, as permitted by the Brazilian Water and Sewage Plan (*Plano Nacional de Saneamento Básico* - PLANASA), the Company capitalized interest on construction in progress through 1988. No interest was capitalized from 1989 to 1995. Interest was again capitalized beginning in 1996, following changes in the CVM requirements in 1996. Beginning in 1999, the Company has capitalized indexation charges on the *real* - denominated loans and financing and the foreign exchange effects on foreign currency loans and financing. The Company capitalizes interest incurred on borrowings to the extent that borrowings do not exceed construction-in-progress, which is recorded as a reduction of interest expense.

Interest capitalized is depreciated with the cost of the asset, once the related asset becomes operational. Through December 31, 1998, but not thereafter, such depreciation of capitalized interest was deductible for purposes of determining taxes on income.

**Repairs and maintenance**

Improvements to existing property are capitalized, while costs of general maintenance and repairs are expensed as incurred. Materials allocated to specific projects are added to construction-in-progress.

**Concession assets acquired**

Beginning in 1999, acquisitions of concession assets and concession rights from third parties have been accounted for at fair values, as determined in technical appraisal reports. Accordingly, the purchase price, plus direct costs of acquisition, is allocated to assets acquired and liabilities assumed based upon their estimated fair values at the date of acquisition. These concessions are recorded as concession assets acquired, included as intangible assets in the balance sheets.

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Concession rights are amortized on a straight-line basis over the estimated future periods to be benefited, not to exceed the contractual term of the concession. The straight-line method of depreciation is modified, when applicable, to avoid the backloading of charges in later years by estimating future disbursement commitments to meet the Company's concession obligations.

**Impairment**

The Company reviews long-lived assets, primarily buildings and water and sewage systems, including property, plant and equipment and concession assets, to be held and used in the business, for the purpose of determining and measuring impairment on a recurring basis or when events or changes in circumstances indicate that the carrying value of an asset or group of assets may not be recoverable. The Company assesses impairment on the basis of the projected recovery of depreciation charges through results of operations. The carrying value of assets or groups of assets is written down to realizable value if and when appropriate.

**(k) Deferred charges**

Deferred charges are comprised primarily of deferred project costs and technical studies, which are being amortized using the straight-line method over 5 years from the date when benefits start to be generated.

**(l) Loans and financing**

Loans and financing are adjusted by indexation charges and foreign exchange variations and include accruals for related interest expense. Loans and financing denominated in foreign currencies are translated to reais using the exchange rate in effect at the balance sheet date. The resulting foreign currency exchange adjustments are recognized as incurred in financial income (expense), net.



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(m) Salaries and payroll charges

Salaries and other payroll charges, including provisions for vacation pay, 13th salary and complementary payments agreed upon through collective bargaining agreements, added by the corresponding payroll charges, are recorded on an accrual basis.

(n) Provisions for contingencies

Provisions for contingencies are recorded at the estimated amounts to cover potential losses related on labor, tax, civil, commercial, environmental and other claims and lawsuits, at administrative and court levels, when such losses are considered probable and are estimateable by management.

(o) Environmental costs

Costs relating to ongoing environmental programs are expensed as incurred. Ongoing programs are designed to minimize the environmental impact of operations and to manage the environmental risks inherent to the Company's activities. Provisions for contingent losses related to environmental claims are recorded when they are considered to be probable and reasonably estimatable by Management.

(p) Pension and postretirement benefits

The Company sponsors a private defined benefit pension plan, which is operated and administered by Fundação SABESP de Seguridade Social ("SABESPREV"). CVM resolution 371 of December 13, 2000 determines the recognition of actuarial liabilities exceeding to the plan assets. As permitted, the Company has elected to recognize the transition obligation as of the date of adoption in earnings on a straight-line basis over five years beginning January 1, 2002.

(q) Interest on shareholders' equity

Brazilian corporations are permitted to deduct for tax purposes interest on shareholders' equity, which is a distribution similar to a dividend. For financial reporting purposes, interest on shareholders' equity is recorded as a deduction directly from unappropriated retained earnings. This interest has been recorded in accordance with Law 9249/95, for tax deductibility purposes, limited to the daily pro-rata variation of the Long-Term Interest Rate ("TJLP"). Withholding taxes with respect to the payment of interest on shareholders' equity is generally withheld and paid by the Company on behalf of shareholders (see note 15).

(r) Use of estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the reported amounts of revenues and expenses for the reporting periods. Actual results could differ from those estimates.

(s) Earnings (loss) per share

Earnings per share is calculated based on the number of shares outstanding at the balance sheet date.

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## 4. CASH AND CASH EQUIVALENTS

	<u>2005</u>	<u>2004</u>
Cash and banks	124,455	49,638
Financial investments	<u>155,718</u>	<u>55,919</u>
	<u>280,173</u>	<u>105,557</u>

## 5. CUSTOMER ACCOUNTS RECEIVABLE

The following summarizes customer accounts receivable balances at December 31:

	<u>2005</u>	<u>2004</u>
(a) Private-sector customers		
General customers and special customers (i) (ii)	813,306	680,844
Agreements (iii)	<u>142,139</u>	<u>119,027</u>
	955,445	799,871
Government Entities:		
Municipal	377,373	289,382
Federal	19,391	16,471
Agreements	<u>59,408</u>	<u>30,979</u>
	456,172	336,832
Wholesale customers – municipal authorities: (iv)		
Guarulhos	294,035	264,867
Mauá	94,887	74,571
Mogi das Cruzes	4,145	4,949
Santo André	256,063	221,913
São Caetano do Sul	2,708	3,559
Diadema	<u>76,054</u>	<u>62,385</u>
Total wholesale customers - municipal authorities	727,892	632,244
Unbilled amounts	<u>239,832</u>	<u>218,545</u>
Subtotal	2,379,341	1,987,492
Allowance for doubtful accounts	<u>(920,736)</u>	<u>(759,640)</u>
Total	<u>1,458,605</u>	<u>1,227,852</u>
Current portion	1,195,249	949,792
Long-term portion (v)	263,356	278,060

(i) General customers – residential and small and medium-sized businesses.

(ii) Special customers – large consumers, commercial industries, plants, condominiums and special billing consumers (industrial waste, wells, etc.)

(iii) Agreements – renegotiation of past-due balances [from non-government controlled companies] into installments. Contractual indexation and interest on renegotiated installments recognized financial income

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were R\$ 61,353, R\$ 53,531, and R\$ 31,687 in 2005, 2004 and 2003, respectively. The amounts under agreements are generally due in approximately 6 – 12 months, except for certain amounts due from municipalities that are receivable through 2011.

(iv) Wholesale customers – municipal authorities - Accounts receivable from wholesale customers relate to the wholesale of treated water to certain municipalities, which are responsible for distribution, billing and collection with the final customers, as follows:

	<u>2005</u>	<u>2004</u>
Balance at beginning of year	632,244	506,309
Billings for services provided	241,126	217,525
Collections –current year services	(113,496)	(68,060)
Collections – prior years' services	<u>(31,982)</u>	<u>(23,530)</u>
Balance at end of year	<u>727,892</u>	<u>632,244</u>
Current portion	13,092	11,179
Long-term portion	714,800	621,065

(v) The long-term portion of customer accounts receivable consists of the long-term portion of renegotiated past-due private sector customer accounts receivable and past-due balances of wholesale customers-municipal authorities for which management believes collection is not likely within the next year. A number of wholesale customers have been contesting certain tariffs since mid-1998 and are not paying the amounts disputed. While such amounts are currently due and payable, management believes that based on the historical settlement and payment history, that such amounts are better classified as long-term. The long-term portion is recorded net of an allowance for doubtful accounts of R\$ 519,632 and R\$ 394,569 at December 31, 2005 and 2004, respectively.

## (b) Customer accounts receivable aging summary

	<u>2005</u>	<u>2004</u>
Current (including unbilled amounts)	669,917	568,789
Past due:		
Up to 30 days	174,129	159,634
From 31 to 60 days	86,206	80,889
From 61 to 90 days	61,743	58,120
From 91 to 120 days	52,237	47,148
From 121 to 180 days	95,253	87,856
From 181 to 360 days	240,533	170,582
For more than 360 days	<u>999,323</u>	<u>814,474</u>
Total aged customer accounts receivable	<u>2,379,341</u>	<u>1,987,492</u>

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## (c) Allowance for doubtful accounts

(i) Changes in the allowance for doubtful accounts are as follows:

	2005	2004
Balance at beginning of year	759,640	669,431
Private-sector customers/government entities	23,457	13,339
Wholesale customers	137,639	76,870
Bad debt expense-net of recoveries	161,096	90,209
Balance	920,736	759,640
Current portion	401,104	365,071
Long-term portion	519,632	394,569

Bad debt included as part of selling expenses for the years ended December 31 was as follows:

	2005	2004	2003
Provisions (over five thousand reais)	(207,233)	(99,297)	(132,063)
Recoveries (over five thousand reais)	46,137	9,088	147,062
Direct write-offs (less than five thousand reais)	(177,138)	(205,261)	(101,111)
Recoveries (less than five thousand reais)	82,942	53,893	48,487
Total bad debt expenses (note 19)	(255,292)	(241,577)	(37,625)

In 2003, recoveries included R\$ 129,118 of previous allowances related to São Bernardo do Campo, which were reversed in connection with the concession agreement reached in December 2003.

A number of wholesale customers have been contesting certain tariffs since mid-1998. As a result, some municipalities are currently not paying the Company's invoices in full or on a timely basis. In addition, some governmental entities located in municipalities the Company serves are also not paying on a regular basis. While the Company continues to enter into negotiations with municipalities to reschedule the related accounts receivable and continues to file legal proceedings against municipalities to collect overdue amounts, in some cases, the Brazilian courts have required that the Company continue to provide water on a wholesale basis to municipalities, even if they fail to pay the Company's invoices.

Management believes that the allowance for doubtful accounts is sufficient to absorb probable losses in customer accounts receivable

## (e) Unbilled amounts

Unbilled amounts represent water and sewage services provided but not yet billed, which are estimated from the last measurement date to month-end based on prior month's billings.

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6 RELATED-PARTY TRANSACTIONS

The Company is a party to a number of transactions with its majority shareholder, the State Government, and its related agencies.

(b) Receivable from shareholder

	<u>2005</u>	<u>2004</u>
Current:		
Water and sewage services (i)	111,550	48,478
GESP Agreement	<u>54,806</u>	<u>32,856</u>
Total current	<u>166,356</u>	<u>81,334</u>
Long-term:		
Water and sewage services –GESP Agreement	127,879	269,803
Reimbursement for pension benefits paid (ii)	<u>672,715</u>	<u>576,326</u>
Gross long-term receivable from shareholder	800,594	846,129
Less amounts due to shareholder – interest on shareholders' equity	-	(105,520)
Total long-term	<u>800,594</u>	<u>740,609</u>
Total receivable from shareholder	966,950	821,943
 Water and sewage services	 294,235	 245,617
Reimbursement for pension benefits	<u>672,715</u>	<u>576,326</u>
	<u>966,950</u>	<u>821,943</u>
 Operating Revenues		
 Gross revenue from sales and services		
Water sales	161,798	147,861
Sewage services	134,313	116,176
Collections	(233,039)	(215,559)
 Financial revenues	 32,293	 23,114

The Company does not record an allowance for doubtful accounts for any amounts due from the State Government or entities controlled by the State Government, since it does not expect losses on such receivables.

(i) Water and sewage services

The Company provides water and sewage services to the State Government and its related agencies under terms and conditions that management believes are equal to those with third parties, except for the settlement of amounts outstanding, as described further below in items (iii) and (iv).

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(iii) Reimbursement for pension and benefits paid.

Reimbursement for pension and benefits paid represents supplementary pension and leave benefit paid by the Company on behalf of the State Government to former employees of State Government-owned companies which merged to form SABESP. These amounts should be reimbursed to the Company by the State Government, as the primary obligor, in conformity with Law No. 200/74. At December 31, 2005 and 2004, 2,761 and 2,770 retirees, respectively, received supplementary pension payments, for which the Company paid R\$ 96,388 and R\$ 85,340 in 2005 and 2004, respectively. There were 189 active employees at December 31, 2005, who will be entitled to these benefits once they retire, as compared to 211 at December 31, 2004.

(iii) GESP Agreement

On December 11, 2001, the Company entered into an agreement with the State of São Paulo Government (the GESP Agreement), through the State Department of Finance and the State Department of Water and Energy (DAEE), having the State Department of Water Resources, Sanitation and Works as intervening party. Pursuant to the GESP Agreement, the State Government, by force of Law No. 200/74, acknowledged to be responsible for the supplemental retirement and pension benefits and agreed to pay amounts it owed to the Company in respect of water and sewage services. The value at the date of the Agreement was R\$ 678,830, of which R\$ 320,623 referred to supplemental retirement and pension benefits in the period from March 1986 until November 2001, and R\$ 358,207 referred to water supply and sewage collection services invoiced and due from 1985 until December 1, 2001.

Considering the strategic importance of Taiacupeba, Jundiaí, Biritiba, Paraitinga and Ponte Nova reservoirs, for ensuring the volume of water of the Alto Tietê System to be maintained, it was agreed that DAEE would transfer these properties to the Company, with the fair value of these transferred assets used to reduce the amounts owed to the Company.

Under the December 2001 agreement, in July and August 2002, a State Government -owned construction company (Companhia Paulista de Obras e Serviços—CPOS), on behalf of the State, and an independent appraisal firm (ENGEVAL—Engenharia de Avaliações), on the Company's 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 the Company had already made investments in these reservoirs by then, the arithmetic average of the appraisals submitted to the Company's Board of Directors for approval in August 2002 of 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 Government is to make payments in 114 consecutive monthly installments, with the first payment to be made upon the latest of (1) 210 days after the date of the agreement, (2) agreement by the parties on the fair value of the reservoirs and (3) conclusion of the audit by a State-appointed auditor of amounts owed. The nominal amount owed by the State Government 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, plus 6.0% per year, starting on the date the first installment becomes due. The original first payment was to be made in July 2002.

On October 29, 2003, the Public Attorney of the State (Ministério Público do Estado de São Paulo), on behalf of the people of the State, brought a civil public action in a Trial Court of the state of São Paulo (12a Vara da Fazenda Pública do Estado de São Paulo) alleging that a transfer to the Company of ownership of the Alto Tietê System reservoirs from 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 Attorney of the State, which the Company believes relates only to the illegality of the transfer of the reservoirs. In response, the Company filed an appeal which is pending final decision and the State Government successfully filed an action suspending the lower Court's decision until final judgment is reached by the Court of Appeals of the state of São Paulo (Tribunal de Justiça do Estado de São Paulo). The Company is unable to predict whether it will succeed in appealing such decision. Management currently

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does not expect that an eventual unfavorable decision would have material adverse effect on the Company's business and financial condition.

The December 2001 agreement also provided that the legal advisors of the State Government 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 Government. Management does not expect these analyses to differ significantly from the amounts recorded in respect of these amounts. The commencement of payments with respect to pension amounts owed by the State Government has been postponed until such analyses are completed, the appraisal report is approved and the credit assignments relating to the transfer of the reservoirs described above are formalized. In addition, the transfer of these reservoirs is currently being disputed and we are not certain whether such transfer will be legally allowed, as discussed above.

Based on Official Notice No. 53/2005 of the State Capital Defense Council (CODEC), dated March 21, 2005, negotiations are still ongoing between the Company and the State Government with a view to restatement of the debt for supplemental retirement and pension benefits, under the terms defined in the December 2001 agreement, including amounts due after November 2001. These negotiations are expected to be consolidated in a second amendment to the December 2001 agreement, including criteria for recovery of future amounts to be disbursed by the Company. The Company has retained Fundação Instituto de Pesquisas Contábeis, Atuariais e Financeiras, USP – "FIPCAFI" to validate the actual values to be reimbursed by the State Government, taking into account the legal advice provided by the General Office of the State Attorney provided by the Office of the State Attorney General.

As these negotiations are still in the early stages, it is not possible to determine the net effects on the balance sheet resulting from such negotiation. Management does not expect to incur significant net losses relating to any differences between the amounts recorded as due from the State Government and the amounts expected to be received by Sabesp.

The following summarizes activity with respect to amounts due from the State Government related to the reimbursement of pension and retirement benefits:

	<u>December 31,</u>	
	<u>2005</u>	<u>2004</u>
Receivable from shareholder – reimbursement for pension benefits paid:		
Balance at beginning of the year	576,326	490,986
Payments made on behalf of State Government	<u>96,389</u>	<u>85,340</u>
Balance at end of the year	<u>672,715</u>	<u>576,326</u>

Management continues to believe that the amounts due from the State Government are collectible and does not expect to incur losses on these accounts receivable.

The balances for water and sewage services were included in the 1st amendment, as described below (iv).

(iv) First Amendment to GESP Agreement

On March 22, 2004, the Company and the State Government amended the terms of the original GESP Agreement, thereby (1) consolidating and acknowledging amounts due from the State Government for water and sewage services through February 2004, monetarily adjusted through February 2004; (2) formally providing for the offset of amounts due from the State Government against interest on shareholders' equity declared by the Company and any other debt owed to the State Government at December 31, 2003, which were monetarily adjusted through February 2004; and (3) defining the payment terms of the remaining obligations of the State Government for water and sewage services.

Under the terms of the Amendment, the State Government acknowledged amounts due to the Company for water and sewage services provided through February 2004, of R\$ 581,779, including monetary adjustments based on the Referential Rate (TR) at the end of each fiscal year through February 2004. In

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addition, the Company acknowledged amounts due to the State Government with respect to interest on shareholders' equity of R\$ 518,732, including (1) amounts declared and payable relating to years prior to 2003 (R\$ 126,967), (2) monetary adjustments on these amounts based on the annual change in the Consumer Prices Index (IPC/FIPE) through February 2004 (R\$ 31,098); and (3) amounts declared and payable relating to 2003 (R\$ 360,667).

The Company and the State Government agreed to the reciprocal offset of R\$ 404,889 (monetarily adjusted through February 2004). The remaining obligation of R\$ 176,890 at February 29, 2004 is being paid in monthly installments from May 2005 through May 2009, which is subject to monthly monetary adjustment at the Expanded Consumer Price Index (IPCA/IBGE), plus 0.5%.

As the right of offset was contemplated in the original terms of the GESP Agreement, the Company recorded the applicable effects of such Amendment as of and through December 31, 2003, including the monetary adjustments of both amounts payable to and receivable from the State Government. In addition, the amounts payable to the State Government for interest on shareholders' equity specifically identified in the agreement for reciprocal offset through 2004 have been reclassified as a reduction of amounts receivable at December 31, 2004.

The balance of Interests on Own Capital, in the amount of R\$ 113,842, adjusted pursuant to the IPCA-IBGE, was netted against accounts overdue after February 2004.

During 2005, the Company received the amount of R\$ 35,797 relating to the payment installments from May to December 2005 and has offset the remaining balance of interest on shareholders' equity due the State Government of R\$ 105,520 against the balance due for water and sewage services as contemplated in the Amendment.

The Amendment to the GESP Agreement does not provide for amounts owed by the State Government for supplementary retirement and pension plan benefits, paid by the Company on behalf of the State Government. Such amounts continue to be subject to the terms of the original GESP Agreement. Part of such amounts may be netted upon the transfer of the reservoirs that make up the Alto Tietê System. As discussed above, the Company and the State Government are negotiating the transfer and netting of the additional amounts owed.

Management believes that the amounts owed by the State Government shall be received and it is not estimated that losses will be incurred with such accounts receivable.

