



COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO—SABESP
(Basic Sanitation Company of the State of São Paulo—SABESP)

5,006,495 American Depositary Shares

Each American Depositary Share, or ADS, represents 250 common shares (*ações ordinárias*), without par value, of Companhia de Saneamento Básico do Estado de São Paulo—SABESP, a Brazilian company. The ADSs are being offered by the State of São Paulo, as selling shareholder, through the underwriters named herein, as international underwriters. We will not receive any of the proceeds from the sale by the selling shareholder of the ADSs and the common shares.

The international underwriters are offering 5,006,495 ADSs in the United States and in other countries outside of Brazil. Brazilian underwriters are concurrently offering 3,363,636,250 common shares in a public offering in Brazil. To the extent that the underwriters sell a number of shares higher than the number offered for sale in the global offering, the international underwriters have the option to purchase from the selling shareholder up to an additional 692,289,000 common shares represented by ADSs within 30 days from the date of this prospectus solely to cover over-allotments. The closings of the international and Brazilian offerings will be conditioned on each other.

The common shares are listed and traded on the São Paulo Stock Exchange. On May 9, 2002, the closing sale price for our common shares was R\$121.00 per 1,000 shares, which is equivalent to US\$12.34 per ADS at the exchange rate in effect on that date. Prior to this offering there has been no public market for the ADSs. The ADSs have been approved for listing on the New York Stock Exchange under the symbol “SBS”, subject to official notice of issuance.

Investing in the ADSs involves certain risks. See “Risk Factors” beginning on page 6.

| | Price to public | Underwriting discounts and commissions | Proceeds to selling shareholder |
|-------------------|--------------------|--|---------------------------------------|
| Per ADS | \$11.22 | \$0.145 | \$11.075 |
| Total | \$56,172,873.90 | \$725,941.78 | \$55,446,932.13 |

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

The international underwriters expect to deliver the ADSs to purchasers against payment on or about May 14, 2002.

UBS WARBURG

SANTANDER CENTRAL HISPANO

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You should rely on the information contained in this prospectus or to which we have referred you. We have not authorized anyone to provide you with information that is different.

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Summary

This summary highlights information contained elsewhere in this prospectus. You should read the entire prospectus carefully, including “Risk Factors” and our financial statements included in this prospectus, before making an investment decision.

SABESP

Sabesp believes it is one of the largest water and sewage companies in the Americas based upon net revenues in 2001. We provide public water and sewage services 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, the State of São Paulo is Brazil’s most populous and economically productive state. We had net operating revenue of R\$3,434.8 million (US\$1,480.3 million) and net income of R\$216.2 million (US\$93.2 million) in 2001. We had total assets of R\$15,917.9 million (US\$6,860.0 million) and shareholders’ equity of R\$7,996.7 million (US\$3,446.3 million) at December 31, 2001.

We provide water and sewage services to a broad range of residential, commercial, industrial and governmental customers in the City of São Paulo and in 365 of the 645 other municipalities in the State of São Paulo. We also supply water on a bulk basis to municipalities in the São Paulo Metropolitan Region in which we do not operate water systems. At December 31, 2001, we distributed water to approximately 20.9 million persons, which we believe includes approximately 59% of the urban population of the State of São Paulo, through approximately 53.3 thousand kilometers of water pipes and mains to more than 5.7 million water connections. We provided sewage services to approximately 16.2 million persons, or 78% of our water customers, through approximately 32.6 thousand kilometers of sewer lines to approximately 4.1 million sewage connections. In addition, we sell water in bulk to seven other municipalities having an estimated population of approximately 3.7 million persons.

The State of São Paulo, our controlling shareholder, is required by State law to own at least two-thirds of our voting (common) shares. At April 30, 2002, approximately 88.3% of our outstanding common shares was owned by the State of São Paulo. After giving effect to the offerings, the State of São Paulo will own approximately 72.1%, or 69.7% if the underwriters’ over-allotment option is exercised in full, of our outstanding common shares.

Our primary mission is to improve the quality of life of the population of the State of São Paulo and, in particular, to meet the growing demand for water and sewage services in an environmentally responsible manner. We are seeking to improve our operations so we can also strengthen our financial condition and enhance our for-profit orientation. Our integrated strategy includes the following elements:

- continue improving and expanding our water and sewage services;
- reduce the water losses that have adversely affected our operations;
- continue to reduce operating costs and increase productivity;
- obtain additional municipal water and sewage concessions on a financially attractive basis;
- improve collections of overdue accounts receivable, including from the State of São Paulo and municipalities to which we sell water on a bulk basis;
- diversify our sources of financing; and
- develop closer relationships with the municipal governments and other customers that we serve.

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.

THE OFFERINGS

| | |
|-------------------------------------|---|
| Issuer | Companhia de Saneamento Básico do Estado de São Paulo—SABESP. |
| Selling shareholder | State of São Paulo. |
| International offering | 5,006,495 ADSs representing 1,251,623,750 common shares are being offered initially through the international underwriters in the United States and in other countries outside of Brazil. |
| Brazilian offering | 3,363,636,250 common shares are being offered in a public offering in Brazil. If our shares are over-subscribed in the Brazilian offering, Brazilian individual retail investors will have priority over other investors, including investors in the ADSs, in the allocation of shares offered in the international and Brazilian offerings. The more shares Brazilian retail investors request, the fewer shares and ADSs will be available for this offering and for other Brazilian investors. See “Underwriting—Brazilian Offering.” |
| The ADSs | Each ADS represents 250 common shares. The ADSs will be evidenced by ADRs. The ADSs will be issued under a deposit agreement among us, The Bank of New York, as depositary, and the owners and holders of American depositary receipts issued thereunder. |
| Offering price | The initial public offering price for the international offering is US\$11.22 per ADS. The offering price for the Brazilian offering is R\$110.00 per 1,000 common shares, which is the approximate <i>real</i> equivalent of the offering price per ADS in the international offering, adjusted to reflect the ratio of 250 common shares to one ADS. Some retail investors in the Brazilian offering will receive a 5% discount on the offering price for common shares. |
| Over-allotment option | The selling shareholder has granted the international underwriters an option to purchase an additional 2,769,156 ADSs representing 692,289,000 common shares, within 30 days from the date of this prospectus, solely to cover over-allotments, if any. |
| Use of proceeds | We will not receive any proceeds from the sale of ADSs and common shares in connection with the international and Brazilian offerings. The selling shareholder will receive all of the net proceeds. |
| Outstanding share capital | We will have 28,479,577,827 common shares outstanding immediately prior to and after the offerings. We do not have any other class of share capital. |
| Voting rights | Holders of the common shares and holders of ADSs have voting rights; however it may be difficult for holders of ADSs to exercise these rights. See “Description of Share Capital—Common Shares” and “Description of American Depositary Shares—Voting Rights.” |
| Dividends | Under the Brazilian corporation law and our by-laws, we are required to distribute as dividends not less than 25% of our annual net income, subject to adjustments and exceptions. The holders of ADSs will be entitled to receive dividends to the same extent as the owners of the common shares, subject to the deduction of any fees and charges of the depositary for the ADSs. Dividends may be made in the form of interest attributed to shareholders’ equity. See “Description of Share Capital” and “Dividends and Dividend Policy.” |

| | |
|---|--|
| | Purchasers of ADSs will not be entitled to receive the dividend declared by our Board of Directors in January 2002, which will be paid subsequent to the offerings. |
| Taxation | Dividend distributions with respect to common shares or ADSs are not currently subject to withholding of Brazilian income tax. However, payment of interest attributed to shareholders' equity is currently subject to withholding of Brazilian income tax. Gains from the sale or other disposition of ADSs outside of Brazil among individuals or corporations not domiciled in Brazil will not be subject to Brazilian income tax. |
| Market for common shares and ADSs | Prior to these offerings, there has not been a public market for the ADSs. The common shares are listed and traded in the Novo Mercado segment on the São Paulo Stock Exchange. |
| Lock-up | We and the selling shareholder have agreed with the international underwriters, subject to some exceptions, not to sell, offer or agree to sell, grant any option to sell or otherwise dispose of, directly or indirectly, any common shares, ADSs or securities convertible into or exchangeable or exercisable for common shares or ADSs or warrants or other rights to purchase common shares or ADSs during the 180-day period following the date of this prospectus without prior written consent of UBS Warburg LLC on behalf of the international underwriters. |
| Listing | The ADSs have been approved for listing on the New York Stock Exchange under the symbol "SBS", subject to official notice of issuance. |