The following summarizes the movement of the related accounts receivable from shareholder related to water and sewage services and the related amounts due to shareholder related to interest on shareholders' equity reflecting the Amendment as of and for the years ended December 31, 2005, 2004 and 2003:

	<u>December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Receivable from shareholder – water and sewage services:			
Balance at beginning of the year	351,137	565,889	423,665
Services provided and billed	296,111	264,037	253,415
Collections	(233,039)	(215,559)	(169,701)
Collections – GESP Amendment	(35,797)	-	-
Amounts offset in accordance with GESP Amendment	(105,520)	(299,369)	-
Monetary restatement	<u>21,343</u>	<u>36,139</u>	<u>58,510</u>
Balance at end of the year	<u>294,235</u>	<u>351,137</u>	<u>565,889</u>
Less amounts due to shareholder – interest on shareholders' equity	<u>-</u>	<u>(105,520)</u>	<u>(401,712)</u>
Receivable from shareholder – water and sewage services net	<u>294,235</u>	<u>245,617</u>	<u>164,177</u>



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Amounts due to shareholder – interest on shareholders' equity (State Government only):			
Balance at beginning of the year	190,751	518,732	207,932
Payments during the period	-	(123,636)	(80,965)
Amounts offset in accordance with GESP Amendment	(105,520)	(299,369)	
Monetary correction	-	9,793	31,098
Interest on shareholders' equity declared and payable for the year	<u>175,009</u>	<u>85,231</u>	<u>360,667</u>
Balance at end of the year	<u>260,240</u>	<u>190,751</u>	<u>518,732</u>
Less amounts reclassified to receivable from shareholder	<u>-</u>	<u>(105,520)</u>	<u>(401,712)</u>
Amounts due to shareholder – interest on equity (State Government) net	<u>260,240</u>	<u>85,231</u>	<u>117,020</u>

**(c) Cash and cash equivalents**

The Company's balance of cash and financial investment accounts with financial institutions controlled by the State Government was R\$ 242,021 and R\$ 72,777 at December 31, 2005 and 2004, respectively. The financial income from such financial investments was R\$ 32,293, R\$ 23,114 and R\$ 67,799 in fiscal years ended December 31, 2005, 2004 and 2003, respectively.

**(d) Arrangements to use certain reservoirs**

The Company uses the Guarapiranga and Billings reservoirs and a portion of some of the reservoirs of the Alto Tietê System, which are owned by the State Department of Water and Energy (DAEE). The Company does not pay any fees with respect to the use of these reservoirs, but is responsible for maintaining and funding the operating costs of these reservoirs. The State of São Paulo does not incur such costs on behalf of the Company. In the event these facilities had not been made available to the Company, it would have had to obtain water from more distant sources which would have been more costly.

As part of these arrangements, the Company funded approximately R\$97,115 of costs for the 1992 and 1997 projects. A portion of these project costs were funded by the State Government, through DAEE. The agreements included the construction of ducts, tunnels and other facilities to interconnect the Tietê River with the Biritiba and Jundiaí reservoirs and other bodies of water in exchange for the Company's use of the reservoirs during a 30-year period.

The Company has the right to draw water from and release emissions into the reservoirs during a 30-year period which began in 1997. The Company capitalizes expenditures on the facilities constructed. The assets relating to the original reservoir project were placed in service in 1994 and 2002 and are being depreciated over the remaining term of the original 30 year period. The Company had recorded as part of property, plant and equipment R\$ 58,397 and R\$ 61,135 of amounts capitalized with respect to these agreements, net of accumulated depreciation, at December 31, 2005 and 2004, respectively.

**(d) Contracts with reduced Fare for State and Municipal Public Entities that adhere to the Program of Rational Use of Water**

The Company has entered into contracts with public entities related to the State Government and other municipalities involving approximately 6,800 properties that are benefited with a 25% tariff reduction for water and sewage services. The contract provides for the implantation of the program of rational use of water, which considers the reduction in water consumption.

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(e) Guarantees

The State Government and the Brazilian Federal Government, in some cases, provide guarantees of, or security for, the Company's loans and financing. The Company does not pay any fees with respect to these guarantees.

7. INDEMNITIES RECEIVABLE

Indemnities receivable is a long-term asset representing amounts receivable from the Municipalities of Diadema and Mauá as indemnification for the unilateral withdrawal by those authorities of the Company's water and sewage service concessions in 1995. As of December 31, 2005, this asset amounted to R\$ 148,794.

Under these concession agreements, the Company invested in the construction of water and sewage systems in these municipalities to meet its concession service commitments. Upon the unilateral termination of the Diadema and Mauá concessions, these assets were impounded by the municipal authorities, which took on the responsibility of providing water and sewage services in these areas. At that time, the Company reclassified from property, plant and equipment balances relating to the impounded assets to long-term assets (indemnities receivable) and recorded impairment charges to reduce the carrying value of the assets to the estimated recoverable amounts for which the Company had contractually agreed as fair compensation with the relevant authorities. The net book value of items of property, plant and equipment items relating to the municipality of Diadema, which was written-off in December 1996, was R\$ 75,231, and the balance of indemnity and other receivables from the local government was R\$ 62,876 at December 31, 2005. The net book value of property, plant and equipment items relating to the municipality of Mauá, which was written-off in fiscal year 1999, was R\$ 103,763, and the balance of the indemnity receivable from the municipality was R\$ 85,918 at December 31, 2005.

The Company's rights to the recovery of these amounts are being disputed by the municipalities and no amounts have been received to date.

In December 1996, the Company filed a claim seeking compensation for the amounts due by the municipality of Diadema. In the first instance, the judge pronounced a sentence against the Company. The Company filed an appeal in November 2000 and on December 1st, 2005, partial acceptance to the appeal was given in order to declare the validation of the agreement with the Municipality of Diadema.

With respect to Mauá, a decision has been issued by the lower court requiring Mauá to pay an amount of R\$ 153.2 million as compensation for the loss of profits. This decision was appealed by Mauá and is pending Appeal Court decision.

Based on the advice of legal counsel, management continues to believe that the Company has the legal right to receive such amounts and it continues to monitor the status of the legal proceedings. However, the ultimate amounts to be received, if any, will most likely be subject to a final court decision. As such, actual amounts received could differ from those recorded.

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**NOTES TO THE FINANCIAL STATEMENTS**

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8. PROPERTY, PLANT AND EQUIPMENT

		December, 31	
	Annual Depreciation rates - %	<u>2005</u>	<u>2004</u>
In use:			
Water systems:			
Land	-	938,589	932,233
Buildings	4%	2,660,875	2,617,359
Connections	5%	800,544	779,626
Water meters	10%	272,240	260,597
Networks	2%	3,235,646	3,191,257
Equipment	10%	246,893	243,847
Other	2 to 20%	<u>498,950</u>	<u>469,340</u>
		8,653,737	8,494,259
Accumulated depreciation		<u>(3,074,797)</u>	<u>(2,804,179)</u>
Total water systems		5,578,940	5,690,080
Sewage system:			
Land	-	352,080	349,553
Buildings	4%	1,456,577	1,433,614
Connections	5%	846,334	824,890
Networks	2%	4,660,594	4,551,989
Equipment	10%	500,449	485,934
Other	2 to 20%	<u>15,493</u>	<u>12,910</u>
		7,831,527	7,658,890
Accumulated depreciation		<u>(2,222,011)</u>	<u>(1,987,981)</u>
Total sewage systems		5,609,516	5,670,909
General use:			
Land	-	102,952	102,868
Buildings	4%	120,853	119,313
Transportation equipment	20%	133,433	130,695
Furniture, fixtures and equipment	10%	<u>280,097</u>	<u>284,160</u>
		637,335	637,036
Accumulated depreciation		<u>(368,534)</u>	<u>(333,110)</u>
Total general use		268,801	303,926
Non operational assets, net of accumulated depreciation		<u>31,832</u>	<u>31,903</u>
Subtotal		<u>11,489,089</u>	<u>11,696,818</u>
Construction in progress:			
Water systems		683,094	561,878
Sewage systems		1,421,491	1,245,036
Other		<u>19,907</u>	<u>19,804</u>
		2,124,492	1,826,718
		<u>13,613,581</u>	<u>13,523,536</u>

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**(a) Disposals of property, plant and equipment**

The Company wrote off property, plant and equipment items in the amount R\$ 19,051, R\$ 34,616 and R\$ 61,654 in 2005, 2004 and 2003, respectively. Of these losses, R\$ 9,879, R\$ 26,034 and R\$ 49,379 in 2005, 2004 and 2003, respectively, related to the disposal, theft and obsolescence of assets in use. The remaining balance of losses, of R\$ 9,172, R\$ 8,582 and R\$ 12,275 in 2005, 2004 and 2003, respectively, related to the write-off of construction in progress projects which were determined to be no longer economically feasible.

Studies supporting the write-offs for obsolescence and construction-in-progress were concluded by the Company in the accounting period of the write-off, based on undiscounted cash flow projections, and have been approved by Management. The carrying value of property, plant and equipment is monitored on an on-going basis and is adjusted, when appropriate, to assure future projected operating revenue is sufficient to recover the carrying value of the assets. When applicable, depreciation rates are adjusted to take into account changes in estimated remaining economic lives as assets are replaced.

**(b) Capitalization of interest and financial charges**

The Company capitalized interests and monetary variation, including foreign currency exchange variation, to property, plant and equipment in the amount of R\$ 4,335 and R\$ 4,907 for the years ended on December 31, 2005 and 2004, respectively during the period in which the related assets were under construction.

**(c) Construction in progress**

Construction in progress primarily related to new projects and operating improvements is as follows:

	<u>2005</u>	<u>2004</u>
Water systems:		
Networks and connections	238,122	231,653
Transmission	36,712	30,020
Water treatment	97,502	101,033
Sub-transmission	155,493	86,502
Production and storage	116,306	74,092
Other	<u>38,959</u>	<u>38,578</u>
Total water systems	<u>683,094</u>	<u>561,878</u>
Sewage systems:		
Collection	1,139,045	990,325
Treatment	182,967	166,916
Others	<u>99,479</u>	<u>87,795</u>
Total sewage systems	1,421,491	1,245,036
Others	<u>19,907</u>	<u>19,804</u>
Total	<u>2,124,492</u>	<u>1,826,718</u>

Estimated disbursements related to construction works already contracted are estimated to be approximately R\$ 957,000 for fiscal years from 2006 to 2011 (unaudited).

**(d) Expropriations**

Development of major water and sewage systems frequently requires the expropriation or establishment of rights of way through third-party properties. The owners of these properties are generally compensated either through negotiated settlements or judicial arbitration in conformity with applicable legislation.

Disbursements to be effected as from fiscal year 2006 are estimated to be approximately R\$ 279,621 (unaudited), which will be paid out of Company funds. The related assets acquired as a result of these negotiations are recorded as property, plant and equipment when the expropriation is complete. The total

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amount paid relating to expropriations of property, plant and equipment in 2005 and 2004 was R\$ 11,472 and R\$ 5,423, respectively.

(e) Assets in guarantee

At December 31, 2005 and 2004, the Company had assets in the amount of R\$ 249,034 provided as guarantee under the Special Tax Debt Refinancing Program - PAES (Note 11).

Three of the Company's properties in the amount of R\$ 60,539 were pledged as collateral for the financing with the International Bank for Reconstruction and Development.

(f) Non-operating assets

The Company had R\$ 31,832 at December 31, 2005 (2004 - R\$ 31,903) referring to other non-operating assets, comprised primarily of land surrounding reservoirs.

(g) Revaluation

Property, plant and equipment items were revaluated in 1990 and 1991 and have been depreciated at annual rates which take into consideration the estimated remaining economic useful lives of the assets as determined in the respective valuation reports that, as a rule, fall within the ranges of the above presented rates.

(h) Totally depreciated assets

On December 31, 2005 and 2004 the gross accounting value of the totally depreciated assets which are still in use is R\$ 336,086 and R\$ 307,078, respectively.

(i) Concessions

(i) Intangible Assets

Beginning in 1999, negotiations and acquisition of new concessions considers the financial economic value of the business, defined in an appraisal report, issued by independent experts.

The terms of these concessions are generally for a period of 30 years and generally include the corresponding right to operate the related concession assets for which the Company does not have title. The purchase price for these concessions is generally the fair value of the concession, based on appraisal reports which take into consideration the projected cash flows and the remaining concession period at the date of acquisition. The cost of the concession assets acquired is amortized over the concession period using the straight-line method.

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<u>Municipalities</u>	<u>Years Ended December 31,</u>	
	<u>2005</u>	<u>2004</u>
Agudos	7,331	7,293
Bom Sucesso do Itararé	131	81
Campo Limpo Paulista	11,509	11,375
Conchas	2,171	2,141
Duartina	1,459	1,430
Estância de Serra Negra	11,423	11,290
Itapira	14,762	14,293
Itararé	5,508	5,459
Marabá Paulista	358	357
Miguelópolis	3,978	3,934
Osasco	260,013	256,418
Paraguaçu Paulista	13,966	13,929
Paulistânia	149	148
Sandovalina	211	210
Santa Maria da Serra	885	873
São Bernardo do Campo	237,459	237,459
Várzea Paulista	<u>11,668</u>	<u>11,542</u>
Total	<u>582,981</u>	<u>578,232</u>
Less accumulated amortization	<u>(80,463)</u>	<u>(60,846)</u>
Concession assets, net	<u>502,518</u>	<u>517,386</u>

Amortization expense related to intangible concession rights was R\$ 19,617, R\$ 18,259 and R\$ 10,510 for the years ended December 31, 2005, 2004 and 2003, respectively. Estimated amortization expense for the next five years is estimated to be approximately R\$ 20,000 per year.

(ii) Fixed Assets in operation

The fixed assets in operation represent the assets involved in the service providing of supply of water and collection of sewage in 352 municipalities the other municipalities were negotiated by financial economic appraisal, as described in the item above. In the case of Sao Bernardo do Campo, the negotiation that occurred in December 2003 was based on a financial economic appraisal amounting to R\$ 415,471 and there was the transfer of services, as well as the ownership of the assets. In December, 2004 the property evaluation of the assets has been completed for the Municipality. The amount arrived at of R\$ 175,858 was reclassified in December 31, 2004 from "intangible assets" to "operating assets".

The concession contracts foresee that the assets shall be transferred to the conceding power at the end of the term.

In 2005, 17 (seventeen) concession contracts expired, being that 8 (eight) were extended for a period from 3 (three) months to 1 (one) year and 9 (nine) are under negotiation. The net accounting value of the fixed assets in the Municipalities where the concessions are under negotiation (2005) or that will expire in 2006, amount to R\$ 1.57 billion.

On December 31, there was no amount pending of payments to the municipalities.

# COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP

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### 9 - LOANS AND FINANCING

	2005			2004				
	Short Term	Long Term	Total	Short Term	Long Term	Total	Guarantees	Final Maturity Date
In local currency:								
Banco do Brasil	194,238	2,028,429	2,222,667	173,539	2,161,423	2,334,962	State of S.Paulo Government and Own Funds	2014
Debentures 4 <sup>th</sup> Issue	99,998	-	99,998	100,001	99,998	199,999		2006
Debentures 5 <sup>th</sup> Issue	148,917	148,917	297,834	148,377	296,754	445,131		2007
Debentures 6 <sup>th</sup> Issue	-	614,383	614,383	-	609,693	609,693		2010
Debentures 7 <sup>th</sup> Issue	-	300,516	300,516	-	-	-		2010
Debentures 8 <sup>th</sup> Issue	-	696,594	696,594	-	-	-		2011
Caixa Econômica Federal	42,938	459,919	502,857	40,042	457,938	497,980	Own Funds	2007/2022
Brazilian Economic and Social Development Bank - BNDES	28,699	182,358	211,057	5,443	172,343	177,786	Own Funds	2013
Other	2,505	24,308	26,813	2,348	24,910	27,258		2008/2011
Accrued interest and financial charges	115,554	-	115,554	76,950	-	76,950		
	<u>632,849</u>	<u>4,455,424</u>	<u>5,088,273</u>	<u>546,700</u>	<u>3,823,059</u>	<u>4,369,759</u>		
<b>In foreign currency:</b>								
Eurobonus: US\$ 225,000 thousand (2004 - US\$ 500,000 thousand)	-	526,658	526,658	729,960	597,240	1,327,200		2008
Interamerican Development Bank (IDB): US\$ 435,451 thousand (2004-US\$ 457,799 thousand)	101,157	918,103	1,019,260	104,048	1,111,133	1,215,181	Federal Government	2007/2025
International Bank for Reconstruction and Development - BIRD ("World Bank"): US\$ 6,439 thousand (2004-US\$ 11,754 thousand)	10,049	5,023	15,072	12,480	18,720	31,200	Federal Government	2007
Deutsche Bank Luxembourg: US\$ 20,000 thousand in 2004	-	-	-	53,088	-	53,088		2005
Société Générale: € 1,020 thousand (2004-€ 1,932 thousand)	2,824	-	2,824	3,303	3,691	6,994	Federal Government	2006
Accrued interest and financial charges	12,134	-	12,134	47,231	-	47,231		
<b>Sub-Total</b>	<u>126,164</u>	<u>1,449,784</u>	<u>1,575,948</u>	<u>950,110</u>	<u>1,730,784</u>	<u>2,680,894</u>		
<b>Total loans and financing</b>	<u>759,013</u>	<u>5,905,208</u>	<u>6,664,221</u>	<u>1,496,810</u>	<u>5,553,843</u>	<u>7,050,653</u>		

Exchange rate at December 31, 2005: US\$ 2.3407 (2004 - US\$ 2.6544) ; EUR 2.76905 (2004- EUR 3.61949

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## (a) Banco do Brasil

In March 1994, existing loan agreements with Caixa Econômica Federal were refinanced and the loan rights were transferred by that financial institution to the Federal Government, with Banco do Brasil acting as an agent. Under the terms of the agreement signed with the Federal Government, charges and payments are made on the "Price" amortization system, indexed monthly to the Standard Reference Unit (UPR), which is equal to the Government's benchmark Interest Rate (TR), plus 8.5% per year. Interest and principal are payable monthly, with final maturity in 2014. This financing is guaranteed by the State of São Paulo Government's revenue and by the Company's own revenues.

## (b) Debentures

(i) 4<sup>th</sup> Issue

On April 1, 2001 the Company made a public placement of 30,000 non-convertible, registered, book-entry type, single series debentures, at the unit value of R\$ 10, in an aggregate amount of R\$ 300,000. The placement of these debentures in the local market occurred through an auction held on June 8, 2001.

Principal amortization is being made in 12 quarterly installments, beginning on March 15, 2004, with a final scheduled redemption date on December 15, 2006.

These debentures bear interest at the daily interbank deposit rate (CDI), as calculated and disclosed by the CETIP (Securities Custody and Financial Settlement Agency), plus 1.20% per annum spread. Interest is paid quarterly, beginning on June 15, 2001.

Proceeds from the issue were used to settle debt obligation that came due in the funding year.

Interest expense was R\$ 30,020, R\$ 42,472 and R\$ 68,297 in 2005, 2004 and 2003, respectively. Accrued and unpaid interest at December 31, 2005 of R\$ 775, is recorded under "Loans and financing" in the current liabilities.

(ii) 5<sup>th</sup> Issue

On April 1, 2002 the Company made a public placement for the 5<sup>th</sup> issue of simple, book-entry, registered, unsecured, non-convertible debentures, with face value of R\$ 10.

Proceeds from the issue were used for settling debt obligations that came due during fiscal year 2002.

40,000 debentures were issued, distributed in two series, as follows:

	1 <sup>st</sup> Series	2 <sup>nd</sup> Series
Placement date	05/16/2002	05/16/2002
Number	31,372	8,628
Face value of Issue	R\$ 313,720	R\$ 86,280
Original yield	CDI + 1.85% per year	IGP-M + 13.25% per year
Interest payments	Quarterly, except for last installment on 03/01/2007	Annual, except for last installment in 03/01/2007
Amortization	3 installments on 04/01/2005, 04/01/2006 and 03/01/2007	3 installments on 04/01/2005, 04/01/2006 and 03/01/2007

The interest rates for the two series were renegotiated for the last time in April 2005, whereby the rate for the 1st Series was changed from CDI + 2.0% per year to CDI + 1.1% per year, and the rate for the 2nd Series was changed from IGPM + 12.7% per year to IGPM + 10.7% per year, which will be in effect until maturity.



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Interest expense was R\$ 45,015, R\$ 54,376 and R\$ 73,653 in 2005, 2004 and 2003, respectively relating to the 1<sup>st</sup> Series and R\$ 11,584, R\$ 16,641, R\$ 15,993, respectively relating to the 2<sup>nd</sup> Series. The remaining balances of R\$ 9,443 (2004 – R\$ 13,893 and 2003 - R\$ 15,257) for the 1<sup>st</sup> Series and R\$ 7,032 (2004 – R\$ 12,328 and 2003 - R\$ 11,403) for the 2<sup>nd</sup> Series are recorded under “Loans and financing”, in current liabilities.

(iii) 6<sup>th</sup> Issue

On September 17, 2004, the Company registered with the CVM a securities program under which it has been able to offer debt securities, including non-convertible debentures and commercial papers, up to a total amount of R\$ 1,500,000 during the subsequent two years. As part of such program, on September 1, 2004 the Company issued 600,000 debentures, distributed in three series, with face value of R\$ 1, totaling R\$ 600,000. The date of the financial settlement of the transaction was September 21, 2004 for the 1<sup>st</sup> series, and September 22, 2004, for the 2<sup>nd</sup> and 3<sup>rd</sup> series.

The debentures were placed in the market as follows:

	<u>Amount</u>	<u>Adjustment</u>	<u>Interest</u>	<u>Interest payment</u>	<u>Amortization</u>	<u>Maturity date</u>
1 <sup>st</sup> Series	231,813	-	CDI+1.75% p.a.	Semiannual	Single payment	Sep/2007
2 <sup>nd</sup> Series	188,267	IGP-M	11%	Annual	Single payment	Sep/2009
3 <sup>rd</sup> Series	179,920	IGP-M	11%	Annual	Single payment	Sep/2010

Proceeds from the issue was used for final settlement of the 3<sup>rd</sup> Issue of debentures and promissory notes issued in June 2004 in the amount of R\$ 130,000.

Interest expense was R\$ 46,481 and R\$ 13,484 in 2005 and 2004, respectively, relating to the 1<sup>st</sup> Series; R\$ 21,420 –and R\$ 6,757 in 2005 and 2004, respectively, relating to the 2<sup>nd</sup> Series and R\$ 20,470 relating to the 3<sup>rd</sup> Series, which will be paid annually. Remaining balances to be paid in the amount of R\$ 14,837 (2004 - R\$13,484) of the 1<sup>st</sup> Series; R\$ 6,757 (2004 - R\$ 6,757) of the 2<sup>nd</sup> Series and R\$ 6,458 (2004 - R\$ 6,457) of the 3<sup>rd</sup> Series. Such amounts are recorded under “Loans and financing” in current liabilities.

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(iv) 7<sup>th</sup> Issue of Debentures

Within the program registered together with the CVM on September 17, 2004, the Company issued, in March 1, 2005, 300,000 debentures distributed into two series, without renegotiation, with face value of R\$ 1, totaling R\$ 300,000. The date of the financial settlement was March 14, 2005.

The debentures were placed in the market as follows:

	<u>Amount</u>	<u>Adjustment</u>	<u>Interests</u>	<u>Interest Payment</u>	<u>Amortization</u>	<u>Maturity Date</u>
1 <sup>st</sup> series	200,000	-	CDI + 1.5%p.a.	Semiannual	Single payment	Mar/2009
2 <sup>nd</sup> series	100,000	IGP-M	10.80%	Annual	Single payment	Mar/2010

Proceeds from the issuance were used to settle obligations due under the 4<sup>th</sup> and 5<sup>th</sup> issues of debentures and for payment of other loan installments.

Accrued interest in 2005 was R\$ 33,378 referring to the 1st series, paid semi-annually, and R\$ 9,013 referring to the 2nd Series, that will be paid annually from March, 2006. The amount relating to the 2nd Series plus the remaining balance of R\$ 12,631 relating to the 1st Series are registered under the line item "Loans and financing" in current liabilities.

(v) 8<sup>th</sup> Issue of Debentures

In completion to the program registered at the CVM on September 17, 2004 the Company issued, on June 1st, 2005, 700,000 debentures, using the option to increase the quantity of debentures allowed up to 20%, according to the paragraph 2 of article 14 of the CVM inscription nr. 400/03. The debentures were distributed in two series, at par value of R\$ 1, amounting to R\$ 700,000. The settlement date of the financial operation was June 24, 2005.

The debentures were placed in the market as follows:

	<u>Amount</u>	<u>Adjustment</u>	<u>Interests</u>	<u>Interest Payment</u>	<u>Amortization</u>	<u>Maturity Date</u>
1 <sup>st</sup> series	350,000	-	CDI+1.5% p.a.	Semiannual	Single payment	Jun/2009
2 <sup>nd</sup> series	350,000	IGP-M	10.75% p.a.	Annual	Single payment	Jun/2011

Proceeds were used to settle obligations due under the Euro Bonds contract (note 9 (e) (i)).

In the fiscal year of 2005, interests in the amount of R\$ 41,028 have been provisioned referring to the 1st series, paid semi-annually, and R\$ 21,420 referring to the 2nd series, that will be paid annually from June, 2006. The amount referring to the 2nd series, plus the remaining balance of R\$ 5,341 referring to the 1st series, are registered under "Loans and Financing" in current liabilities.

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(c) Caixa Econômica Federal

Pro-Sanitation Program

(i) Water and sewage agreements

During 1996 through 1998, the Company entered into several loan agreements under the Federal Government Pro-Sanitation Program, with a view to expanding and improving the water supply and sewage systems of several municipalities of the State of São Paulo and of the City of São Paulo. The loans are collateralized by collections of the daily billings from water supply and sewage services up to the total amount of the debt.

Contractually established repayment terms range from 120 to 180 months, from the date the related projects become operational.

The balance as of December 31, 2005 and 2004 were R\$ 482,984 and R\$ 480,389, respectively. In addition, amounts available from these loans are R\$ 462,875.

Contract charges are as follows:

	Contract executed in:		
	1996	1997	1998 - 2004
Interest rates	9.5% p.a.	6.5% to 8.0% p.a.	6.5% to 8.0% p.a.
In the grace period:			
Risk fee	1.0% on disbursed amount	1.0% on disbursed amount	0.6% p.a. or 2% p.a. on outstanding balance
Management fee	0.12% p.m. on contract value	2.0% p.a. on disbursed value	1.0% p.a. on disbursed value or 2% p.a. on outstanding balance por agreements executed in 2003-2004.
In the operational stage:			
Management fee	Difference between calculation of installment at the rate of 10.5% p.a. less rate of 9.5% p.a.	1.0% p.a. on outstanding balance	1.0% p.a. on outstanding balance

(ii) Pro-sanitation Program - "Pró-Sanear"

In 1997 and 1998 contracts were signed under the Pro-Sanitation - "Pró-Sanear" program for the improvement of water and sewage services in several municipalities of the Metropolitan Region of São Paulo, with the participation of the communities receiving the services. The loans are collateralized by collections of the daily billings from water supply and sewage services up to the total amount of the debt. Contractually established repayment terms are 180 months from the date the related projects become operational. Outstanding loan balances under this program at December 31, 2005 and 2004 were R\$ 19,873 and R\$ 17,591, respectively. The amount available for use from these loans for projects already in progress was R\$ 24,287.

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Applicable financial charges:

Interest rate – 5.0% p.a.

Management fee (Grace period) – 2.0% p.a. on outstanding balance

Management fee (amortization stage) – 1.0% p.a. on outstanding balance

Risk fee (grace period) – 1.0% on disbursement

(d) BNDES

Agreement 01.2.619.3.1 – This agreement was executed in August 2002 in the total amount of up to R\$ 60,000 to partially finance the second stage of the Tietê River Clean-up Project, which is also the project object of loan agreement No. 1212/OC – BR with the Interamerican Development Bank (IDB). The related project is in the execution stage and aggregate borrowings under these agreements in 2005 were R\$ 8,093. The outstanding loan balances at December 31, 2005 and 2004 were R\$ 52,735 and R\$ 44,446, respectively.

In addition, the Company has an onlending agreement (10/669.748-6) for a total amount of up to R\$ 180,000. The onlending agreement has the same purpose as the agreement above with BNDES. The onlending agreement funds are passed on from BNDES to the agents, and by the agents to the Company, distributed among the financial agents as follows:

Agent	Amount
Unibanco – União de Bancos Brasileiros S.A.	60,000
Banco BBA Creditanstalt S.A.	51,000
Banco Alfa de Investimento S.A.	39,000
Banco Itaú S.A.	30,000
Total	180,000

The related project is in the execution stage, aggregate borrowings under the onlending agreements were R\$ 24,280 in December 31, 2005. Outstanding loan balances at December 31, 2005 and 2004 were R\$ 158,322 and R\$ 133,340, respectively.

Applicable interest and charges and amortization for these BNDES loans are equal for both. Interest is charged at the Long-Term Interest Rate (“TJLP”) limited to 6.0% plus a spread of 3.0% per annum, which is payable quarterly during the grace period and monthly in the repayment period. The portion of the TJLP in excess of 6.0% p.a. is added to the outstanding principal balance. Principal is payable in 84 monthly installments beginning in September 2005, with final maturity in February 2013. The agreements are collateralized by part of the revenue from water and sewage services.

(e) Eurobonds

(i) A foreign credit transaction was entered into in July 1997, having “UBS - Securities LLC” as lead arranger and “Deutsche Morgan Grenfell” and “BB Securities” as co-lead arrangers, in the amount of US\$ 275 million. The credit facility bore interest at 10%, which was payable semiannually. The outstanding loan matured in July 28, 2005, and was settled with the funds obtained from the 8<sup>th</sup> issue of debentures.

(ii) In June 2003, the Company issued US\$ 225 million 12% Notes due 2008. Interest is payable semiannually with final maturity in June 2008. “The Bank of New York” acted as lead arranger and “The Bank of Tokyo Mitsubishi Ltd.” as principal paying agent. Proceeds were used for settlement of obligations under the Eurobond issue of US\$ 200 million that matured in July 2003.

(f) Inter-American Development Bank (IDB)

Agreement 229 – In June 1987, the Company signed a loan agreement with the IDB for US\$ 163 million to finance improvements and expansion of the sewage systems in the São Paulo Metropolitan Region.

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Semiannual principal repayments began in January 1994, with final maturity in July 2007. The loan bears interest of 7.7% per annum. A guarantee agreement between the Federative Republic of Brazil and the IDB was executed in June 1987, to warrant the provision of funds to meet the obligations set forth in the financing agreement. Outstanding loan balances under the agreement on December 31, 2005 were US\$ 26.1 million (R\$ 61,051 and R\$ 109,421 at December 31, 2005 and 2004 respectively).

Agreement 713 – In December 1992, the Company signed a loan agreement with the IDB for US\$ 400 million to finance the Tietê River Clean-up Project – Stage I. Semiannual principal repayments began in June 1999, with final maturity in December 2017. The loan bears interest at a variable rate based on the cost of funding to the IDB. A guarantee agreement between the Federative Republic of Brazil and the IDB was executed in December 1992, to warrant the provision of funds to meet the obligations set forth in the financing agreement. The outstanding balance of such agreement at December 31, 2005 was US\$ 253.7 million (R\$ 593,868 and R\$ 782,609 at December 31, 2005 and 2004, respectively).

Agreement 896 – In December 1992, the Company signed an additional loan agreement with the IDB for US\$ 50 million for the Tietê River Clean-up Project – Stage I. This loan bears interest at 3.0% per annum. Semiannual principal repayments began in June 1999, with final maturity in December 2016. A guarantee agreement between the Federative Republic of Brazil and the IDB was executed in December 1992, to warrant the provision of funds to meet the obligations set forth in the financing agreement. The outstanding balance of such agreement at December 31, 2005 was US\$ 30.6 million (R\$ 71,521 and R\$ 88,480, at December 31, 2005 and 2004, respectively).

Agreement 1.212 – In July 2000, the Company signed a loan agreement with the IDB for US\$ 200 million to finance the Tietê River Clean-up Project – Stage II. The related project is in the execution stage, and aggregate borrowings under such agreement in 2005 were US\$ 36.7 million. A guarantee agreement between the Federative Republic of Brazil and the IDB was executed in July 2000, to warrant the provision of funds to meet the obligations set forth in the financing agreement. The balance available under this facility was US\$ 74.9 million at December 31, 2005.

The loan will be repaid in semiannual installments, beginning in January 2006 with scheduled maturity in July 2025. The loan bears interest at a variable rate, payable semiannually, on the daily outstanding balance, based on the cost of funding to the IDB. The outstanding balance of such agreement at December 31, 2005 was US\$ 125.1 million (R\$ 292,820 and R\$ 234,671 at December 31, 2005 and 2004 respectively).

(g) International Bank for Reconstruction and Development – BIRD (World Bank)

Agreement 3.504 – In March 1993, the Company signed an agreement with the State Government for the transfer of the funds received by the State Government from the World Bank in December 1992. The proceeds from this loan were designated to finance the environmental clean-up of the Guarapiranga Basin. In December 1992, a guarantee agreement was executed between the Federative Republic of Brazil and the BIRD, to warrant the provision of funds to meet the obligations set forth in the financing agreement. Semiannual principal repayments began in October 1997, with final maturity in April 2007. The loan bears interest at 0.5% above the World Bank cost of funding. The outstanding balance at December 31, 2005 was US\$ 6.5 million (R\$ 15,072 and R\$ 31,200, at December 31, 2005 and 2004, respectively).

(h) Syndicated loans

Deutsche Bank Luxembourg

In October 2000, the Company signed a loan agreement for US\$ 100 million having the Deutsche Trust Bank Limited as paying agent and the Brazilian American Merchant Bank as arranger, for the purpose of refinancing the Company's financial obligations. The loan bears interest at 11.125% per year, and was repaid in 10 semiannual installments, comprising principal and interest for the period, with final maturity in October 2005.

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(i) Japan Bank for International Cooperation ("JBIC")

On August 6, 2004, the Company executed a financing agreement with the JBIC - Japan Bank for International Cooperation, guaranteed by the Federal Government, in the amount of 21,320 million Japanese Yens, equivalent to approximately R\$ 422,840, which is intended for the Environment Recovery Program for the Metropolitan Region of Santos Coastal Area.. The first disbursements under this loan were made in January 2006. In addition to the amount received under the JBIC credit agreement, the Company intends to invest up to R\$355,000 million in this program. The total term of the financing agreement is 25 years, comprising 18 years for amortization in semiannual installments and 7 years for grace period. Interest will be paid semiannually at the rate of 2.5% p.a. for the sewage network and 1.8% p.a. for sewage treatment facilities.

(j) Financial Covenants

The above loans generally include certain financial and operating covenants that require the Company to maintain certain operating and financial ratios, including but not limited to current ratio, debt-to-equity ratios, certain EBITDA and debt service coverage ratios, as well as other operating, profit and productivity ratios, each as specifically defined in the respective loan agreements.

In addition, certain agreements, including but not limited to those relating to the IDB and the Eurobonds, contain, among other provisions, limitations on the Company's ability to incur debt. The indenture relating to the 12.0% Notes due 2008 is the most stringent of these debt agreements.

Brazilian regulations provide that a state-owned company, such as the Company, must, subject to some exceptions, use the proceeds of "external credit operations" (i.e., foreign currency borrowings) to refinance outstanding financial obligations. 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 Japan Bank for International Cooperation, the World Bank and the Inter-American Development Bank.

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Financial covenants of the 6th, 7th and 8th issue of Debentures

- Adjusted current ratio over 1.0; current assets divided by current liabilities, excluding from the current liabilities the short-term portion of the long-term debts undertaken by the Company.
- EBITDA/Financial Expenses equal to or less than 1.5.
- Non-compliance with these obligations will not be evidenced unless if recorded in quarterly financial statements, for at least two consecutive quarters, or for two non-consecutive quarters within a period of twelve months.

Financial covenants of Caixa Econômica Federal – Pro-Sanitation

- The loans under the Pro-Sanitation program are subject to the Company meeting certain financial and operating covenants (including operating margin, personnel expense margin, and revenue versus collection index, as defined). Such indexes, based on the previous 2 years, are semiannually projected for the next 2 years.

Financial covenants of BNDES

- Adjusted current ratio: over 1.0;
- Ratio of EBITDA to operating revenue: equal or higher than 38%;
- Ratio of connections (water and sewage) to employees: equal or higher than 520;
- Ratio of EBITDA to debt service: equal or higher than 1.5;
- Ratio of shareholders' equity to total liabilities: equal or higher than 0.8.

Covenants of Eurobonds (In the constant currency method):

- No incurrence of additional indebtedness if the debt/adjusted capitalization (\*) ratio is greater than 0.42;
- Debt Service Coverage Ratio cannot be less than 2.5 (adjusted EBITDA(\*\*)/financial expenses);
- Loans to controlling shareholder must be limited to the respective amount of accounts receivable.

(\*) Adjusted capitalization excludes from the Shareholders' Equity overdue accounts receivable, both from the State of São Paulo Government and from self-operated wholesale water distribution companies

(\*\*) Adjusted EBITDA is calculated by excluding unpaid sales of water and sewage services to the State of São Paulo Government and unpaid sales of water on a wholesale basis to self-operated systems in the Metropolitan Region of São Paulo – RMSP (non-accounting information).

Financial covenants of IDB

- Agreement 229 – Long-term debt must not exceed 1.5 times the shareholders' equity.
- Agreements 713, 896 and 1212 – Tariffs must: a) produce enough revenue to cover the system operating expenses, including those related to management, operation, maintenance and depreciation; b) ensure profitability on property, plant and equipment of not less than 7%. During the performance of the project the outstanding balances of short-term loans must not exceed 8.5% of the Company's shareholders' equity.

At December 31, 2005 the Company was in compliance with all such covenants.

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**(k) Maturity dates of loans and financing**

	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012 onward</u>	<u>Total</u>
In domestic currency	632,849	675,299	317,027	1,085,952	653,816	741,483	981,847	5,088,273
In foreign currency	<u>126,164</u>	<u>106,180</u>	<u>597,290</u>	<u>70,632</u>	<u>70,632</u>	<u>70,632</u>	<u>534,418</u>	<u>1,575,948</u>
Total	759,013	781,479	914,317	1,156,584	724,448	812,115	1,516,265	6,664,221

**(l) Investment Fund in Credit Rights SABESP I**

The INVESTMENT FUND IN CREDIT RIGHTS SABESP I (the "Fund") has as objective, observing its investment policy, the portfolio diversification and composition, the acquisition of credit rights of SABESP, under the form of closed condominium, having a 60 month-duration term counted from the date of issuance of its quotas, that is March 23, 2006. The fund and the distribution of its senior quotas have been registered with the Securities Exchange Commission – CVM, on March 17, 2006, under the number CVM/SRE/RFD/2006/010.

The fund issued 500 senior quotas with unit value at the issuance date corresponding to R\$ 500, totalling R\$ 250,000 of funds received which will be used by the Company for settlement of debts becoming due during the fiscal year 2006.

These seniors quotas are collateralized by collections from residential customers and will be amortized in 54 monthly installments. The fund will have a parameter of profitability corresponding to 100% (one hundred per cent) of the DI rate variation, added by an interest pre-fixed coupon of 0,7% (zero point seventy per cent) per year based on 252 working days, observed the terms of the Fund Regulations.

A unique series of 26 subordinate quotas, with unit value at the issuance date corresponding to R\$ 500, amounting to R\$ 13,000, has been subscribed by the Company and is kept in a deposit account. The subordinate quotas have been amortized and paid-in exclusively by SABESP.

The Fund is managed by Caixa Econômica Federal and has as custody entity the under-writer agent Banco do Brasil S.A.

**10. TAXES AND CONTRIBUTIONS**

Income tax and social contribution (a federally mandated tax based on income) are accrued on taxable results at the applicable tax rates, generally 25% for income tax and 9% for social contribution tax (34% composite rate).



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## (a) Reconciliation of the effective tax rate

The amount recorded as income tax and social contribution expenses in the financial statements is reconciled from the nominal rates provided by law, as shown below:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Income before taxes on income	1,217,148	789,987	1,111,078
Statutory rate	<u>34%</u>	<u>34%</u>	<u>34%</u>
Tax expense at statutory rate	(413,830)	(268,596)	(377,767)
Permanent differences			
Realization of revaluation reserve	(30,413)	(35,530)	(45,643)
Interest on shareholders' equity	118,393	51,998	171,390
Other differences	<u>9,471</u>	<u>10,291</u>	<u>9,384</u>
Income and social contribution taxes	<u>(316,379)</u>	<u>(241,837)</u>	<u>(242,636)</u>
Current	(343,426)	(250,609)	(216,089)
Deferred	27,047	8,772	(26,547)
Effective rate	<u>26%</u>	<u>31%</u>	<u>22%</u>

## (b) Composition of deferred taxes and social contributions

In current assets:	<u>2005</u>	<u>2004</u>
Provision for contingencies	10,730	7,650
Tax loss carryforwards	<u>12,785</u>	<u>22,565</u>
	<u>23,515</u>	<u>30,215</u>
In long-term assets:		
Provision for contingencies and pension obligations	288,898	228,929
Tax loss carryforwards	-	21,081
Other	<u>9,922</u>	<u>7,261</u>
	<u>298,820</u>	<u>257,271</u>
Total deferred tax assets	<u>322,335</u>	<u>287,486</u>
In current liabilities:		
Deferred PASEP	21,827	22,217
Deferred COFINS	<u>49,066</u>	<u>49,685</u>
	<u>70,893</u>	<u>71,902</u>
In long-term liabilities:		
Profit for governmental agencies	80,031	90,324
Revenue for governmental agencies	<u>53,412</u>	<u>39,731</u>
	<u>133,443</u>	<u>130,055</u>
Total deferred tax liabilities	<u>204,336</u>	<u>201,957</u>

## (i) In Current Assets

Mainly calculated on temporary differences related to currently non-deductible provisions for contingencies in the amounts of R\$ 31,557 and R\$ 22,501 at December 31, 2005 and 2004). The tax loss carryforwards basis of social contribution accumulated in December 31, 2005 was R\$ 142,061 (2004 – R\$ 250,719) which will be realized until December 31, 2006.