Unless otherwise specified, share amounts in this prospectus do not reflect the exercise of the underwriters' over-allotment option.

This prospectus relates to the ADSs being offered in the international offering. This prospectus also relates to common shares that are being offered in the Brazilian offering, but that may be resold in the form of ADSs from time to time in the United States under circumstances requiring delivery of a prospectus.

SUMMARY FINANCIAL INFORMATION

The following summary financial and operating data should be read in conjunction with our financial statements included in this prospectus and information under the captions “Presentation of Financial Information,” “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Selected Financial Information.” Our financial statements have been prepared in accordance with the Brazilian corporation law method, which differs in significant respects from U.S. GAAP. Solely for the convenience of the reader, *real* amounts as at and for the year ended December 31, 2001 have been translated into U.S. dollars at the commercial selling rate at December 31, 2001 of R\$2.3204 to US\$1.00.

| | As at and for the year ended December 31, | | | |
|---|---|-------------|-------------|-------------|
| | 1999 | 2000 | 2001 | 2001 |
| | (in millions, except share, per share and per ADS data) | | | |
| Corporation Law Method | | | | |
| Statement of Operations Data: | | | | |
| Net operating revenue | R\$ 3,235.7 | R\$ 3,355.8 | R\$ 3,434.8 | US\$1,480.3 |
| Cost of services rendered | (1,364.2) | (1,474.1) | (1,590.4) | (685.4) |
| Gross profit | 1,871.5 | 1,881.7 | 1,844.3 | 794.8 |
| Selling expenses | (278.7) | (332.7) | (332.6) | (143.3) |
| General and administrative expenses | (153.8) | (137.3) | (203.1) | (87.5) |
| Financial expenses, net | (1,529.9) | (737.7) | (1,105.2) | (476.3) |
| Operating profit (loss) | (90.9) | 674.0 | 203.4 | 87.7 |
| Non-operating income (expenses), net | (124.5) | (82.3) | (76.9) | (33.1) |
| Income (loss) before taxes on income | (215.4) | 591.6 | 126.5 | 54.5 |
| Income tax and social contribution | (20.2) | (70.2) | 89.7 | 38.7 |
| Net income (loss) | (235.6) | 521.4 | 216.2 | 93.2 |
| Net income (loss) per 1,000 common shares | (8.28) | 18.31 | 7.59 | 3.27 |
| Net income (loss) per ADS | (2.07) | 4.58 | 1.90 | 0.82 |
| Dividends and interest attributed to shareholders’ equity per 1,000 common shares | — | 18.97 | 17.20 | 7.41 |
| Number of common shares outstanding at year end (in thousands of shares) | 28,437,155 | 28,479,578 | 28,479,578 | 28,479,578 |
| Balance Sheet Data: | | | | |
| Customer accounts receivable, net | R\$ 1,078.2 | R\$ 996.4 | R\$ 811.7 | US\$ 349.8 |
| Reimbursement due from State Government for pensions paid | 184.2 | 253.5 | 19.7 | 8.5 |
| Long-term receivables from State Government agreements | — | — | 649.1 | 279.7 |
| Property, plant and equipment | 13,298.3 | 13,346.4 | 13,510.0 | 5,822.3 |
| Total assets | 15,116.9 | 15,192.1 | 15,917.9 | 6,860.0 |
| Total short-term loans and financings | 841.6 | 381.7 | 549.3 | 236.7 |
| Total long-term loans and financings | 5,023.6 | 5,616.1 | 5,920.6 | 2,551.5 |
| Total liabilities | 6,845.3 | 6,923.7 | 7,921.2 | 3,413.7 |
| Shareholders’ equity | 8,271.5 | 8,268.5 | 7,996.7 | 3,446.3 |
| Other Financial Information: | | | | |
| Cash provided by operating activities | R\$ 1,874.2 | R\$ 1,744.1 | R\$ 1,700.6 | US\$ 732.9 |
| Cash used in investing activities | (801.8) | (598.4) | (709.5) | (305.8) |
| Cash used in financing activities | (943.4) | (1,098.3) | (763.6) | (329.1) |
| Adjusted EBITDA | 1,873.3 | 1,868.6 | 1,785.9 | 769.7 |
| Capital expenditures | 790.7 | 596.3 | 694.6 | 299.3 |
| Depreciation and amortization | 434.1 | 457.0 | 477.3 | 205.7 |