## (ii) In Long-Term Assets

Mainly calculated on temporary differences in the amount of R\$ 873,152 (2004 – R\$ 690,613) related to income tax and R\$ 894,795 (2004 – R\$ 705,969) related to social contribution.

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The loss carry forward basis of social contribution has been transferred to short-term in 2005, at December 31, 2004 the balance was R\$ 234,231.

(iii) In current liabilities

Substantially calculated on amounts invoiced to government agencies, with taxes being deducted upon receipt of the invoices.

(iv) In long-term liabilities

- Income tax and social contribution

Substantially calculated based on temporary differences in the amount of R\$ 248,651 (2004 - R\$ 278,923) relating to income tax and R\$ 198,545 (2004 - R\$ 228,817) relating to social contribution.

- PASEP and COFINS

Substantially calculated on amounts invoiced to government agencies, which are accrued for when services are rendered and which are paid when the related amounts are effectively received by the Company.

(c) Tax effects on the revaluation of assets

As permitted by CVM Instruction 197/93, the Company did not record a provision for the tax effects (deferred taxes) on the surplus of the revaluation of property, plant and equipment carried out in 1990 and 1991. Had the income tax and social contribution on the revaluation reserve been accounted for, the unrealized amount at December 31, 2005 and 2004 would have been R\$ 461,068 and R\$ 491,475, respectively. In the years ended on December 31, 2005 and 2004, the realized revaluation reserve amounts were R\$ 89,449 and R\$ 104,500.

11. TAXES PAYABLE

	Current		Long-term	
	2005	2004	2005	2004
Income tax	2,040	21,162	-	-
Social contribution	2,536	7,080	-	-
COFINS and PASEP	39,470	29,232	-	-
PAES	39,401	36,311	256,114	272,338
INSS	17,320	15,531	-	-
Other	5,364	5,803	-	-
Total	<u>106,131</u>	<u>115,119</u>	<u>256,114</u>	<u>272,338</u>

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The Company applied for enrollment in the Special Tax Debt Refinancing Program ("PAES") on July 15, 2003 in accordance with Law No. 10,684 of May 30, 2003, in which the Company included certain tax liabilities related to COFINS and PASEP, which had previously been the subject of a legal action by the Company challenging the application of Law No. 9718/98, and consolidated the previously outstanding balance of tax liabilities included under the previous Tax Recovery Program ("REFIS"). The total amount of tax liabilities included in the PAES was R\$ 316,953, as follows:

<u>Tax</u>	<u>Principal</u>	<u>Fine</u>	<u>Interest</u>	<u>Total</u>
COFINS	132,499	13,250	50,994	196,743
PASEP	5,001	509	2,061	7,571
REFIS	<u>112,639</u>	<u>-</u>	<u>-</u>	<u>112,639</u>
Total	<u>250,139</u>	<u>13,759</u>	<u>53,055</u>	<u>316,953</u>

The PAES obligation is being paid in 120 months. After enrolling in the PAES Program, the Company paid R\$ 37,986 and R\$ 34,894 during the years ended December 31, 2005 and 2004, respectively; financial charges in the amount of R\$ 24,852 and R\$ 28,128 were recorded for the years ended December 31, 2005 and 2004, respectively. Assets pledged as guarantee under the previous REFIS Program, in the amount of R\$ 249,034 continue to secure amounts under the PAES Program.

## 12. PENSION AND HEALTH BENEFIT PLANS

### (a) Health benefit plan

Managed by Fundação Sabesp de Seguridade Social – "SABESPREV", the plan is comprised of free-election health benefit plans, funded by contributions from the sponsor and the participating employees, which were the following in the year:

Company: average of 6.89% (2004 – 6.89%) of on the payroll;

Participating employees: 3.21% of base salary and bonus, corresponding to 2.19% of the gross payroll, on average.

### (b) Pension benefits

Managed by Fundação Sabesp de Seguridade Social – "SABESPREV", the defined benefit pension plan is supported by monthly contributions as follows: 2.10% from the Company and 2.19% from the participating employees. In order to meet the provisions of CVM Resolution No. 371, of December 13, 2000, below is a description of the amounts of pension and retirement benefits paid granted and payable, to which the employees will be entitled after their service time.

Based on independent actuarial reports at December 31, 2005, calculated in conformity with the Projected Unit Credit Method, the Company had a net actuarial liability of R\$ 329,772 (R\$ 328,605 in 2004), representing the difference between the present value of the Company's benefit obligations to the participating employees, retired employees, and pensioners, and the fair value of the related assets, as shown below:

(i) Reconciliation of assets and liabilities	<u>2005</u>	<u>2004</u>
Present value of actuarial liabilities	(790,552)	(760,015)
Fair value of plan assets	678,185	584,702

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Unrecognized gains	(217,405)	(153,292)
Net actuarial liability	(329,772)	(328,605)
Amortization of past service cost	53,214	106,429
Net liability recognized in the balance sheet	(276,558)	(222,176)

(ii) Expenses recognized in the statements of income	2005
--	------

Current service cost	9,889
Interest cost	91,886
Expected return on plan assets	(70,221)
Amortization (gain)/loss	(5,312)
Employee contributions	(13,752)
Amortization of past service cost	53,215
Total	65,705

(iii) Changes in net actuarial liabilities
--

Present value of the net actuarial liability on December 31, 2004	(222,176)
Current service cost	(9,889)
Interest cost	(91,886)
Expected return on plan assets	70,221
Amortization (gain)/loss	5,312
Employee contributions	13,752
Amortization of past service cost	(53,215)
	(287,881)
Actual contributions by the Company in 2005	11,323
Present value of net actuarial liability in December 2005	(276,558)

(iv) Reconciliation of changes in the present value of liabilities
--

Fair value of plan assets at December 31, 2004	584,702
Actual return on plan assets	98,667
Actual contributions in 2005	25,076
Benefits paid in 2005	(30,260)
Fair value of plan assets at December 31, 2005	678,185

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(v) Reconciliation of changes in the present value of liabilities

Present value of liabilities at December 31, 2004	760,015
Current service cost	9,889
Interest cost	91,886
Benefits paid in 2005	(30,260)
Actuarial gain in the present value of liabilities	(40,978)
Present value of liabilities on December 31, 2005	<u>790,552</u>

(vi) Estimated expenses

	<u>2006</u>
Current service cost	17,545
Interest cost	93,270
Expected return on plan assets	(83,065)
Amortization (gain)/loss	(9,508)
Employees contributions	(15,411)
Amortization of past service cost	<u>53,214</u>
Total	<u>56,045</u>

(vii) Actuarial assumptions

Several statistical and other factors that attempt to project future events are used in calculating the expense and liability related to the plans. These factors include assumptions about the discount rate, expected return on plan assets and the rate of future salary increases as determined by the Company, within certain internal guidelines. In addition, the actuary also uses subjective factors such as termination, turnover and mortality rates to estimate these factors. The actuarial assumptions used by the Company are reviewed on a regular basis and may differ materially from actual results due to changing market and economic conditions, regulatory events, judicial rulings, higher or lower termination/withdrawal rates or longer or shorter life spans of participants. Such differences may result in a significant impact on the amount of pension expense recorded by the Company.

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The assumptions used for the actuarial valuation were as follows:

Economic assumptions	2005	2004
Discount rate	12.32% p.a.	12.32% p.a.
Expected rate of return on plan assets	12.06% p.a.	12.06% p.a.
Future salary increases	6.08% p.a.	6.08% p.a.
Growth in social security benefits and limits	4.00% p.a.	4.00% p.a.
Capacity factor		
- Salaries	98%	98%
- Benefits	98%	98%
Demographic assumptions for	<u>2005</u>	<u>2004</u>
Mortality table	GAM 83	Adjusted IBGE
Disabled mortality table	RRB 1944	RRB 1944
Disability entry table	Modified RRB 1944	Modified RRB 1944
Turnover table	Prudential	Prudential
Retirement age	First age with entitlement to one of the benefits	First age with entitlement to one of the benefits
% active participants married at time of retirement	95%	95%
Age difference between participants and their spouses	Wives are 4 years younger than husbands	Wives are 4 years younger than husbands

For the 2005 actuarial assessment, the general mortality table has been changed to GAM-83 in replacement to the adjusted IBGE table, as the GAM-83 table reflects the increase in life expectancy of the population evaluated.

The number of active participants at December 31, 2005 and 2004 was 16,449 and 16,673, respectively. The number of inactive participants at December 31, 2005 and 2004 was 4,881 and 4,908, respectively.

The evaluation of "SABESPREV" costing plan is made by an independent actuarial expert, based on different assumptions than those adopted for purposes of ascertaining benefits to employees, as set forth in CVM Resolution no. 371. SABESPREV's technical deficit at December 31, 2005 is R\$ 456,861 (2004 – R\$ 357,378). The calculation is substantially different as for the actuarial method in calculating risk benefits before retirement, with sharing to "SABESPREV" and capitalization for the purpose of meeting CVM Resolution no. 371. Another significant difference is the discount rate of 6% for "SABESPREV" and 12.32% nominal rate for CVM Resolution no. 371, resulting from the combination of a long-term inflation rate of 4% per year and actual interest rate of 8%.

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As permitted by CVM Resolution No. 371, the Company has elected to amortize the actuarial liability R\$ 266,074 at December 31, 2001 over five years using the straight-line method beginning in 2002. The amortization of the transition obligation for past service cost is being recorded as an "Extraordinary Item", net of tax effects, in the statement of income for the year as follows:

	2005	2004	2003
Extraordinary item	53,215	53,215	53,215
Deferred income and social contribution taxes	(18,093)	(18,093)	(18,093)
Net extraordinary item	35,122	35,122	35,122
Liabilities on December 31, 2001		266,074	
Extraordinary item recorded for the period from 2002 to 2005		(212,860)	
Balance to be recorded		53,214	

The Sponsor and the "SABESPREV" are in process of negotiation so that the technical deficit may be resolved, considering the possibility of changing from the Defined Benefit Plan to Defined Contribution Plan. The Management estimates not incurring in additional costs resulting from any potential change of the referred plans.

### 13. PROFIT SHARING

The Company recorded additional salary and payroll charges in the amounts of R\$ 44,292, R\$ 40,262, and R\$ 39,978 for the years ended December 31, 2005, 2004 and 2003, respectively, relating to employees profit sharing, in accordance with the labor legislation and agreements with trade unions. Such agreements define certain targets to be met and also define limits for distribution per employee based on monthly salaries. These charges represent an estimate made by management, as the final determination of the amounts payable is not yet available at the date of the preparation of the financial statements.

As a result of negotiations held by the Company with entities representing the employees, a Profit Sharing Program was implemented for the period from July 2005 to June 2006, with the payment of an amount corresponding to up to one month's payroll, depending on achievement of defined targets. In December 2005 the Company made an advance payment of R\$ 22,906, equivalent to 50% of one month's payroll. The remainder of the 2005 accrual, if applicable, is estimated to be paid at the end of August 2006.

### 14. PROVISIONS FOR CONTINGENCES

#### (a) Provisions for contingencies

The Company is party to a number of claims and legal proceedings arising in the normal course of business, including civil, labor, environmental, tax and other matters. The Company has recorded provisions for those claims and assessments whose risk of loss has been determined by management, based on the advice of the Company's legal and tax advisors, as probable and for which amounts are estimable. These recorded provisions, by nature of the related cases, are summarized below as of December 31:

	2005	2004
Disputes taxes – Finsocial	-	7,872
Customer claims (i)	279,509	219,042

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Contractor claims (ii)	194,357	174,354
Civil and tax claims (iii)	74,510	34,590
Labor claims(iv)	28,576	25,854
Environmental claims (v)	24,198	17,884
Other claims	11,247	11,008
Total	<u>612,397</u>	<u>490,604</u>
Current portion	31,557	30,373
Long-term portion	580,840	460,231

**(b) Lawsuits with possible risk of loss**

In addition to those claims and assessments above whose risk of loss has been determined as probable and for which related provisions have been recorded, the following summarizes the estimated amounts related to other claims and assessments for which management, based on the advice of the Company's legal and tax advisors, has assessed the likelihood of loss as possible and for which no provision has been recorded in the financial statements.

	<u>2005</u>	<u>2004</u>
Customers claims(i)	728,900	594,200
Contractor claims (ii)	178,700	178,300
Civil and tax claims(iii)	324,400	148,500
Labor claims (iv)	11,500	9,600
Environmental claims (v)	202,600	200,300
Other claims	7,900	15,900
Total	<u>1,454,000</u>	<u>1,146,800</u>

**(c) Escrow Deposits**

The Company had made escrow deposits in the amount of R\$ 4,069 and R\$ 1,247 at December 31, 2005 and 2004, respectively, related to pending litigation. Such deposits are restricted and held by the court, pending final resolution of the matters.

**(d) Summary of claims and assessments****(i) Customer claims**

Approximately 930 customer claims have been filed against the Company by commercial customers claiming that their tariffs should be equal to those of other categories of consumers and, consequently, claim the refund of amounts imposed and charged by the Company. The Company has obtained final decisions, both favorable and adverse, in several different court levels, and has recorded provisions for cases whose risk of loss has been assessed as probable.

Out of the R\$ 728,900 for which the Company has assessed the likelihood of loss as possible, an estimated amount of R\$ 103,000 (including claims for refunds, monetary adjustment, interest and attorney's fees) relates to new lawsuits, and approximately R\$ 186,200 refers to thirteen lawsuits. At December 31, 2005, the lower court's decisions on four of these lawsuits were still pending. While the lower courts have ruled in favor of the Company in connection with other nine lawsuits, a final decision is still pending in all nine cases.

**(ii) Contractor claims**

Certain construction service contractors have filed claims in court alleging underpayment of monetary adjustments, withholding of amounts relating to the effects of the Real Plan and monetary losses from economic-financial imbalance in the applicable contracts. These lawsuits are in progress in several different court levels, and provisions are recorded for cases with probable chance of loss.



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Out of the amount of R\$ 178,700 for which we have assessed the likelihood of loss as possible, approximately R\$ 140,600 refers to four lawsuits. At December, 31, 2005, three of these lawsuits were in their respective initial stages and one had been ruled in favor of the Company, but was still pending final judgment by the appellate court.

(iii) Civil and Tax claims

The Company is party to a number of civil claims related to indemnifications for material damages, pain and suffering and loss of profits allegedly caused to third parties and which have been brought before different court levels. In addition, the Company is party to a number of tax proceedings. At December 31, 2005, provisions have been recorded in the amount of R\$74,510 for civil and tax claims for which the risk of loss has been assessed as probable.

The Company is party to a series of lawsuits initiated by the municipality of Ferraz de Vasconcelos in 1997, seeking payment of penalties in the aggregate amount of R\$70.1 million, which we allegedly owe for damages caused during construction in the municipality. Several of these lawsuits have already been rejected by lower courts but are still subject to appeal. The Company has assessed the risk of loss related to these cases as remote, and as such, no amounts have been provisioned at December 31, 2005.

In November 2004, the Company took legal action against the Municipality of Bragança Paulista against the imposition of a new charge over the use of public areas for the installation of water and sewage mains related to the public sanitation services provided to the municipality. In February 2005, the Company was granted an injunction suspending the imposition of this charge and preventing the municipality from collection of any current or future amounts due in respect of this change until there is a final decision on the merits of the case. In June 2005, the lower court ruled in Company's favor and the injunction was maintained. The municipality appealed such decision and a trial decision was still pending.

The Company initiated legal action in July 1999 to challenge the creation by the Municipality of City of São Paulo of a tax on the use of public areas. The tax would apply to the Company's water and sewage mains and other installations located in public areas. Based on the advice of internal legal counsel, the Company believes that this municipal tax is unlawful because it was established by a municipal decree instead of a municipal statute. The Company is currently disputing the creation of this tax and any related tax assessment. On May 11, 2000, the trial court of the state of São Paulo (12a. Vara da Fazenda Pública do Estado de São Paulo) issued a decision upholding this municipal tax. The Company has appealed the trial court decision to the Court of Appeals of the state of São Paulo (Tribunal de Justiça do Estado de São Paulo). A recently approved law enacted the tax on the use of public areas in the city of São Paulo. In April 2004, the Company filed a request for injunction seeking the suspension of the tax assessment by the municipality. The injunction was granted on first instance and maintained in the decision of the lower courts. The municipality has appealed this decision to the court of appeals of the state of São Paulo and the decision is still pending. The Company has assessed the risk of loss as possible and currently cannot estimate the potential increase in its expenses if it were required to pay this tax or if any future assessment of this tax would be retroactive to 1999. To date, the Company has not established a provision for any potential expense arising from this municipal tax.

The Company has also taken legal action to challenge a City of São Paulo municipal law enacted in 2002 that revoked the Company's blanket exemption from municipal taxes. As a result of the loss of the exemption from municipal taxes, the Company may be subject to a tax on services charged at a rate of 5.0% on gross revenue from water and sewage services. The Company requested an injunction against the municipality, which was granted by the trial court of the state of São Paulo (11a. Vara da Fazenda Pública do Estado de São Paulo), and such injunction was maintained after the filing of an appeal by the municipality. However, on May 5, 2005, the lower court issued a decision against the Company. The Company intends to appeal such decision to the fullest extent permissible by law. This action, for which potential expense amounts to approximately R\$ 108,095, is assessed as of possible loss by the Company's tax advisors.

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In 2005, new actions, whose risk of loss has been assessed as possible, were filed in the approximate amount of R\$ 117,000, with monetary adjustment to the lawsuits in course of approximately R\$ 59,000.

(iv) Labor claims

The Company is party to a number of labor claims and proceedings, at various legal stages and in a number of courts, brought by São Paulo Water, Sewage and Environment Service Workers Union (Sindicato dos Trabalhadores em Água Esgoto e Meio Ambiente de São Paulo—SINTAEMA) and the Company's current and former employees related to overtime pay, health hazard, premium claims, prior notice period, job deviation, salary parity, and other benefits among others. At December 31, 2005, the Company had recorded provisions totaling R\$28,576 with respect to potential damages in lawsuits and administrative proceedings whose risk of loss has been determined as probable.

On January 9, 1990, SINTAEMA initiated a lawsuit against the Company, alleging that it had failed to pay certain employee benefits and were required to make a penalty payment to SINTAEMA under a then existing collective bargaining agreement. On July 31, 1992, the Labor Court issued a ruling against the Company, but did not award damages to SINTAEMA at that time. The Company and SINTAEMA are currently engaged in negotiations concerning the amount to be paid by it. The Company also filed a writ of mandamus seeking a court decision establishing that the penalty imposed against us, amounting to approximately R\$ 5,558, is excessive since it exceeds the principal amount by a large margin. The Company's request was denied by the courts and the lawsuit is now awaiting a final decision at Superior Labor Court (Tribunal Superior do Trabalho).

The Company is also a defendant in approximately 1,841 labor proceedings and in one civil public action initiated by and on behalf of some of the Company's current and former employees relating to certain benefits awarded by Law No. 4,819, of August 26, 1958. Approximately 40 of these plaintiffs are also seeking the same benefits in the civil courts. In all cases, the Company claims that the State Government is responsible for the payments due to the plaintiffs. Some labor and civil proceedings have been ruled upon by the lower courts, but no final decision has been issued to date in any of these legal proceedings. An injunction was granted at the first instance in the civil public action to compel the Company to pay the benefits awarded by Law No. 4,819 to all plaintiffs in that lawsuit. To date, the Company and the State Government have not agreed on any amounts to be reimbursed. The civil public action is now awaiting decision on the merits of the case.