See the introductory paragraphs and footnotes to “Selected Financial Information.”

U.S. GAAP

Statement of Operations Data:

| | As at and for the year ended December 31, | | | |
|--|---|-------------|-------------|-------------|
| | 1999 | 2000 | 2001 | 2001 |
| | (in millions, except share, per share and per ADS data) | | | |
| Net operating revenue | R\$ 3,235.7 | R\$ 3,355.8 | R\$ 3,434.8 | US\$1,480.3 |
| Gross profit | 1,691.3 | 1,668.6 | 1,613.8 | 695.5 |
| Selling expenses | (295.9) | (349.6) | (349.9) | (150.8) |
| General and administrative expenses | (198.5) | (184.1) | (214.8) | (92.6) |
| Operating profit | 963.2 | 983.0 | 951.1 | 409.9 |
| Financial expenses, net | (1,563.2) | (740.6) | (1,107.1) | (477.1) |
| Net income (loss) | (449.3) | 284.4 | 16.7 | 7.2 |
| Net income (loss) per 1,000 common shares—basic and diluted | (15.95) | 10.00 | 0.59 | 0.25 |
| Net income (loss) per ADS—basic and diluted | (3.99) | 2.50 | 0.15 | 0.06 |
| Weighted average number of common shares outstanding (in thousands of shares) | 28,159,721 | 28,448,607 | 28,479,578 | 28,479,578 |

Balance Sheet Data:

| | | | | |
|--|-------------|-------------|-------------|-------------|
| Property, plant and equipment | R\$15,643.0 | R\$15,583.8 | R\$15,656.0 | US\$6,747.1 |
| Total assets | 17,493.2 | 17,381.0 | 17,581.8 | 7,577.1 |
| Total short-term debt (including current portion of long-term debt) | 816.5 | 381.7 | 549.3 | 236.7 |
| Total long-term debt | 5,023.6 | 5,612.2 | 5,873.2 | 2,531.1 |
| Total liabilities | 9,883.2 | 10,046.5 | 10,688.5 | 4,606.3 |
| Shareholders' equity | 7,610.0 | 7,334.4 | 6,893.3 | 2,970.7 |

Operating Data (at period end):

| | At December 31, | | |
|--|-----------------|--------|--------|
| | 1999 | 2000 | 2001 |
| Number of water connections (in thousands) | 5,242 | 5,535 | 5,717 |
| Number of sewage connections (in thousands) | 3,763 | 3,976 | 4,128 |
| Volume of water billed during period (in millions of cubic meters) | 1,789 | 1,731 | 1,698 |
| Water loss percentage (average) | 31.4% | 31.4% | 32.6% |
| Number of employees | 18,324 | 18,048 | 18,159 |

See the introductory paragraphs and footnotes to "Selected Financial Information."

Risk Factors

Prior to making an investment decision, prospective purchasers should consider carefully all of the information set forth in this prospectus and, in particular, the risk factors applicable to Sabesp and relating to investments in Brazil that are not normally associated with other investments in other countries and with other issuers.

RISKS RELATING TO OUR CONTROL BY THE STATE OF SÃO PAULO

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

The State of São Paulo, through its ownership of our common shares, has the ability to control the election of a majority of the members of our *Conselho de Administração* (Board of Directors), the appointment of our senior management, and our operations and strategy. The State of São Paulo owned 88.3% of our common shares at April 30, 2002.