In October 1989, the São Paulo Water, Sewage and Environment Service Workers Union (Sindicato dos Trabalhadores em Água Esgoto e Meio Ambiente de São Paulo—SINTAEMA) commenced a lawsuit against the Company on behalf of employees, alleging that the Company had violated Brazilian labor laws and collective bargaining contracts when it ceased making certain payments to 21,337 employees in 1989. Those payments related to previously mandated inflation-related index adjustments to such employees' wages and salaries, which, due to a change in applicable law, the Company had ceased making. In November 1995, the Labor Court issued a decision in favor of SINTAEMA, although it never ruled with respect to the amount of damages payable by the Company. The Company appealed the decision of the Labor Court and in April 1997 lost the appeal. The Company later appealed this decision to the Superior Labor Court (Tribunal Superior do Trabalho) and the Superior Court ruled against it. However, the Company filed a motion to vacate (ação rescisória), seeking the annulment of the Superior Court ruling and obtained a favorable decision. SINTAEMA appealed this decision and the Supreme Court maintained the decision in the Company's favor. The proceeding was dismissed in January 2006.

(v) Environment claims

Environmental claims refer to several administrative proceedings brought by municipalities and other public agencies, including Companhia de Tecnologia de Saneamento Ambiental – "CETESB" (Environment Sanitation Technology Company), seeking to impose fines and penalties for alleged environmental damages.

The Company is being sued by the Public Prosecution Office of the State of São Paulo as well as some non-governmental organizations through a number of environmental civil public actions (i) aiming to

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enjoin the Company from releasing untreated sewage into certain local water courses, and, in some of them, (ii) seeking remedies for environmental damages, which have not yet been specified and evaluated by technical experts of the courts; and (iii) aiming to require the Company to install and operate sewage treatment facilities in those locations. In each case, the Company is or may be subject to daily fines for noncompliance thereto. In its response to these lawsuits, the Company emphasizes that the installation and operation of sewage treatment facilities in those locations is included in its business plan and that the immediate cessation of the release of untreated sewage into the relevant local water courses would hinder it from collecting sewage in those locations, causing much more damages against the environment and public health. In most of these lawsuits, no final judicial decision has been reached by local judges.

Among those aforementioned civil public lawsuits are the following:

The Public Prosecution Office of the State has brought a civil public action before the São Bernardo do Campo Court (5a. Vara Cível de São Bernardo do Campo) which seeks reparation for environmental damage caused by the Company dumping sludge from its water treatment facilities into certain receiving waters, the immediate cessation of this practice and the implementation of an environmental recovery project. A judge issued a preliminary order that the Company immediately cease such dumping and established a daily R\$50 fine for not complying with such order; however, this order has been suspended at the Company's request. Although the lower court has issued a decision in the Company's favor, the Public Prosecution Office of the State of São Paulo has appealed such ruling. As a result, the upper courts have decided against the Company and have ordered it to stop dumping sludge within a year from the date the decision is considered final, or to pay a daily penalty of R\$10, in addition to repairing the environmental damage caused. This decision is not yet final. The Company is currently unable to evaluate the extent or cost of any remedy that it may be held responsible for in connection with this matter, whose risk of loss has been assessed as possible.

The Public Prosecution Office of the State of São Paulo has brought a civil public action before the Paraguaçu Paulista Courts of Law (1a. Vara de Paraguaçu Paulista) which seeks reparation for and cessation of environmental damage allegedly caused by the Company's release of raw sewage into the Alegre River, situated in the Municipality of Paraguaçu Paulista. The lower court has issued a decision against the Company, requiring that it (i) cease the release of raw sewage into the Alegre River, (ii) invest in a water and sewage treatment facility in the Municipality of Paraguaçu Paulista; and (iii) pay an administrative penalty in the amount of R\$116,900 for environmental damage. The decision also imposes a daily penalty if the Company fails to comply with numbers (i) and (ii) above. The Company has appealed this decision and such decision will not be effective until a final ruling is issued on this appeal. The Company has assessed the risk of loss in this case as possible.

A civil public action was brought against the Company by the Coordination Council for the Civil Entities of Piracicaba (Conselho Coordenador das Entidades Cíveis de Piracicaba) concerning the limits for water collection from the Piracicaba river and the operation of the Cantareira water distribution system. The plaintiff requests, among other things, a prohibitory injunction in order to restrict the amount of water that the Company collects, the reduction of the Piracicaba river's collection limit and the payment of damages to the riparian cities in order to cover the direct and indirect environmental damages allegedly caused by the installation and operation of the Cantareira water distribution system. The Company presented its defense in January 2004, alleging that the plaintiff has no standing to bring this action and that some of the requests are inconsistent and/or impossible. The Company has explained that the water collection limit was duly authorized by law and by the competent governmental agency, and that the plaintiff did not prove or specify the damages. The injunction was not granted, and this action is now awaiting judgment on the first instance.

On February 25, 2003, a request for a preliminary injunction was filed against the Company, restricting it from disposing of sewage without due treatment in the municipality of Lúécia. The injunction also determined that payments for water and sewage services by users be deposited with the court until the Company has made the necessary investment in the water and sewage system of the municipality, in addition to paying a daily fine in the amount of R\$300,000 (one thousand minimum salaries) in the event the case is decided against it. After submission of an expert report, the Public Prosecutor Office

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requested that the Company be sentenced to pay an amount of R\$82,800. In anticipation of a settlement with the Public Prosecutor Office, the Company condemned the area and requested the respective environmental licenses for it.

The Company is also party to a number of other civil public actions brought by municipalities that seek cessation of the collection of fees relating to sewage services, alleging that the Company does not treat the sewage in such municipalities and that it has failed to make certain investments in sewage treatment systems as provided in the relevant concession agreements.

The Company is also party to several administrative proceedings with CETESB – Companhia de Tecnologia de Saneamento Ambiental (Environmental Sanitation Technology Company) seeking the imposition of penalties for environmental damages allegedly caused by the Company and other regulatory matters. However, the Company does not believe that the final determination in these proceedings will, individually or in the aggregate, have a material adverse effect on its business, results of operations, financial condition or prospects.

At December 31, 2005, the Company had provisioned R\$24,198 for environmental claims.

(vi) Other proceedings relating to concessions

The Company is also party to a number of proceedings related to its concessions.

In December 1997, the municipality of Santos enacted a law expropriating the Company's water and sewage systems in Santos. In response, the Company filed an action seeking an injunction against this expropriation, which was denied by the lower court. This decision was later reversed by the Court of Appeals of the State of São Paulo, which issued a preliminary order suspending that law. On August 2, 2002, a decision on this matter was rendered in the Company's favor by a lower court, but that decision remains subject to appeal. Despite the pending lawsuit, the Company continues to provide water and sewage services to Santos.

In connection with discussions held with the municipality of Presidente Prudente, the Company filed a suit against the municipality seeking a court decision determining the continuation of the concession agreement with that municipality until the indemnification payment owed to the Company in connection with the return of water and sewage system of Presidente Prudente is made. The lower court issued a decision in the Company's favor to the effect that it still continue to provide services in the municipality until the indemnification provided for in the concession agreement is paid.

On March 25, 2004, the Public Attorney's Office filed a civil action against the Municipality of Itapira, its mayor, the Municipal House of Representatives and the Company, claiming that Municipal Law No. 3,593/04 is unconstitutional and seeking termination of the Company's concession agreement with the municipality. Although an injunction was granted, the São Paulo State Court of Appeals has stayed the injunction. On March 23, 2005, the House of Representatives of Itapira approved a decree revoking the concession agreement. In addition, Municipal Law No. 3,730/05 was enacted revoking an earlier law which authorized the municipality to enter into the concession agreement. The Municipality of Itapira has further filed an action against the Company seeking to repossess the assets related to its water and sewage services and has obtained an injunction which was later confirmed by a court decision. The Company has appealed this ruling but has not been able to suspend the effects of the decision until final judgment. Accordingly, the Company is currently not rendering water and sewage services at Itapira. A trial decision on this litigation is still pending.

The Municipality of Sandovalina has brought a legal action against the Company seeking to (i) obtain the termination of the Company's concession and (ii) obtain remedies for environmental damage and alleged losses caused to the municipality due to its failure to provide sewage treatment, as well as other damage caused to public property. The Company responded with a counterclaim against the municipality for payment of R\$ 115 related to the supply of water from December 1999 to August 2003. The Company is also seeking the payment of a contractual indemnification based on the early termination of the contract.

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The Company currently continues to operate the water and sewage systems of Sandovalina, and the lawsuit is still in the fact-finding phase.

The Municipality of Salto de Pirapora has obtained an injunction to regain control of the basic sanitation. The Company has filed a lawsuit, aiming at suspending the effects of the injunction granted, which has been accepted.

In addition, the Company is party to a number of proceedings with the Public Prosecution Office and several municipalities which have contested its right to charge a tariff for sewage services provided as opposed to charging a fixed fee for these services. In most of these proceedings, the Company has received decisions in its favor. In addition, the Supreme Court has confirmed the understanding that the Company has the right to charge a tariff for the sewage services it provides. The Company does not believe that the final outcome of these proceedings will have a material adverse effect on its business, results of operations, financial condition or prospects.

#### 15. SHAREHOLDERS' EQUITY

##### (a) Authorized capital

The Company is authorized to increase its capital up to a maximum of R\$ 4,100,000 registered common shares without par value, upon resolution of the board of directors.

The Company has from time to time issued shares to purchase assets from third parties, usually municipal authorities. These shares are issued at market value, which correspond to the fair value of the assets acquired.

##### (b) Subscribed and paid-up capital

Subscribed and paid-up capital is represented by 28,479,577,827 registered common shares without par value as follows:

Shareholders	2005		2004	
	Number of shares	%	Number of shares	%
State of São Paulo Department of Finance	14,313,511,871	50.26	14,313,511,872	50.26
Companhia Brasileira de Liquidação e Custódia	7,708,472,937	27.06	8,070,467,685	28.33
The Bank of New York ADR Department (Equivalent to stock) (*)	6,430,069,500	22.58	6,068,470,750	21.31
Other	<u>27,523,519</u>	<u>0.10</u>	<u>27,127,520</u>	<u>0.10</u>
	<u>28,479,577,827</u>	<u>100.00</u>	<u>28,479,577,827</u>	<u>100.00</u>

(\*) each ADR equals 250 shares

In October 2004, the State of São Paulo Government sold 5.27 billion of its common shares, of which 1.43 billion were sold in Brazil and 3.84 billion were sold as 15.36 million American Depositary Shares ("ADSs") on the New York Stock Exchange - NYSE.

##### (c) Distribution of earnings

Shareholders are entitled to a mandatory minimum dividend distribution of 25% of adjusted net income, calculated in conformity with Brazilian Corporate Law. This requirement can be met through payments made in the form of dividends and interest on shareholders' equity (net of withholding tax), to the extent amounts are available for distribution. Dividend distributions are limited to retained earnings as determined in accordance with BR CL. At December 31, 2005, as required by the CVM, management designated the retained earnings balance to a discretionary investment reserve account (see (e) below).

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For purposes of BR CL, and in accordance with the by-laws of the Company, adjusted annual net income is an amount equal to the Company's annual net income adjusted to reflect allocations to or from (i) statutory legal reserve, (ii) an equity contingency reserve for anticipated losses, if any, and (iii) an unrealized revenue reserve, if any. The calculation of the mandatory minimum dividends for 2005 is as follows:

Net income for the year	865,647
(-) Legal reserve 5%	<u>43,282</u>
Net income	<u>822,365</u>
Mandatory minimum dividend	<u>205,591</u>

The Company by-laws also provide for distribution of interest on shareholders' equity as an alternative form of distribution to shareholders. The interest rate is limited to the variation in the TJLP during the applicable period and the deductible distribution cannot exceed the greater of 50% of net income (before distribution and deductions for income taxes) for the period or 50% of retained earnings. Distribution of interest on shareholders' equity is a tax-deductible expense for both income tax and social contribution purposes. The amount paid to shareholders as interest on shareholders' equity, net of any withholding tax, is taken into account in determining the mandatory dividend.

The Company declared interest on shareholders' equity, in lieu of dividends, in the amount of R\$ 324,461, net of withheld income tax in the amount of R\$ 23,755, in 2005. Interest on shareholders' equity was calculated in conformity with article 9 of Law No. 9.249/95, at the Long-Term Interest Rate (TJLP); this interest was originally recorded in "Financial expenses" for income and social contribution tax purposes and subsequently, for presentation purposes, has been reflected directly in "Shareholders' equity" in conformity with CVM Deliberation No. 207/96.

(di) Capital reserve

Capital reserve comprises of tax incentives and donations from government agencies and private entities.

The tax incentive reserve results from an option to invest in the capital stock of companies undertaking specified government-approved projects. In lieu of paying part of the income tax due, the amount is credited to income tax and subsequently appropriated from retained earnings to this reserve.

The donations reserve reflects the value of assets received from government entities, principally enabling the Company to provide service access to properties. No shares are issued in exchange nor other remuneration provided in connection with assets received. These donations are recorded as a direct benefit to shareholders' equity.

(e) Investment reserve

Management proposed to transfer the balance of retained earnings not distributed to shareholders to a discretionary reserve (investment reserve) in accordance with the Company's capital expenditure program.

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The following summarizes the allocation of net income to the investment reserve for the years ended December 31,

	<u>2005</u>	<u>2004</u>
Profit for the year	865,647	513,028
(+) Revaluation reserve realization	89,449	104,500
(-) Interest on own capital	348,216	152,935
(-) Legal reserve 5%	<u>43,282</u>	<u>25,651</u>
Investment reserve	<u>563,598</u>	<u>438,942</u>

Management will propose to transfer the balance of retained earnings in the amount of R\$ 563,598 to the "Investment Reserve" account in order to meet the needs for investments out of own funds, as provided for in the Capital Budget.

(f) Legal (statutory) reserve

Under Brazilian Corporate Law, the Company is required to record a legal reserve to which it must allocate 5% of the adjusted net income each year until the amount of the reserve equals 20% of paid-in capital. Accumulated deficit, if any, may be charged against the legal reserve.

16. INSURANCE COVERAGE

Insurance policies held by the Company provide the following coverage, taking into account the risks and nature of the related assets:

<u>Type of insurance</u>	<u>Insured amount – R\$</u>
Engineering risk	605,483
Fire	290,692
Civil liability – officers and employees	80,008
Civil liability – construction in progress	5,689
Civil liability – operations	1,500

The Company does not have insurance coverage for business interruption risks nor for liabilities arising from contamination or other problems involving the supply of water to customers. In addition, the Company does not have insurance coverage for liabilities relating to non-compliance with environmental laws and regulations.

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**17. FINANCIAL INSTRUMENTS AND RISK**

In accordance with CVM Instruction No. 235/95, the Company has determined the market values of its assets and liabilities based on available information and appropriate valuation methodologies. Market values and book values of the Company's financial instruments at December 31, 2005 and 2004 are as follows:

	December 31, 2005			December 31, 2004		
	Book value	Market value	Unrealized gain	Book value	Market value	Unrealized gain
Financial investments (i)	155,718	155,718	-	55,919	55,919	-
Debentures (ii)	(918,367)	(955,630)	37,263	(1,309,412)	(1,364,223)	54,811
Loans and financing (ii)	(526,658)	(604,315)	77,657	(5,741,241)	(5,880,397)	139,156
	<u>(1,289,307)</u>	<u>(1,404,227)</u>	<u>114,920</u>	<u>(6,994,734)</u>	<u>(7,188,701)</u>	<u>193,967</u>

The market values determined by the Company were based on available information and appropriate valuation methodologies, both of which require considerable judgment and estimates. Consequently, the estimates of fair values presented above do not necessarily indicate the amounts that might be realized or settled in a current market transaction. The use of different market approaches and/or methodologies could have a significant effect on the estimated market values.

**(a) Exchange rate risk**

Exchange rate risk is the risk that the Company may incur losses due to exchange rate fluctuations, which could increase the liability balances and related financial expenses of loans and financing denominated in foreign currencies. The Company does not enter into hedge or swap transactions to mitigate foreign currency risk, given the amounts and related costs involved. However, at times, it may enter into forward exchange transactions and financial funding transactions in Brazilian reais to mitigate foreign currency exposure.

A significant portion of the Company's debt is denominated in foreign currency, primarily the US dollar and the Euro, totaling R\$ 1,575,948 (see Note 9). The Company's net exposure to the exchange rate risk at December 31, 2005 and 2004 is summarized as follows:

	In thousands			
	December 31, 2005		December 31, 2004	
	US\$	€	US\$	€
Loans and financing	<u>666,890</u>	<u>1,020</u>	<u>989,553</u>	<u>1,932</u>

**(b) Interest rate risk**

This risk arises out of the possibility for the Company to incur losses due to interest rates fluctuations that would increase its financial expenses related to loans and financing. The Company has not entered into hedge agreements to mitigate such risk. The Company does, however, continually monitors market interest rates in order to evaluate the possible need to replace or refinance its debt. On December 31, 2005 and 2004, the Company had loans and financing in the amount of R\$ 1,327,694 and R\$ 981,928, respectively, at variable interest rates (primarily indexed to CDI and TJLP).

Another risk faced by the Company is that adjustments to the Company's related water and sewage tariff rates are not necessarily correlated with the increases in the interest rates and price-level restatement indices associated with the Company's debt.



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**(c) Credit risk**

The Company manages credit risk principally by selling to a geographically dispersed customer base, including sales to municipal governments.

No single customer represented more than 10% of the Company's sales and services rendered in the years ended December 31, 2005, 2004, and 2003.

**(d) Drought weather risk**

The atypical meteorological conditions for the past three years, resulted in the need to launch institutional campaigns to encourage economical and rational use of water, which has led to a decrease in billed water volumes. At the same time, higher investments were required to mitigate the drought effects on the Company's water production systems. This drought period has required a reduction in water supply, with a consequent reduction in water volumes billed. In view of the present levels of the reservoirs, no rationing is estimated to occur in 2006.

**(e) Valuation of financial instruments**

The Company's main financial instruments of the Company as of December 31, 2005 and the criteria adopted for their valuation are as follows:

(i) Cash and cash equivalents – These comprise cash on hand, bank accounts, short-term investments and forward exchange transactions. The market value of these assets is not different from the amounts stated in the Company's balance sheet.

(ii) Loans and financing and debentures had their market value determined based on the discounted cash flow, using the interest rate projections available.

**18. GROSS REVENUE**

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Metropolitan São Paulo	4,044,191	3,456,837	3,268,768
Regional systems	<u>1,312,135</u>	<u>1,185,654</u>	<u>1,038,766</u>
Total	<u>5,356,326</u>	<u>4,642,491</u>	<u>4,307,534</u>

(a) In October 2003, the Company launched a new campaign "Watch the Water Level", involving advertisements in all media, together with a program consisting of discounts to customers who reduce their water consumption for the period from March to September 2004, by at least 20%, in relation to the average consumption determined by the Company. The Incentive Program for Water Consumption Reduction was implemented in the Metropolitan Region of São Paulo.

The program resulted in a reduction of R\$ 74.1 million in the revenue from water and sewage services in the Metropolitan Region of São Paulo during its effective period.

**19. OPERATING EXPENSES**

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Cost of sales and services:			
Payroll and related and charges	854,573	806,362	791,648
General supplies	105,333	84,489	77,250

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	2005	2004	2003
Treatment supplies	98,823	91,450	88,610
Outside services	297,469	260,423	207,176
Electric power	421,319	396,940	321,323
General expenses	40,603	35,044	33,419
Depreciation and amortization	<u>572,301</u>	<u>578,672</u>	<u>547,722</u>
Total cost of sales and services	<u>2,390,421</u>	<u>2,253,380</u>	<u>2,067,148</u>
Selling expenses:			
Payroll and related charges	142,687	138,180	130,978
General supplies	6,632	6,028	5,328
Outside services	82,354	66,956	82,515
Electric power	941	802	743
General expenses	46,667	46,025	37,924
Depreciation and amortization	3,291	2,952	2,421
Bad debt expense, net of recoveries (note 5(c))	<u>255,292</u>	<u>241,577</u>	<u>37,625</u>
Total selling expenses	<u>537,864</u>	<u>502,520</u>	<u>297,534</u>
Administrative expenses:			
Payroll and related charges	113,030	110,388	110,509
General supplies	3,973	3,527	3,424
Outside services	94,153	94,825	39,915
Electric power	1,250	904	816
General expenses	73,376	60,936	58,661
Depreciation and amortization	20,389	17,287	14,312
Tax expenses	<u>29,334</u>	<u>25,690</u>	<u>26,423</u>
Total administrative expenses	<u>335,505</u>	<u>313,557</u>	<u>254,060</u>
Total costs and expenses:			
Payroll and related charges	1,110,290	1,054,930	1,033,135
General supplies	115,938	94,044	86,002
Treatment supplies	98,823	91,450	88,610
Outside services	473,976	422,204	329,606
Electric power	423,510	398,646	322,882
General expenses	160,646	142,005	130,004
Depreciation and amortization	595,981	598,911	564,455
Tax expenses	29,334	25,690	26,423
Bad debt expense, net of recoveries	<u>255,292</u>	<u>241,577</u>	<u>37,625</u>
Total costs and expenses	<u>3,263,790</u>	<u>3,069,457</u>	<u>2,618,742</u>
Financial expenses:			
Interest and other charges on loans and financing - local currency	526,585	448,955	523,418
Interest and other charges on loans and financing - foreign currency	141,844	218,900	255,824

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	2005	2004	2003
Interest on shareholders' equity (note 15 (e))	348,216	152,935	504,089
Interest on shareholders' equity (reversal)	(348,216)	(152,935)	(504,089)
Other expenses on loans and financing	1,825	282	5,801
Income tax on remittances abroad	9,450	(23,786)	37,355
Other financial expenses	35,574	41,126	58,612
Monetary variations on loans and financing	80,411	76,057	144,689
Exchange variations on loans and financing	(312,116)	(179,697)	(540,569)
Other monetary and foreign exchange variations	1,611	21,257	33,268
Provisions	<u>76,482</u>	<u>38,483</u>	<u>138,440</u>
Total financial expenses	<u>561,666</u>	<u>641,577</u>	<u>656,838</u>
Financial income:			
Monetary variations	33,958	60,305	203,938
Income from financial investments	32,292	23,114	69,958
Interest	48,368	57,552	37,450
Other	<u>44</u>	<u>1</u>	<u>2</u>
Total financial income	114,662	140,972	311,348
COFINS and PASEP (taxes on financial income)	<u>-</u>	<u>(3,101)</u>	<u>(987)</u>
Total financial income – net of taxes on financial income	<u>114,662</u>	<u>137,871</u>	<u>310,361</u>
Financial expenses (income), net	<u>447,004</u>	<u>503,706</u>	<u>346,477</u>

20. MANAGEMENT COMPENSATION

Compensation paid by the Company to the members of its board of directors and management totaled R\$ 2,104, R\$ 1,838 and R\$ 1,478 for the years ended December 31, 2005, 2004 and 2003, respectively.

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**21. COMMITMENTS****(i) Operating leases**

Administrative operating leases and property leases already contracted require the following minimum, noncancellable payments:

2006	10,106
2007	2,766
2008	556
2009	<u>24</u>
Total	13,452

Lease expenses for the years ended December 31, 2005, 2004 and 2003 were R\$ 9,505, R\$ 11,300 and R\$ 11,800, respectively.

**(ii) Take-or-pay contracts**

The Company has entered into long-term take-or-pay-contracts with electric power providers. The minimum amounts payable under such arrangements are as follows:

2006	192,274
2007	167,994
2008	155,890
2009	159,623
2010	161,725
2011	166,968
2012	<u>139,530</u>
Total	1,144,004

Electric power expenses for the years ended December 31, 2005, 2004 and 2003 were R\$ 423,814, R\$ 398,744 and R\$ 322,460, respectively.

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**22. SUMMARY OF DIFFERENCES BETWEEN BR CL AND US GAAP**

The Company's primary financial statements have been prepared in accordance with BR CL which differs significantly from US GAAP as described below:

(a) Inflation accounting methodology and indices

In Brazil, because of highly inflationary conditions which prevailed in the past, a form of inflation accounting had been in use for many years to minimize the impact of the distortions in financial statements caused by inflation. Two methods of inflation accounting were developed: one required under BR CL; and the other known as the Constant Currency Method. The primary difference between BR CL and the Constant Currency Method relates to accounting for the effects of inflation. Under BR CL, inflation accounting was discontinued effective January 1, 1996. Prior to that date, BR CL required inflationary indexation of property, plant and equipment, investments, deferred charges and shareholders' equity, the net effect of which was reported in the statement of operations as a single line item. The Constant Currency Method is similar to U.S. Accounting Principles Board Statement No. 3 ("APS 3"), except that the former continues to apply inflationary accounting in periods of low inflation. Under US GAAP, the Brazilian economy ceased to be highly inflationary effective July 1, 1997. The other significant difference between the two sets of principles relates to the present-value discounting of fixed-rate receivables and payables, which is required by the Constant Currency Method and is prohibited under BR CL.

Financial statements prepared in accordance with BR CL have been, and continue to be, required of all Brazilian corporate entities and are used by the Brazilian tax authorities in determining taxable income. Financial statements prepared in accordance with the constant currency method were required through 1995 for those entities whose securities were registered with the CVM. Since 1996, presentation of supplemental financial statements under the Constant Currency Method has been optional.

(i) Additional inflation restatement in 1996 and 1997 for US GAAP

In the reconciliation from BR CL to US GAAP, consistent with the position paper prepared by the U.S. AICPA International Practice Task Force, an adjustment for inflation accounting has been included for the period from January 1, 1996 to December 31, 1997. During this period, inflation accounting was prohibited by BR CL but was required by APB statement 3 under US GAAP. Shareholders' equity under US GAAP was increased by R\$ 1,247,117 and R\$ 1,309,072 at December 31, 2005 and 2004, respectively, due to the additional inflation restatement adjustments.

(ii) Supplementary inflation restatement replaces revaluation of property, plant and equipment for US GAAP

The price-level restatement methodology under BR CL relied on an official inflation index announced by the Brazilian Federal government which was also used for purposes of determining taxes payable. Shortly after the launch of an economic stabilization plan in 1990, the government announced an inflation rate for that year which was materially understated in relation to the general and consumer price indexes as measured by independent economic institutes. In 1991, the government acknowledged this distortion and companies were required to re-present their statutory financial statements using a revised inflation index and the effects thereof were also used to determine income taxes, retroactively. The same law (Law No. 8,200/91) also granted companies the option (and the CVM required adoption when the effects were significant) to reprocess the accumulated inflation accounting effects since the date of acquisition of assets based on an independently sourced consumer or general price index. This supplemental indexation of property, plant and equipment, investments and deferred charges was to be

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recorded in the statutory BR CL accounting books but would have no effect for tax purposes. The Company anticipated the effects of this measure by contracting an independent firm of experts to perform an appraisal to market value of its property, plant and equipment and recorded the revaluation increment in its statutory BR CL accounting records, without affecting its tax position, in much the same way as Law No. 8,200/91 later required. As the revaluation increment had eliminated the effects of the supplemental price-level restatements, no further action was taken and the Company did not apply the incremental indexation.

Under US GAAP, revaluations of assets to market value are not permitted and the effects of the revaluation have been reversed in the reconciliation to US GAAP. However, in order to preserve the integrity of the historical cost of its assets based on the price-level restatement convention adopted by BR CL, the Company has recorded the supplemental price-level restatement adjustments, in accordance with Article 2 of Law No. 8,200/91, as an adjusting item in the reconciliation to US GAAP. The Company has presented the balances of shareholders' equity and net income (loss) under BR CL, adjusted for the effects of the revaluation and the replacement of the reversal by the supplemental price-level restatements, and related tax effects, as a subtotal, prior to presenting the reconciling items to US GAAP. The subtotal also includes the effects of including an additional two years' inflation accounting adjustments through to 1997 for purposes of US GAAP.

Shareholders' equity under US GAAP was increased by R\$ 2,924,881 and R\$ 3,028,301 at December 31, 2005 and 2004, respectively, due to the supplementary inflation restatement adjustments and reduced by R\$ 2,529,771 and R\$ 2,619,220 at December 31, 2005 and 2004, respectively, due to the reversal of the revaluations, before tax effects.

(iii) Inflation indices

The indexation of the financial statements through 1995, except for the year 1990, under BR CL was based on an official government index, the *Unidade Fiscal de Referência* - UFIR and for the year ended December 31, 1990 on a consumer price index (*Índice de Preços ao Consumidor*, or IPC). For purposes of US GAAP, a general price index, the *Índice Geral de Preços - Mercado*, or IGP-M, was used to record the additional inflation restatement in 1996 and 1997 and the supplementary inflation restatement through 1995 (see above).

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(b) Income taxes and social contribution

Under BR CL, deferred tax assets are recognized at the estimated amounts that management considers are probable to be recovered. In addition, deferred income taxes are shown gross rather than net.

Under US GAAP, deferred taxes are recorded on all temporary tax differences. Valuation allowances are established when it is more likely than not that deferred tax assets, including tax loss carryforwards, will not be recovered. Deferred tax assets and liabilities are classified as current or long-term based on the classification of the asset or liability underlying the temporary difference, and are presented net.

For purposes of deferred tax accounting, the US GAAP adjustments relating to monetary variation of land and the push-down expenses from the Plan G0 pension fund (j)(ii) below and sabbatical paid leave benefits are treated as permanent tax differences, as such items are not deductible for tax purposes by the Company.

Taxes on income in Brazil consist of two types of taxes: income tax and social contribution. In Brazil, the tax law and tax rates are sometimes significantly altered by provisional measures ("*medidas provisórias*") announced by Presidential decree. The provisional measures can affect tax rates as well as other areas that could impact deferred taxes. Until September 2001, these measures remained in force for one month and expired automatically if they were not extended for an additional one-month period. In September 2001 all provisional measures were automatically enacted, and the Presidential decree powers restricted. Under BR CL, when calculating deferred income taxes, the provisional measures are usually taken into account.

Under US GAAP, only enacted tax rates may be used to calculate deferred taxes. Tax rates for future periods which have been established by provisional measures are not considered to have been enacted and are ignored. However, the provisional measure, to the extent it has not lapsed, is used for determining the amount of current tax payable.

Shareholders' equity under US GAAP was reduced by R\$ 1,304,723 and R\$ 1,325,935 at December 31, 2005 and 2004, respectively, due to deferred tax adjustments on US GAAP differences, excluding revaluations and permanent differences related to monetary readjustment on land of approximately R\$ 150,0 million.

No valuation allowance adjustments were required to be included in the reconciliation between BR CL and US GAAP.

(c) Financial instruments and concentration of credit risk

Under BR CL, there are less detailed requirements regarding the disclosure of information on financial instruments not reflected on the balance sheet or on concentration of financial instruments with credit risk.

Under US GAAP, the applicable accounting practice for financial instruments depends on management's intention for their disposition and requires adjustments to their market or fair values. Additional information on face or contract or notional principal amount; nature and terms including (i) credit and market risk, (ii) cash requirements and (iii) accounting policy followed; amount of loss, if any party to the financial instrument fails to perform; and policy as to requiring collateral is required. Disclosure as to concentration of credit risk arising from all financial instruments is required to include information about the activity, region or other characteristic that identifies the concentration; amount of

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loss if parties to the concentrated risk fail to completely perform; and policy as to requiring collateral.

Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities" of the U.S. Financial Accounting Standards Board ("FASB") establishes accounting and reporting standards for derivative instruments and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities and measure those instruments at fair value. This statement was effective January 1, 2001 and did not have a significant impact on the Company's financial statements.

No adjustments have been included in the reconciliation from BR CL to US GAAP.

(d) Cash and cash equivalents

Under BR CL, cash equivalents are not defined.

Under US GAAP, SFAS No. 95, "Statement of Cash Flows", defines cash equivalents as short-term highly liquid investments that are both (i) readily convertible to known amounts of cash and (ii) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Generally, only investments with original maturities of three months or less qualify under that definition. No adjustments have been included in the reconciliation from BR CL to US GAAP, as the reported amounts of cash and cash equivalents under BR CL qualify under US GAAP.

(e) Investments in debt and equity securities

Under BR CL, marketable debt and equity securities are generally stated at the lower of inflation-indexed amortized cost or market value less interest or dividends received. Gains and losses are reflected in earnings.

Under US GAAP, in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities", the accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities is as follows:

- (i) Debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and are reported at amortized cost.
- (ii) Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings.
- (iii) Debt and equity securities not classified as either held to maturity or trading securities are classified as available for sale securities and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders' equity.

For purposes of US GAAP, certain unrealized gains and losses from the Company's available-for-sale securities are recorded directly in shareholders' equity, net of tax effects, until realized. Shareholders' equity under US GAAP was reduced by R\$ 30 and R\$ 92 at December 31, 2005 and 2004, respectively, for unrealized losses from available-for-sale securities.

(f) Property, plant and equipment

- (i) Revaluations of property, plant and equipment

BR CL permits appraisal write-ups, provided that certain formalities are complied with. The revaluation increment is credited to a reserve account in shareholders' equity. Depreciation of the asset revaluation increments is charged to income and an offsetting portion is relieved from the



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revaluation reserve in shareholders' equity and transferred to retained earnings as the related assets are depreciated or are disposed

For US GAAP reconciliation purposes, net revaluation of property, plant and equipment in the amounts of R\$ 2,529,771 and R\$ 2,619,220 at December 31, 2005 and 2004, respectively, have been eliminated in order to present property, plant and equipment at historical cost, indexed for inflation through 1997 based on a general price index, less accumulated depreciation. The depreciation on such revaluation charged to income, totaling R\$ 89,449, R\$ 104,500 and R\$ 134,245 for the years ended December 31, 2005, 2004 and 2003, respectively, has also been eliminated for US GAAP purposes in the reconciliation of net income.

Under BR CL, no deferred tax liability was recorded on the revaluation increment. Under US GAAP, although the depreciation from the additional inflation restatement ((a)(i) above) and the supplementary inflation restatement ((a)(ii) above) will not be deductible for tax purposes, these depreciation charges are considered to be temporary tax differences as the related expense will reverse through income in the future, and, as such, are recorded for purposes of determining deferred tax liabilities.

(ii) Different criteria for capitalizing and depreciating capitalized interest

Under BR CL, until December 31, 1995, capitalization of interest cost incurred during the construction period as part of the cost of the related property, plant and equipment was not required. However, as permitted by the Brazilian Water and Sewage Plan (*Plano Nacional de Saneamento Básico* - PLANASA), SABESP capitalized interest on construction-in-progress through 1989. Also, under BR CL as applied to companies in the utilities industry, during the period from 1979 to 1985, a notional interest rate was applied to construction-in-progress computed at the rate of 12% per annum of the balance of construction-in-progress; that part which related to interest on third-party loans was credited to interest expense based on actual interest costs with the balance relating to the self-financing portion being credited to capital reserves. Beginning in 1999, SABESP has capitalized interest, including indexation charges on the real - denominated loans and financing and the foreign exchange effects on foreign currency loans and financing.

Under US GAAP, in accordance with SFAS No. 34, "Capitalization of Interest Cost", interest incurred on borrowings is capitalized to the extent that borrowings do not exceed construction-in-progress. Such interest is capitalized as part of the cost of the related assets with a corresponding credit to financial expenses. Under US GAAP, the amount of interest capitalized excludes the indexation charges associated with real-denominated borrowings and the foreign exchange gains and losses on foreign currency denominated borrowings.

The effects of these different criteria for capitalizing and amortizing interest are presented below:

	<u>2005</u>	<u>2004</u>
Interest capitalized under US GAAP in the period from 1989 to 1995	208,826	208,826
Amortization thereof	(100,222)	(92,583)
Capitalized interest credited to income under BR CL (12% per annum, applied monthly to the balance of construction-in progress) in excess of actual interest	(32,983)	(32,983)
Amortization thereof	28,285	27,078
Indexation charges and foreign exchange losses capitalized since 1999 under BR CL, net	<u>27,528</u>	<u>(4,833)</u>
US GAAP difference in shareholders' equity at December 31	<u>131,434</u>	<u>105,505</u>
US GAAP difference on pre-tax income for the year ended December 31	<u>25,929</u>	<u>17,934</u>

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(iii) Valuation of long-lived assets

Under BR CL, companies are required to determine if operating income is sufficient to absorb the depreciation or amortization of long-lived assets, within the context of the balance sheet as a whole, in order to assess potential asset impairment. As it pertains to property, plant and equipment, in the event that such operating income is insufficient to recover the depreciation due to their permanent impairment, the assets, or groups of assets, are written-down to recoverable values, preferably, based on the projected discounted cash flows of future operations.

Under US GAAP, SFAS No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets", requires companies to periodically evaluate the carrying value of long-lived assets to be held and used, and for long lived assets to be disposed of, when events and circumstances require such a review. The carrying value of long-lived assets is considered impaired when the anticipated undiscounted cash flows from identified assets, representing the lowest level for which identifiable cash flows largely independent of the cash flows of other groups of assets and liabilities, is less than their carrying value. In that event, a loss is recognized to the extent that the carrying value exceeds the fair market value of the assets.

No adjustment has been included in the reconciliation from BR CL to US GAAP to take account of differences between the measurement criteria, as based on analysis of cash flows measured at the smallest unit of assets groups for which cash flow data is captured, no impairment provisions were required. Losses recognized on the write-off of property, plant and equipment arose primarily from adjustments related to the withdrawal of concession assets, construction-in-progress projects which were deemed to be no longer economically feasible and obsolescence write offs.

(g) Deferred charges

Under BR CL deferral of feasibility study costs and pre-operating expenses incurred in the construction or expansion of a new facility is permitted until such time as the facility begins commercial operations. Deferred charges are amortized over a period of five to ten years.

Under US GAAP, such amounts do not meet the conditions established for deferral, and accordingly, are charged to income as incurred.

The balance of feasibility study costs outstanding under BR CL was R\$ 20,531 and R\$ 39,097 at December 31, 2005 and 2004, respectively, and was written-off for US GAAP purposes. The net effects from amortization and deferrals in the statement of operations at December 31, 2005 and 2004 were an increase of R\$ 18,566 and R\$ 9,854 respectively, at December 31, 2003 was reduction of R\$ 3,894.

(h) Dismissal encouragement program

In December 2003 the Company announced a one-time, special dismissal encouragement / early retirement program. Under BR CL, the total estimated termination benefits for all employees who would formally accept the offer were accrued for at December 31, 2003. Under US GAAP, such benefits are considered special termination benefits, as defined in SFAS No. 88, "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits" and as such, are only allowed to be accrued as an expense when an employee accepts the offer. At December 31, 2003, approximately 330 employees had requested to apply to enter the dismissal encouragement program. In the reconciliation between BR CL and US GAAP, the difference between

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the estimated benefits under BR CL and the estimated benefits associated with those employees who had accepted offers at December 31, 2003 has been reversed for US GAAP. Such benefits were accrued and expensed in 2004. At December 31, 2004, 711 employees entered this program and the Company had paid R\$ 29,409.

(i) Pension benefits

Under BR CL, prior to 2002, amounts related to the pension plan were recorded on an accrual basis as the obligations for contributions fell due. In accordance with a new accounting standard issued by IBRACON and approved by the CVM, effective January 1, 2002, Brazilian public companies must account for pension obligations based on actuarial calculations and provide certain disclosures related to their pension plans. Under the new standard, the actuarial pension obligation determined at the date of adoption could be either recorded directly in shareholders' equity, or prospectively, during the five-year period ending December 31, 2006 in results of operations. As permitted, the Company has elected to recognize this transition obligation on a straight-line basis through income over five years beginning in 2002. The amortization of the liability is being presented as an "Extraordinary item" in the statements of operations, net of applicable tax effects.

Under US GAAP, the Company accounts for its pension plans in accordance with the provisions of SFAS No. 87, "Employers' Accounting for Pensions," which among other requirements, requires that the Company recognize the actuarially-determined liability of its pension plan obligations. SFAS No. 87 also requires that an additional liability (minimum pension liability) is required to be recorded when the accumulated benefit obligation exceeds the fair value of the plan assets, less accrued pension amounts. This additional minimum liability is recorded as a charge to accumulated other comprehensive income in equity.

Although the recently adopted accounting standard under BR CL requires the Company to recognize pension obligation based on actuarial methods effective January 1, 2002, differences under BR CL related to the prescribed actuarial methods, date of first adoption and amortization of transition obligations, among others, as compared with those under US GAAP, generate reconciling adjustments for US GAAP purposes.

SFAS No. 132 (revised 2003), "Employers' Disclosures about Pensions and Other Postretirement Benefits" sets forth the requirements for information that must be disclosed with respect to the Company's pension plans.

(i) Pension plan (Plan G1)

The Company sponsors a defined-benefit plan for its employees (Plan G1). For the purposes of calculating the funded status of Plan G1, the provisions of SFAS No. 87, were applied with effect from January 1, 1992, because it was not feasible to apply them from the effective date specified in the standard.