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

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

The State of São Paulo will hold a gubernatorial election in the fourth quarter of 2002. New Governors 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 Water, Sanitation and Public Works Secretariat, or Water Secretariat, of the State of São Paulo. Recently, the current Governor of the State of São Paulo, Mr. Geraldo Alckmin, appointed new senior officials for his administration, including Mr. Mauro Guilherme Jardim Arce as the new Secretary of the Water Secretariat. The new Secretary of the Water Secretariat, who is also the Secretary of the Energy Secretariat of the State of São Paulo, was elected as Chairman of our Board of Directors.

A reconstituted Board of Directors and new senior management for our company may pursue a strategy or conduct operations in a manner that diverges significantly from our current strategy and operations. Changes in government or government policy could have a material adverse effect on our business, results of operations, financial condition or prospects.

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

Historically, the State of São Paulo and some State entities have had substantial overdue accounts payable to Sabesp relating to (1) the provision of water and sewage services and (2) State-mandated special retirement and pension payments which we make to some of our former employees for which the State is required to reimburse us.

In December 2001, we entered into an agreement with the State of São Paulo whereby a substantial amount of overdue accounts receivable due from the State of São Paulo and some State entities was converted to long-term accounts receivable. We recognized net operating revenues in respect of these accounts receivable

Risk Factors

in prior financial periods. As part of the December 2001 agreement, we also converted to long-term accounts receivable a portion of the accounts receivable owed by the State of São Paulo for State-mandated special retirement and pension payments which we made to some of our former employees for which the State is required to reimburse us.

Under a federal law enacted in December 1996, we are not permitted to write-off any amounts owing to Sabesp from the State, our controlling shareholder, or entities controlled by the State and we have not provisioned for these amounts.

We signed a protocol of understanding in September 1997 with the State of São Paulo. The protocol provides for the settlement of unpaid accounts receivable for water and sewage services due from the State using dividends payable by us to the State as one of our shareholders. We have in the past applied dividends, in the form of interest attributed to shareholders' equity, paid to the State of São Paulo to settle a corresponding amount of unpaid accounts receivable, in accordance with the terms of the protocol.

At December 31, 2001, we had accounts receivable due from the State of São Paulo, including State entities, relating to the provision of water and sewage services totaling R\$378.3 million. In addition, at December 31, 2001, we had R\$326.3 million in accounts receivable due from the State in respect of State-mandated special retirement and pension payments to certain former employees of Sabesp.

The December 2001 agreement included provisions whereby the State acknowledged and agreed to pay some of these amounts to us in monthly installments, including in part by transferring to us some reservoirs in the Alto Tietê System owned by the State. As a result, R\$649.1 million of such amounts owing by the State became a long-term accounts receivable from the State Government in our financial statements at December 31, 2001. However, the agreement provides for an extended period of time before such installment payments are made.

At a meeting held on January 30, 2002, our Board of Directors unanimously declared dividends, in the form of interest attributed to shareholders' equity, in an aggregate amount of R\$489.8 million. This distribution will be paid within 60 days after our annual shareholders meeting, which took place on April 25, 2002, to our shareholders who held shares as of February 7, 2002. Accordingly, the State of São Paulo will be entitled to receive R\$432.7 million of this distribution.

Pursuant to the provisions of the September 1997 protocol of understanding and the December 2001 agreement, Sabesp expects the State to apply approximately R\$287.7 million of this declared dividend payable to the State of São Paulo to settle current and future accounts receivable owed by the State or its controlled entities. We expect to pay approximately R\$145.0 million, the remaining share of the dividend that the State is entitled to, to the State in cash. At a meeting, our Board of Directors reviewed our 2002 budget, which incorporated the cash payment of this amount, and one of our directors voted against Sabesp making this cash payment to the State.