(ii) Supplementary pension plan (Plan G0)

Pursuant to a law enacted by the State Government, certain employees who provided service to the Company prior to May 1974 and retired as an employee of the Company acquired a legal right to receive supplemental pension payments (which rights are referred to as "Plan G0"). The Company pays these supplemental benefits on behalf of the State Government and makes claims for reimbursement from the State Government, which are recorded as accounts receivable, shareholder under BR CL. No expense is recognized for these benefits under BR CL.

Consistent with the guidance in SEC Staff Accounting Bulletin Topic 5-T ("SAB No. 5-T"), under US GAAP, the Company recognizes the costs and obligations associated with Plan G0 supplemental pension benefits incurred by the State Government on behalf of the Company with respect to its employees on a "push-down basis," as the Company is the recipient of the benefits

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of the employee service for which the supplemental pension benefits are made. These benefits are accounted for in accordance with SFAS No. 87. Eventual amounts received as reimbursement from the State Government, if any, are treated as additional paid-in-capital.

Retained earnings was reduced in the first year of presentation (1998) for the actuarial liability computed under SFAS No. 87. and the balance of amounts due from the State Government for pensions paid was charged to income, as this amount related to a charge for past services rendered by the Company's former employees. Amounts reimbursed to the Company by the State Government were accounted for as additional paid-in capital and a reduction of the actuarial liability to reflect gross benefits paid. The remaining unpaid reimbursable balance due from the State Government (effectively a subscription receivable) is charged off as a deduction to shareholders' equity.

(iii) Sabbatical paid leave

The Company also pays amounts equivalent to three months of vacation for each five years' of service as a form of sabbatical paid leave to certain of the Company's employees for which it also claims reimbursement from the State Government. Consistent with the guidance in SAB Topic 5-T, under US GAAP the Company recognizes the costs and obligations associated with these sabbatical leave benefits incurred by the State Government on behalf of the Company with respect to its employees on a "push-down basis," as the Company is the recipient of the benefits of the employee service for which the supplemental pension benefits are made. The Company has accounted for this sabbatical expense by relieving directly against retained earnings for the first year presented and subsequently the Company recognized as a charge to income the receivable due from the State Government, for sabbatical leave paid, as this amount relates to a charge for past services rendered by the Company's former/current employees. Amounts reimbursed by the State Government, if any, are accounted for as additional paid-in capital.

During the year ended December 31, 2000, in the financial statements prepared in accordance with BR CL, sabbatical leave accruals totaling R\$ 23,747, which had in prior years been charged to income, and were accounted for as a receivable (reimbursement) due from the State Government, were reversed, as the Company does not consider this to be an expense under BR CL. Similarly, during December 31, 2005, 2004 and 2003, total amounts not accrued were R\$ (968), R\$ (14,743) and R\$ 140, respectively. Such amounts, consistent with the US GAAP difference mentioned above, were 'pushed down' as expenses in the reconciliation to US GAAP.

(iv) Summary of pension benefits adjustments

The effects included in the shareholders' equity reconciliation arising from these different criteria for pension and benefit accounting are presented below:

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	<u>2005</u>	<u>2004</u>
Plan G1		
Accrued pension liability under US GAAP	(585,637)	(576,418)
Accrued pension liability under BR CL	<u>276,558</u>	<u>222,176</u>
Difference Plan G1 (i) (i)	<u>(309,079)</u>	<u>(354,242)</u>
Plan G0		
Accrued pension cost under US GAAP (i) (ii)	<u>(1,130,511)</u>	<u>(1,103,253)</u>
Sabbatical paid leave		
Recognition of reversed expense (i) (iii)	<u>(10,556)</u>	<u>(11,524)</u>
Push-down accounting of Plan G0 and sabbatical paid leave		
Gross amount paid for Plan G0 and sabbatical paid leave recorded as receivables from the State Government under BR CL (i)	<u>(787,685)</u>	<u>(691,296)</u>
Additional paid-in capital - Plan G0 and sabbatical paid leave reimbursed by the State Government (i)	<u>114,970</u>	<u>114,970</u>

The effects included in the reconciliation of net income (loss) arising from these different criteria for pension and benefit accounting are presented below:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Plan G1			
Accrued pension obligation Plan G1	<u>45,163</u>	<u>41,617</u>	<u>41,898</u>
Plan G0			
Accrued pension obligation Plan G0	<u>(27,258)</u>	<u>(37,148)</u>	<u>(121,306)</u>
Sabbatical paid leave			
Recognition of reversed expense	<u>968</u>	<u>14,743</u>	<u>(140)</u>
Push-down accounting of Plan G0 and sabbatical paid leave			
Gross amount paid for Plan G0 and sabbatical paid leave recorded as receivables from the State Government	<u>(96,388)</u>	<u>(85,340)</u>	<u>(87,123)</u>

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(j) Costs associated with issuance of debentures

Under BR CL the costs associated with issuance of debenture are recognized as a operational expenses. Under US GAAP, APB 21 – “Interest on Receivables and Payables” debt issue costs are deferred and amortized using the effective interest method over the remaining term of the applicable debt obligations. At December 31, 2005, the balance of deferred debt issue costs included as an adjustment to shareholders’ equity, primarily related to debt issue costs incurred in 2005 was R\$ 13,976, net of accumulated amortization.

(k) Segment reporting

Under BR CL, no separate segment reporting is required.

Under US GAAP, SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" establishes the standards for the manner in which public enterprises are required to report financial and descriptive information about their operating segments. SFAS No. 131 defines operating segments as components of an enterprise for which separate financial information is available and evaluated regularly as a means for assessing segment performance and allocating resources to segments. A measure of profit or loss, total assets and other related information are required to be disclosed for each operating segment.

The Company operates in two segments: water services and sewage services.

(l) Comprehensive income

BR CL does not embody the concept of comprehensive income.

Under US GAAP, the Company has adopted the provisions of SFAS No. 130, "Reporting Comprehensive Income." A foreign (i.e., non-U.S.) registrant may present the statement of comprehensive income in any format permitted by SFAS No. 130. The information required by SFAS No. 130, has been included in the condensed financial statement information as prepared in accordance with US GAAP below.

(m) Provision for dividends and interest on shareholders' equity

Under BR CL, at each annual balance sheet date management is required to propose a dividend distribution from earnings and accrue for this in the financial statements. Under BR CL, companies are permitted to distribute a notional amount of interest, subject to certain limitations, calculated based on the government TJLP interest rate, on shareholders' equity. Such amounts are deductible for tax purposes and are presented as a deduction from shareholders' equity. Although not affecting net income except for the tax benefit, in certain cases companies include this notional charge in interest expense and reverse the same amount before totaling net income. The Company presents the financial expense net of the reversal in its financial statements.

Under US GAAP, since proposed dividends must be ratified or modified at the annual shareholders' meeting, dividends would generally not be considered as declared at the balance sheet date and, as such, would not be accrued. However, because the State Government is the Company's controlling shareholder, the minimum dividend proposal when made by management at year end is maintained as a provision, and therefore, no adjustments has been included in the reconciliation from BR CL to US GAAP. Interim dividends paid or interest credited to shareholders as interest on shareholders' equity under BR CL is considered as declared for US GAAP purposes. Under US GAAP, no similar interest distribution concept exists.

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Distributions per share data (in the form of dividends or interest on shareholders' equity) is not required to be disclosed under BR CL.

Interest on shareholders' equity per thousand common shares for the years ended December 31, 2005, 2004 and 2003 were as follows:

		<u>December 31,</u>	
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Interest on shareholders' equity per thousand shares	12,23	5,37	17,70

No other dividend distributions, other than interest on shareholders' equity was declared by the Company for the years ended December 31, 2005, 2004 and 2003.

(n) Related parties

Under BR CL, related parties are generally defined in a more limited manner and require fewer disclosures than US GAAP. The Company has expanded its disclosure for purposes of BR CL.

No adjustments have been included in the reconciliation from BR CL to US GAAP.

(o) Items posted directly to shareholders' equity accounts

Under BR CL, various items are posted directly to shareholders' equity accounts. Examples include certain capitalized interest, the effects of adjustments to tax rates and tax incentive investment credits received. As noted in (a) above, Brazilian utility companies used to capitalize interest attributable to construction-in-progress at the rate of 12% per annum of the balance of construction-in-progress and that part which relates to interest on third-party loans is credited to interest expense based on actual interest costs with the balance relating to the self-financed portion being credited to capital reserves.

Under US GAAP, such items relating to third-party debt would be posted to the statement of operations. Since the original posting to equity accounts would, under US GAAP, be made directly to the statement of operations, these adjustments are included in the reconciliation of shareholders' equity and net income determined in accordance with US GAAP.

(p) Discounting

Under BR CL, discounting of trade receivables and payables to present value is not permitted. Under US GAAP, APB No. 21 "Interest on Receivables and Payables", such discounting, in certain cases, is required to record the effects of implicit interest income or expense or which are different from market rates on long-term assets and liabilities, except for transactions in which interest rates are affected by the tax attributes or legal restrictions prescribed by a government agency. The company does not have original long term agreements.

No adjustments have been included in the reconciliation from BR CL to US GAAP as the Company had no long-term trade accounts payables or receivables potentially subject to discounting at December 31, 2005 and 2004.

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(q) Classification of statement of operations line items

Under BR CL, as noted above, the classification of certain income and expense items is presented differently from US GAAP. The Company has recast its statement of operations under BR CL to present a condensed statement of operations prepared in accordance with US GAAP. The reclassifications are summarized as follows:

- (i) Interest income and interest expense, together with other financial charges, are displayed within operating income in the statement of operations presented in accordance with BR CL. Such amounts have been reclassified to non-operating income and expenses in the condensed statement of operations prepared in accordance with US GAAP.
- (ii) Under BR CL, gains and losses on the disposal or impairment of permanent assets are classified as non-operating income (expense). Under US GAAP, gains and losses on the disposal or impairment of property, plant and equipment are classified as an adjustment to operating income.
- (iii) Following the issue of a new accounting standard under BR CL, effective January 1, 2002, the Company is amortizing the related transition obligation related to Plan G1 over five years. The related amortization, as permitted, is being presented as an "Extraordinary item" net of taxes, in the statement of operations. Under US GAAP, this amortization expense would be included as part of operating income.

(r) Earnings per share

Under BR CL, net income (loss) per share is calculated on the number of shares outstanding at the balance sheet date. Information is disclosed per lot of one thousand shares, because this is the minimum number of shares of the Company that can be traded on the stock exchanges.

Under US GAAP, in accordance with SFAS No. 128, "Earnings per Share", the presentation of earnings per share is required for public companies, including earnings per share from continuing operations and net income per share on the face of the statement of operations, and the per share effect of changes in accounting principles, discontinued operations and extraordinary items either on the face of the statement of operations or in a note. A dual presentation is required: basic and diluted. Computations of basic and diluted earnings per share data are based on the weighted average number of shares outstanding during the period and all potentially dilutive shares outstanding during each period presented, respectively.

The weighted-average number of shares used in computing basic earnings per share for December 31, 2005, 2004 and 2003 was 28,479,577,827. The Company had no potentially dilutive shares outstanding during 2005, 2004 or 2003.

(s) Financial statement note disclosures

BR CL requires, in general, less information to be disclosed in the notes to the financial statements than US GAAP. The additional disclosures required by US GAAP which are relevant to these financial statements are included in this Note 22, 23 and 24.

(t) Leasing Transactions

Under Brazilian GAAP, generally, lessees account for long-term leases as operating leases, whereas in accordance with U.S. GAAP such leases could be accounted for as operating or capital leases. As a result, under Brazilian GAAP, lease payments by lessees with respect to leases are charged as an expense as incurred. Under U.S. GAAP, the lease payments may be charged as an expense as incurred (operating leases) or the leased asset and the corresponding lease liability may be recognized



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in the balance sheet and the effect of depreciation and interest expense in the results of operations (capital leases).

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**Net income (loss) reconciliation of the differences between  
BR CL and US GAAP**

The following is a reconciliation of the differences in net income (loss) between BR CL and US GAAP:

		<u>2005</u>	<u>2004</u>	<u>2003</u>
Net income (loss) as reported under BR CL		<u>865,647</u>	<u>513,028</u>	<u>833,320</u>
Depreciation of additional inflation restatement in 1996 and 1997	(a) (i)	(61,955)	(70,251)	(86,354)
Reversal of depreciation of revaluation increments	(f) (i)	89,449	104,500	134,245
Depreciation of supplementary restatement prior to 1991	(a)(ii)	(103,420)	(120,820)	(155,213)
Deferred tax effects on above (excluding revaluation)	(b)	56,228	64,964	82,133
Accrued pension cost - Plan G1	(i) (iv)	45,163	41,617	41,898
Accrued supplementary pension cost - Plan G0	(i) (iv)	(27,258)	(37,148)	(121,306)
Sabbatical leave benefits	(i) (iv)	968	14,743	(140)
Actuarial liability (Plan G0) and sabbatical leave benefits push-down recognition	(i) (iv)	(96,388)	(85,340)	(87,123)
Capitalized interest	(f) (ii)	25,929	17,934	9,032
Interests on capital leasing	(t)	(645)	-	-
Deferred charges, net of effects of accumulated amortization		18,566	9,854	(3,894)
Costs associated with issuance of debentures	(j)	<u>13,976</u>	-	-
Dismissal Encouragement Program	(h)	-	<u>(18,113)</u>	<u>18,113</u>
		<u>826,260</u>	<u>434,968</u>	<u>664,711</u>
Deferred income taxes effects:				
Other GAAP differences above, excluding reversal of revaluation increments	(b)	<u>(35,016)</u>	<u>(17,439)</u>	<u>(22,151)</u>
Net income (loss) under US GAAP		<u>791,244</u>	<u>417,529</u>	<u>642,560</u>
Net income (loss) per thousand common shares Basic and diluted (in reais)	(r)	<u>27,78</u>	<u>14,66</u>	<u>22,56</u>
Weighted average number of common shares outstanding (thousand shares)	(r)	28,479,578	28,479,578	28,479,578

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**Shareholders' equity reconciliation of the differences  
between BR CL and US GAAP**

The following is a reconciliation of the differences in shareholders' equity between BR CL and US GAAP:

		<u>2005</u>	<u>2004</u>
Shareholders' equity, as reported under BR CL		8,482,548	7,951,588
Add (deduct):			
Additional inflation restatement in 1996 and 1997, net	(a) (i)	1,247,117	1,309,072
Reversal of revaluation increments, net	(a)(ii)	(2,529,771)	(2,619,220)
Supplementary restatement prior to 1991, net	(a)(ii)	2,924,881	3,028,301
Deferred tax effects on above (excluding revaluation, monetary adjustment on land)	(b)	(1,367,571)	(1,423,798)
Shareholders' equity, as reported under BR CL, adjusted for inflation restatements and revaluations		8,757,204	8,245,943
Accrued pension cost - Plan G1	(i) (i)	(309,079)	(354,242)
Accrued supplementary pension cost -Plan G0	(i) (ii)	(1,130,511)	(1,103,253)
Actuarial liability (Plan G0) and sabbatical leave expense push-down recognition	(i)	(787,684)	(691,296)
Additional paid-in capital - Plan G0 and sabbatical expense reimbursed by the State Government	(i)	114,970	114,970
Sabbatical paid leave of absence benefits	(i) (iii)	(10,556)	(11,524)
Capitalized interest	(f) (ii)	131,434	105,505
Interests on capital leasing	(t)	(645)	-
Deferred charges expensed, net	(g)	(20,531)	(39,097)
Costs associated with issuance of debentures	(j)	13,976	-
Other GAAP differences	(b)	(30)	(92)
Deferred income taxes effects:			
Other deferred tax effects on US GAAP differences above, excluding adjustments for available-for-sale securities, inflation restatements and revaluation increments		62,848	97,863
Shareholders' equity under US GAAP		6,821,396	6,364,777

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**Supplemental Condensed Financial Statement Information in Accordance with US GAAP**

The following presents condensed financial statement information in accordance with US GAAP.

	<u>2005</u>	<u>2004</u>
<b>Assets</b>		
Current assets		
Cash and cash equivalents	280,173	105,557
Customer accounts receivable, net	1,195,249	949,792
Receivables from shareholder, net	166,356	81,334
Inventories	36,070	29,604
Other current assets	<u>27,768</u>	<u>33,288</u>
Total current assets	<u>1,705,616</u>	<u>1,199,575</u>
Investments	710	5,008
Intangible assets – concession rights, net	502,518	517,386
Property, plant and equipment, net	15,393,916	15,347,194
Other long-term assets		
Customer accounts receivable, net	263,356	278,060
Receivables from shareholder, net	127,880	164,283
Escrow deposits	27,926	16,189
Indemnities receivable	148,794	148,794
Other assets	<u>43,151</u>	<u>27,976</u>
	<u>611,107</u>	<u>635,302</u>
Total assets	<u>18,213,867</u>	<u>17,704,465</u>

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	<u>2005</u>	<u>2004</u>
Liabilities and shareholders' equity		
Current liabilities		
Accounts payable to suppliers and contractors	77,781	51,578
Loans and financing	759,013	1,496,810
Accrued payroll and related charges	117,289	107,228
Deferred income taxes	47,378	41,687
Taxes payable	106,131	115,119
Provisions for contingencies	31,557	30,373
Interest on shareholders' equity	409,725	144,078
Other current liabilities	<u>137,452</u>	<u>95,325</u>
Total current liabilities	<u>1,686,326</u>	<u>2,082,198</u>
Long-term liabilities		
Loans and financing	5,905,208	5,553,843
Taxes payable	256,114	272,338
Accrued pension obligation		
Plan G0	1,130,511	1,103,253
Plan G1	585,637	576,418
Provisions for contingencies	580,840	460,231
Deferred income taxes	1,139,346	1,198,719
Other liabilities	<u>108,489</u>	<u>92,688</u>
Total long-term liabilities	<u>9,706,145</u>	<u>9,257,490</u>
Commitments and contingencies		
Shareholders' equity		
Paid-in capital	3,518,658	3,518,658
Capital reserves	78,820	65,291
Supplementary and additional inflation restatement reserves	4,171,998	4,337,373
Appropriated earnings	215,273	171,991
Accumulated deficit	<u>(1,163,353)</u>	<u>(1,728,536)</u>
Total shareholders' equity	<u>6,821,396</u>	<u>6,364,777</u>
Total liabilities and shareholders' equity	<u>18,213,867</u>	<u>17,704,465</u>

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**Condensed Statements of Operations in accordance with US GAAP**

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Gross revenue from sales and services	5,356,326	4,642,491	4,307,534
Taxes on sales and services	<u>(402,963)</u>	<u>(245,419)</u>	<u>(176,782)</u>
Net revenue from sales and services	4,953,363	4,397,072	4,130,752
Cost of sales and services	<u>(2,584,226)</u>	<u>(2,443,965)</u>	<u>(2,277,444)</u>
Gross profit	2,369,137	1,953,107	1,853,308
Operating expenses			
Selling	(555,468)	(521,532)	(323,444)
Administrative	(336,101)	(324,119)	(276,644)
Other operating expenses, net	<u>(7,356)</u>	<u>(34,465)</u>	<u>(116,686)</u>
Income from operations	1,470,212	1,072,991	1,136,534
Financial expenses, net	<u>(401,894)</u>	<u>(479,243)</u>	<u>(329,413)</u>
Income (loss) before taxes on income	1,068,318	593,748	807,121
Income and social contribution taxes	<u>(277,074)</u>	<u>(176,219)</u>	<u>(164,561)</u>
Net income (loss) for the year	<u>791,244</u>	<u>417,529</u>	<u>642,560</u>
Net income (loss) per thousand shares Basic and diluted (in reais)	<u>27.78</u>	<u>14.66</u>	<u>22.56</u>
Weighted average number of common shares outstanding – thousands	<u>28,479,578</u>	<u>28,479,578</u>	<u>28,479,578</u>

**Condensed Statement of Comprehensive Income (Loss) in accordance with US GAAP (under SFAS No. 130)**

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Net income (loss) for the year	791,244	417,529	642,560
Unrealized gains (losses) on available-for-sale securities	<u>62</u>	<u>7</u>	<u>86</u>
Comprehensive income (loss)	<u>791,306</u>	<u>417,536</u>	<u>642,646</u>

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**Condensed Statement of Changes in Shareholders' Equity  
in accordance with US GAAP**

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Balance at beginning of the year	6,364,777	6,085,624	5,945,831
Donations	13,529	14,552	1,236
Unrealized gains (losses) on available-for-sale securities	62	7	86
Net income (loss) for the year	791,244	417,529	642,560
Interest on shareholders' equity	<u>(348,216)</u>	<u>(152,935)</u>	<u>(504,089)</u>
Balance at end of the year	<u>6,821,396</u>	<u>6,364,777</u>	<u>6,085,624</u>

(t) New and recently issued US GAAP accounting pronouncements

In June 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3". SFAS 154 requires retrospective application to financial statements of prior periods for changes in accounting principles as if such principles had always been used. The cumulative effect of the change is reflected in the carrying value of assets and liabilities as of the first period presented and the offsetting adjustments are recorded to opening retained earnings. This statement is effective January 1, 2006. The Company will apply this statement as of January 1, 2006 as such changes in accounting principles occur.

In March 2005, the FASB issued FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations". This statement requires companies to recognize a liability for the fair value of a legal obligation to perform asset retirement obligations that are conditional on a future event if the amount can be reasonably estimated. This statement becomes effective on December 31, 2005. Management has previously evaluated the application of FASB Statement No. 143 to its operations and concluded that no material effects would be expected.

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**23. ADDITIONAL DISCLOSURES REQUIRED UNDER US GAAP****(a) Pension and post-retirement benefits****(i) Pension plan - Plan G1**

The Company sponsors a defined-benefit pension plan ("Plan G1"), which is operated and administered by "SABESPREV". The status of this pension plan and the related actuarial assumptions presented in accordance with US GAAP are as follows:

	<u>2005</u>	<u>2004</u>	
Accumulated benefit obligation			
Vested	369,490	364,807	
Non-vested	<u>270,764</u>	<u>192,284</u>	
Total	<u>640,254</u>	<u>557,091</u>	
Projected benefit obligation	790,552	760,015	
Fair value of plan assets	<u>(678,185)</u>	<u>(584,702)</u>	
Funded position	<u>112,367</u>	<u>175,313</u>	
Unrecognized net transition obligation	(29,082)	(58,164)	
Unrecognized net gains	<u>502,352</u>	<u>459,269</u>	
Accrued pension liability	<u>585,637</u>	<u>576,418</u>	
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Net periodic pension cost			
Service cost	9,889	11,960	11,324
Interest cost	91,886	93,991	102,319
Expected return on assets	(70,222)	(58,478)	(66,364)
Amortization of transition obligation	29,082	29,082	29,082
Amortization of actuarial gain	(26,341)	(17,484)	(17,765)
Employee contributions	<u>(13,752)</u>	<u>(13,754)</u>	<u>(11,678)</u>
Total net periodic pension cost	<u>20,542</u>	<u>45,317</u>	<u>46,918</u>
<b>Weighted-average assumptions</b>			
Discount rate (nominal)	12.3%	12.3%	12.3%
Projected long-term inflation rate	4.0%	4.0%	4.0%
Expected return on plan assets	12.1%	12.1%	12.1%
Rate of compensation increase	6.1%	6.1%	6.1%



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The reconciliation of changes in the projected benefit obligation and the fair value of plan assets is as follows for the years ended December 31:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Change in projected benefit obligation			
At beginning of year	760,015	774,126	666,248
Service cost	9,889	11,960	11,324
Interest cost	91,886	93,991	102,319
Actuarial (gain) loss	(40,978)	(93,546)	16,389
Benefits paid	<u>(30,260)</u>	<u>(26,516)</u>	<u>(22,154)</u>
At end of year	<u>790,552</u>	<u>760,015</u>	<u>774,126</u>
Change in fair value of plan assets			
At beginning of year	584,702	482,881	380,472
Actual return on plan assets	98,667	104,015	99,501
Employer contributions	11,324	10,298	11,612
Employee contributions	13,752	14,024	13,450
Gross benefits paid	<u>(30,260)</u>	<u>(26,516)</u>	<u>(22,154)</u>
At end of year	<u>678,185</u>	<u>584,702</u>	<u>482,881</u>
Funded status	112,367	175,313	291,245
Unrecognized actuarial gain	502,352	459,269	337,400
Unrecognized net transition obligation	<u>(29,082)</u>	<u>(58,164)</u>	<u>(87,246)</u>
Net amounts recognized in financial statements	<u>585,637</u>	<u>576,418</u>	<u>541,399</u>

The date used to determine pension benefits was December 31, 2005.

The amortization of the unrecognized liability at transition is over 16 years commencing on January 1, 1990.

The expected long-term rate of return on plan assets was determined based on the weighted average estimated return of the plan assets, which includes equity securities, real state, loans and fixed income, based on information obtained from "SABESPREV". This projected long-term rate includes the projected long-term inflation rate and takes into consideration such factors as projected future interest yield curves and economic projections available in the market.

The plan's investment policies and strategies are aimed to reduce investment risk through diversification, considering such factors as the liquidity needs and funded status of plan liabilities, types and availability of financial instruments in the local market, general economic conditions and forecasts as well as requirements under local pension plan law. The plan's asset allocation and external asset management strategies are determined with the support of reports and analyses prepared by "SABESPREV" and independent financial consultants. Under its current investment strategy, pension assets of the Company are allocated with a goal to achieve the following distribution:

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<u>Asset category</u>	<u>%</u>
Cash	0.44
Equity securities	18.19
Real estate	7.48
Loans	2.96
Fixed income	<u>70.93</u>
Total	100.00

Restrictions with respect to asset portfolio investments, in the case of federal government securities for internal management, are as follows:

- papers securitized by the National Treasury will not be permitted.
- exposure to fluctuations in exchange rates will not be permitted, i.e., if there are any exchange bills in the portfolio, swaps must be used to hedge existing exposure.

Restrictions with respect to asset portfolio investments, in the case of variable-income securities for external management, are as follows

- day-trade operations will not be permitted.
- sale of uncovered options is prohibited.
- swap operations without guarantee are prohibited.
- leverage will not be permitted, i.e., operations with derivatives representing leverage of asset or selling short are prohibited; such operations cannot result in losses higher than invested amounts.

The weighted average actual asset allocations of Plan G1 at December 31 by asset category, are as follows for the years ended December 31:

<u>Asset Category</u>	<u>%</u>	
	<u>2005</u>	<u>2004</u>
Equity securities	15	15
Real estate	6	6
Fixed income	<u>79</u>	<u>79</u>
Total	<u>100</u>	<u>100</u>

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Expected future benefit payments, which reflect expected future service as appropriate, under Plan G1 are as follows:

	<u>G1 Plan</u>
2006	35,336
2007	39,309
2008	42,842
2009	46,853
2010	51,613
Years 2011-2015	<u>359,361</u>
Total	<u>575,314</u>

The expected Company's contributions for 2006 amounts to R\$ 11,776.

(iv) Supplementary pension plan - Plan G0

The Company is also co-obligor to a supplemental defined benefit pension plan ("Plan G0") .

The status of the supplemental pension benefit plan and the related actuarial assumptions used in accordance with US GAAP are as follows:

	<u>2005</u>	<u>2004</u>
Accumulated benefit obligation		
Vested	1,006,397	976,986
Non-vested	<u>83,681</u>	<u>48,611</u>
Total	<u>1,090,078</u>	<u>1,025,597</u>
Projected benefit obligation	<u>1,096,517</u>	<u>1,034,285</u>
Funded position	<u>1,096,517</u>	<u>1,034,285</u>
Unrecognized actuarial gain	<u>33,994</u>	<u>68,968</u>
Accrued pension liability	<u>1,130,511</u>	<u>1,103,253</u>

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	<u>2005</u>	<u>2004</u>	<u>2003</u>
Net periodic pension cost			
Service cost	1,858	2,531	2,584
Interest cost	121,685	117,547	142,847
Amortization of transition obligation	-	-	61,684
Total net periodic pension cost	<u>123,543</u>	<u>120,078</u>	<u>207,115</u>
Weighted-average assumptions			
Discount rate (nominal)	12.3%	12.3%	12.3%
Projected long-term inflation rate	4.0%	4.0%	4.0%
Rate of compensation increase	6.1%	6.1%	6.1%

The reconciliation of changes in the projected benefit obligation is as follows:

	<u>Years Ended December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
Change in projected benefit obligation			
At beginning of year	1,034,285	997,534	959,168
Service cost	1,858	2,531	2,584
Interest cost	121,685	117,547	142,847
Actuarial (gain) loss	34,975	(397)	(21,256)
Benefits paid	<u>(96,285)</u>	<u>(82,930)</u>	<u>(85,809)</u>
At end of year	<u>1,096,518</u>	<u>1,034,285</u>	<u>997,534</u>
Funded status	1,096,518	1,034,285	997,534
Unrecognized actuarial gain	33,993	68,968	68,571
Net amount recognized	<u>1,130,511</u>	<u>1,103,253</u>	<u>1,066,105</u>

The date used to determine pension benefits was December 31, 2005.

The amortization of the unrecognized liability at transition was over 15 years commencing on January 1, 1988.

Expected future benefit payments, which reflect expected future service as appropriate, under Plan G0 are as follows:

2006	102,044
2007	105,654
2008	109,207
2009	112,733
2010	116,214
Years 2011-2015	<u>630,510</u>
Total	<u>1,176,362</u>

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(b) Other information

(i) Concentration of labor in unions –

Approximately 70% of all the Company's employees are members of unions. The four main unions that represent the Company's employees are the *Sindicato dos Trabalhadores em Água, Esgoto e Meio Ambiente de São Paulo*—SINTAEMA, *Sindicato dos Trabalhadores da Região Urbana de Santos, São Vicente, Baixada Santista, Litoral Sul e Vale Ribeira*—SINTIUS, the *Sindicato dos Engenheiros do Estado de São Paulo*—SEESP and the *Sindicato dos Advogados de São Paulo*—SASP. Every year the Company negotiates collective bargaining agreements, which establish the level of compensation and other benefits of the employees.

(ii) Proposed regulations/pending legislation for the basic sanitation sector

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

Currently, several bills are under debate at the Brazilian Federal Congress and at the Brazilian Senate. Both Houses of Representatives have agreed upon the creation of a joint committee (*comissão mista*) that will be responsible for the organization and systemization of the proposed regulation for water and sewage services in Brazil. Any proposed regulation, when and if approved, could establish a new municipal regulatory authority for the sanitation industry that may, in part, preempt the existing State regulatory authorities under which we operate in the Metropolitan Region.

(iii) State elections in 2006

Many of the Company's 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. They may be particularly open to reconsideration following State elections, which are next scheduled to be held in October 2006. Among the practices that could change are those described below concerning the application of dividends to offset accounts receivable from the State, the provision of State guarantees, and the terms on which the Company uses state-owned reservoir facilities.

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**24. STATEMENT OF CASH FLOW**

The statement of cash flows reflects the Company's operating, investing and financing activities derived from accounting records prepared in accordance with BR CL and has been presented in accordance with International Accounting Standards (IAS) No. 7 - "Cash Flow Statements".

	<u>Years Ended December 31,</u>		
	<u>2005</u>	<u>2004</u>	<u>2003</u>
<b>Cash flows from operating activities:</b>			
Net income for the year	865,647	513,028	833,320
Adjustments to reconcile net income:			
Deferred taxes	(32,470)	340	16,617
Loss on disposal of property, plant and equipment	19,051	34,440	62,634
Provisions for contingencies	135,714	91,183	156,793
Pension obligation	68,665	89,906	77,204
Property, plant and equipment received as donations			(2,428)
Loss on write-off of deferred assets	6,700		
Provision for investments	4,360		
Depreciation	564,392	570,353	544,731
Amortization	31,589	28,558	19,724
Interest calculated on loans and credit facilities payable	677,921	693,684	802,946
Foreign exchange and indexation on loans and financings	(226,573)	(101,718)	(396,117)
Bad debt expense – net of recoveries	255,292	241,577	37,625
Variation in assets:			
Accounts receivable, net	(486,045)	(413,886)	(479,368)
Inventories	(6,466)	(7,296)	334
Accounts receivable from shareholder	(124,379)	(271,604)	(170,837)
Other assets	(7,416)	(20,639)	67,626
Variation in liabilities:			
Accounts payable to suppliers and contractors	26,203	(356)	15,323
Accrued payroll and related charges	10,061	(28,066)	49,543
Taxes payable	(50,064)	6,639	3,012
Provisions for contingencies	(13,921)	(4,416)	(314)
Other liabilities	36,567	14,399	16,922
Net cash provided by operating activities	<b><u>1,754,828</u></b>	<b><u>1,436,126</u></b>	<b><u>1,655,290</u></b>
Cash flows from investing activities:			
Purchase of property, plant and equipment	(660,373)	(670,257)	(641,302)
Proceeds from the sale of property, plant and equipment		176	7
Increase in deferred assets	(106)	(444)	(9,469)
Net cash used in investing activities	<b><u>(660,479)</u></b>	<b><u>(670,525)</u></b>	<b><u>(650,764)</u></b>
Cash flows from financing activities:			
Loans and financing			
Funds raised	1,153,479	910,722	918,623
Repayments	(1,991,370)	(1,719,283)	(1,937,286)
Payment of interest on shareholder's equity	(81,842)	(132,496)	(119,521)
Net cash used in financing activities	<b><u>919,733</u></b>	<b><u>(941,057)</u></b>	<b><u>(1,138,184)</u></b>
Increase (decrease) in cash / cash equivalents	<u>174,616</u>	<u>(175,456)</u>	<u>(133,658)</u>
Cash and cash equivalents at the beginning of year	<u>105,557</u>	<u>281,013</u>	<u>414,671</u>
Cash and cash equivalents at the end of year	<u>280,173</u>	<u>105,557</u>	<u>281,013</u>
	<u>2005</u>	<u>2004</u>	<u>2003</u>
<b>Supplementary cash flow information:</b>			
Interest paid on loans and financing	701,641	701,261	856,331

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	<u>2005</u>	<u>2004</u>	<u>2003</u>
Income tax and social contribution paid	359,826	129,973	130,731
<b>Non - cash transactions</b>			
Property, plant & equipment received as donations and/or paid for with shares	13,529	14,552	3,664
<b>Acquisition related to São Bernardo de Campo</b>			
Purchase price			415,471
Settlement of customer accounts receivable			(265,432)
Amounts payable (other current liabilities)			(100,526)
Cash paid in 2003			49,513

## 25. SEGMENT INFORMATION

The Company has two identifiable reportable segments: (i) water supply systems; and (ii) sewage collection systems. The chief operating decision maker uses these two segments to analyse the Company and uses income from operations before financial expenses, net as a measure of segment profit or loss.

Total assets by segment is not readily available, and therefore not regularly provided to, nor reviewed by the Company's chief operating decision maker. However, total property, plant and equipment by segment is readily available and reviewed regularly by the Company's chief operating decision maker to make decisions about resource allocations and to measure performance. As such, management believes that total property, plant and equipment is a relevant measure for its operating segments and is disclosed by segment in Note 8.

	<u>Year Ended December 31, 2005</u>		
	<u>Water</u>	<u>Sewage</u>	<u>Consolidated</u>
	<u>system</u>	<u>system</u>	
Gross revenue from sales and services	2,771,633	2,256,857	5,028,490
Gross sales revenue – wholesale	241,209	-	241,209
Other sales and services	<u>57,034</u>	<u>29,593</u>	<u>86,627</u>
	3,069,876	2,286,450	5,356,326
Taxes on sales and services	<u>(213,394)</u>	<u>(189,569)</u>	<u>(402,963)</u>
Net revenue from sales and services	2,856,482	2,096,881	4,953,363
Cost of sales and services and operating expenses	<u>(2,205,146)</u>	<u>(1,058,644)</u>	<u>(3,263,790)</u>
Income from operations before financial expenses, net	<u>651,336</u>	<u>1,038,237</u>	<u>1,689,573</u>

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<u>Year Ended December 31, 2005</u>				
	<u>Water system</u>	<u>Sewage System</u>	<u>Common assets and concession assets acquired</u>	<u>Consolidated</u>
Depreciation and amortization charges				
BR CL	(336,450)	(259,531)	-	(595,981)
US GAAP	(392,449)	(302,728)	-	(695,177)
Additions to property, plant and equipment				
BR CL	301,815	345,426	30,995	678,236
US GAAP	301,815	376,560	30,995	709,370

<u>Year Ended December 31, 2004</u>			
	<u>Water system</u>	<u>Sewage system</u>	<u>Consolidated</u>
Gross revenue from sales and services	2,396,159	1,939,971	4,336,130
Gross sales revenue – wholesale	217,378	-	217,378
Other sales and services	<u>60,931</u>	<u>28,052</u>	<u>88,983</u>
	2,674,468	1,968,023	4,642,491
Taxes on sales and services	<u>(133,494)</u>	<u>(111,925)</u>	<u>(245,419)</u>
Net revenue from sales and services	2,540,974	1,856,098	4,397,072
Cost of sales and services and operating expenses	<u>(2,051,911)</u>	<u>(1,017,546)</u>	<u>(3,069,457)</u>
Income from operations before financial expenses, net	<u>489,063</u>	<u>838,552</u>	<u>1,327,615</u>



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	Year Ended December 31, 2004			
	Water <u>system</u>	Sewage <u>System</u>	Common assets and concession assets <u>acquired</u>	<u>Consolidated</u>
Depreciation and amortization charges				
BR CL	(333,200)	(265,711)	-	(598,911)
US GAAP	(380,346)	(303,308)	-	(683,654)
Additions to property, plant and equipment				
BR CL	207,651	336,545	56,707	600,903
US GAAP	207,651	359,437	56,707	623,795

	Year Ended December 31, 2003		
	Water <u>system</u>	Sewage <u>system</u>	<u>Consolidated</u>
Gross revenue from sales and services	2,190,971	1,756,399	3,947,370
Gross sales revenue – wholesale	262,045	-	262,045
Other sales and services	<u>66,110</u>	<u>32,009</u>	<u>98,119</u>
	2,519,126	1,788,408	4,307,534
Taxes on sales and services	<u>(100,911)</u>	<u>(75,871)</u>	<u>(176,782)</u>
Net revenue from sales and services	2,418,215	1,712,537	4,130,752
Cost of sales and services and operating expenses	<u>(1,729,605)</u>	<u>(889,137)</u>	<u>(2,618,742)</u>
Income from operations before financial expenses, net	<u>688,610</u>	<u>823,400</u>	<u>1,512,010</u>

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	<u>Year Ended December 31, 2003</u>			
	Water	Sewage	Common assets and concession assets <u>acquired</u>	<u>Consolidated</u>
	<u>system</u>	<u>System</u>		
Depreciation and amortization charges				
BR CL	(316,218)	(248,237)	-	(564,455)
US GAAP	(346,573)	(272,067)	-	(618,640)
Additions to property, plant and equipment				
BR CL	154,333	409,391	445,641	1,009,365
US GAAP	154,333	424,388	445,641	1,024,362

**PRINCIPAL EXECUTIVE OFFICES OF**

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**

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

**TRUSTEE, TRANSFER AGENT, REGISTRAR AND PRINCIPAL PAYING AGENT**

**Deutsche Bank Trust Company Americas**

60 Wall Street, 27th Floor  
Mail Stop: NYC60-2710  
New York, New York 10005  
USA

**LUXEMBOURG LISTING AGENT AND PAYING AGENT IN LUXEMBOURG**

**Deutsche Bank Trust Luxembourg**

2 Boulevard Konrad Adenauer  
L-1115 Luxembourg

**LEGAL ADVISORS**

*To Companhia de Saneamento Básico do  
Estado de São Paulo - SABESP as to  
United States Law*

**Shearman & Sterling LLP**

Av. Brigadeiro Faria Lima 3400, 17th floor  
04538-132 São Paulo, SP  
Brazil

*To Companhia de Saneamento Básico do  
Estado de São Paulo - SABESP as to  
Brazilian Law*

**Mattos Filho, Veiga Filho, Marrey Jr. e  
Quiroga Advogados**

Al. Joaquim Eugênio de Lima, 447  
01403-001 São Paulo, SP  
Brazil

*To the Initial Purchaser  
as to United States Law*

**White & Case LLP**

1155 Avenue of the Americas  
New York, New York 10036  
USA

*To the Initial Purchaser  
as to Brazilian Law*

**Souza, Cescon Avedissian, Barrieu e  
Flesch Advogados**

Rua Funchal, 263, 11º andar  
04551-060 São Paulo, SP  
Brazil

**INDEPENDENT PUBLIC ACCOUNTANTS**

*To Companhia de Saneamento Básico do Estado de São Paulo - SABESP*

**Deloitte Touche Tohmatsu Auditores Independentes**

Rua Alexandre Dumas, 1981  
04717-906 São Paulo, SP  
Brazil