We cannot assure you as to when or whether the State will pay overdue amounts owing to us, or as to whether, as a result of the December 2001 agreement, the State will continue to apply dividends payable to the State to settle amounts owing to us by the State and some State entities. Furthermore, due to the history of the State not making timely payments to us in respect of services provided by us or timely reimbursing us for the State-mandated special retirement and pension payments we make, 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.

Risk Factors

A portion of the amount of long-term accounts payable that the State owes us will be paid by the transfer to us of reservoirs in the Alto Tietê System owned by the State. We cannot assure you of the value to be given to these reservoirs or when such transfer will take place.

In December 2001, we entered into an agreement with the State whereby the State, among other things, agreed to transfer the reservoirs in the Alto Tietê System to us in exchange for the cancellation of a portion of accounts receivable due from the State and reimbursement due from the State for State-mandated special pension payments we have made. Pursuant to this agreement, the value of these reservoirs will be determined by an appraisal process prior to being transferred and amounts owing to us from the State are subject to an audit by a State-appointed auditor. There may be extended delays in our agreeing with the State on a valuation of these reservoirs, when the transfer of these reservoirs to us will take place and when the cancellation of the amounts owing to us from the State will be made.

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

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

RISKS RELATING TO SABESP

Proposed regulation for the water and sewage industry may negatively affect our operations in the São Paulo Metropolitan Region as well as other metropolitan areas which we serve.

The Brazilian Federal Congress has been debating Law Project No. 4,147 of February 21, 2001, which would establish directives for basic sanitation services. This proposed legislation, when and if approved, would establish a new federal regulatory authority for our industry that may, in part, preempt the existing state regulatory authorities under which we operate.

The proposed new legislation and new regulatory regime may grant to the new regulatory authorities power to deny renewals of our concessions after they expire or to cancel existing ones. In addition, the proposed new legislation would modify the way we charge for our water and sewage services businesses as well as our capital expenditure program. Any of these changes, if they were to occur, could have an adverse effect on our revenues, by causing us to lose concessions we currently hold, or on our expenses, by limiting our ability to pass our costs on to our customers.

Under the proposed new legislation, the State would continue to be the ultimate concession-granting authority for metropolitan areas. There have been discussions, however, to introduce changes in the proposed legislation by which the State would share the authority with municipalities comprising the metropolitan area. These changes, if adopted, could negatively affect our operations in the São Paulo Metropolitan Region as well as other metropolitan areas which we serve.

As of the date of this prospectus, the proposed new legislation has not been voted on by the Brazilian Federal Congress or been sent to the Brazilian Senate for debate. Accordingly, we cannot anticipate when, or if, Law Project No. 4,147 will become legislation.

Risk Factors

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

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

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

We do not hold formal concessions in the City of São Paulo, which accounts for a substantial majority of our sales and services rendered, or in 42 other municipalities in the State of São Paulo. Although we do not have written contracts which we could enforce, we believe that we have a vested, or implied, right to provide water and sewage services in these municipalities based upon, among other things, our ownership through our predecessor entities of the water and sewage systems serving the City of São Paulo and these other municipalities and certain rights of succession resulting from the merger of state governmental agencies and the state-controlled companies which formed Sabesp in 1973 that were involved in providing water and sewage services in the City of São Paulo and these other municipalities. Because we do not hold concessions or formal contract rights to provide services in these municipalities, we may not be able to effectively enforce our right to continue to provide services or to be paid for the services we provide. It is possible that 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, including the enactment of the law contemplated by Law Project No. 4,147.

From time to time mayors of the City of São Paulo, including the present mayor, have initiated or proposed discussions with the State of São Paulo regarding entering into a formal concession contract with Sabesp to provide water and sewage services in the City of São Paulo. We cannot assure you as to whether or when any formal concession would be granted by the City of São Paulo, or the terms of any concession contract.

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

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

Diadema and Mauá, two municipalities previously served by Sabesp, terminated our concessions in 1995. Legal proceedings are currently pending with respect to the terms of these terminations. In addition, in 1997, the municipality of Santos enacted a law expropriating the water and sewage systems of Sabesp in Santos. In response, we filed an action seeking an injunction against this expropriation which was denied by

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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. A final decision on this matter has not yet been rendered by the Court of Appeals, and we cannot assure you that the final decision will be favorable to us. Despite the pending lawsuit, we continue to provide water and sewage services to Santos.

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

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

At December 31, 2001, we had accounts receivable totaling R\$460.6 million from municipalities to which we provide water on a bulk basis. Of this amount, we estimate that approximately R\$38.8 million was between 90 and 360 days overdue and R\$363.6 million was more than 360 days overdue. The Brazilian courts have required that we continue to provide water on a bulk basis to municipalities, even if they fail to pay our invoices. Although we have entered into negotiations with municipalities to reschedule such accounts receivable and have also filed legal proceedings against municipalities to collect the overdue amounts, some municipalities are currently not paying our invoices in full or on a timely basis. In addition, some governmental entities located in municipalities we serve are also not paying us on a current basis. We cannot assure you as to whether or when these municipalities will resume making current payments or pay overdue amounts owing to us.

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

Our results of operations and financial condition are highly dependent upon our ability to set and collect adequate tariffs for our water and sewage services. Although we generally have broad power to establish tariffs, this power is, in practice, subject to political and legal constraints. Since 1995, we generally have been able to raise tariffs yearly in line with increases in inflation or operating expenses and to support our liquidity and capital resource requirements. However, during this period we did not raise our tariffs from mid-1999 until mid-2001, due to a State policy of not increasing tariffs for public services. In 2001, we did raise tariffs in line with the inflation rates in Brazil since mid-1999. We will continue to rely upon tariff revenues, among other things, to provide funds for our capital expenditure program and to meet our debt service requirements. Any failure to establish or maintain tariffs commensurate with these and our other needs could have an adverse effect on our results of operations and financial condition.

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

Our capital expenditure program calls for expenditures of approximately R\$2,745.2 million in the period from 2002 through 2006, including approximately R\$583.0 million in 2002 and R\$388.9 million in 2003. We plan to fund these expenditures and our other liquidity and capital resource needs out of funds generated by operations and domestic and foreign currency borrowings on acceptable terms.

We cannot assure you that we will be able to obtain sufficient funds to complete our capital expenditure program or satisfy our other liquidity and capital resources requirements. Failure to obtain the requisite funds could delay or prevent completion of our capital expenditure program and other projects, which may have a material adverse effect on the operation and development of our business.

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

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

Under our existing debt instruments, we are subject to covenants limiting our ability to incur additional indebtedness, whether denominated in *reais* or foreign currency. Under these covenants, we would have been able to borrow up to an additional R\$290.0 million at December 31, 2001. If, however, these and other limitations restrict our ability to borrow, we may be unable to satisfy all of our liquidity and capital resources requirements, which could have a material adverse effect on our business.

Droughts may result in major shortages in our water supply, which may have a material adverse effect on our company.

We experience decreases in our water supply from time to time due to droughts. Brazil recently experienced a prolonged and severe drought, which commenced in 2000 and, as of March 2002, appeared to be ending. As a result of this drought, our revenues declined as our volume of water billed decreased and our costs increased as a result of additional capital expenditures required to alleviate the effects of this drought on our water production systems. We cannot assure you that this or any future drought will not materially adversely affect our water supply and, accordingly, our business and results of operations.

A Brazilian electrical energy crisis could adversely affect our financial condition and results of operations.

Brazil experienced a severe shortage of capacity to generate and transmit electrical power during 2001, primarily due to the prolonged and severe drought which negatively affected the hydroelectric generation of power as well as to a lack of investment in power generation. In May 2001, the Brazilian government announced measures aimed at an average reduction of 20% in electricity consumption in a number of regions of Brazil, including areas in which we operate. However, companies that render “essential services,” such as companies like Sabesp that render water and sewage services, were not subject to these measures. As a result of higher water levels in reservoirs as well as steps taken by the Brazilian government to increase the amount of available electrical power, as of March 2002, the Brazilian government eliminated all electricity consumption restrictions.

Because water production, treatment and distribution and sewage collection, treatment and disposal demand a significant consumption of electric energy, a substantial shortage or lack of electrical energy could result in a temporary interruption of our services. In addition, due to electricity conservation measures, our customers have curtailed their use of our water services, resulting in a lower volume of water and sewage billed.

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

Our facilities are subject to many Brazilian federal, state and local laws and regulations relating to the protection of human health and the environment. We have incurred, and will continue to incur, substantial expenditures to comply with these provisions. In addition, because environmental laws and their enforcement are becoming more stringent, our capital expenditures and expenses for environmental compliance may increase substantially in the future. The amount of investments that we make in any given year is subject to limitations by the State Government. Expenditures required for compliance with environmental regulation may result in reductions in other strategic investments that we have planned,

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which could negatively affect our profitability. We could also be exposed to criminal and administrative penalties, in addition to indemnification obligations, for eventual damage for non-compliance with environmental laws and regulations. Any material unforeseen environmental costs and liabilities may have a material adverse effect on our future financial performance.

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

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

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

We are a party to a number of legal proceedings involving significant monetary claims. These legal proceedings include, among others, tax, labor, condemnation and other proceedings. A substantial monetary judgment against us in one or more of these legal proceedings may have a material adverse effect on our business or financial condition.

For example, we are party to various tax proceedings, including two lawsuits we have filed to challenge tax laws relating to a particular tax on revenue and a particular sales tax. While these lawsuits are being adjudicated, at December 31, 2001, we have provisioned approximately R\$111.0 million and R\$51.8 million for them.

In addition, the labor proceedings in which we are involved include two lawsuits filed against us by the Sindicato dos Trabalhadores em Água, Esgoto e Meio Ambiente de São Paulo (the São Paulo Water, Sewage and Environment Service Workers Union, or SINTAEMA). In each of these suits, SINTAEMA has alleged that we failed to pay our employees amounts we were required to pay. We are also party to a large number of other lawsuits and administrative proceedings involving SINTAEMA and our present and former employees. At December 31, 2001, we established a provision totaling R\$15.3 million with respect to potential damages in lawsuits and administrative proceedings involving present and former employees, including the SINTAEMA lawsuit.

We are also party to a significant number of condemnation proceedings arising from our partial or total expropriation or use of private property for water mains, sewer lines and facilities. At December 31, 2001, we estimated that we will be required to make payments totaling R\$55.9 million with respect to all pending condemnation matters, which will be recorded as fixed assets upon payment.

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

We do not have insurance coverage for business interruption risk or for liabilities arising from contamination or other problems involving our water supply to customers. In addition, we do not have insurance coverage for liabilities relating to non-compliance with environmental laws and regulations

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relating to our sewage services. As a result, any major business interruption or environmental-related liability may have a material adverse effect on our future financial performance.

RISKS RELATING TO BRAZIL

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

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

Actions taken by the Brazilian government concerning the economy may have important effects on Brazilian corporations and other entities, including Sabesp, and on market conditions and prices of Brazilian securities, including our common shares and ADSs. Our financial condition and results of operations may be adversely affected by, as well as the Brazilian government's response to, the following factors:

- devaluations and other exchange rate movements;
- inflation;
- exchange control policies;
- social instability;
- price instability;
- energy shortages;
- interest rates;
- liquidity of domestic capital and lending markets;
- tax policy; and
- other political, diplomatic, social and economic developments in or affecting Brazil.

In addition, the next Brazilian presidential elections are scheduled to occur in October 2002. We cannot predict the outcome of the elections, the policies the new administration may adopt or the effect that those policies may have on Brazilian economic conditions or our results of operations.

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

The Brazilian currency has been devalued frequently during the last four decades. Throughout this period, the Brazilian government has implemented various economic plans and utilized various exchange rate policies, including sudden devaluations, periodic mini-devaluations (during which the frequency of adjustments has ranged from daily to monthly), exchange controls, multiple exchange rate markets and floating exchange rate system. From time to time, there have been significant fluctuations in the exchange rates between the Brazilian currency and the U.S. dollar and other currencies. For example, in 1999, 2000 and 2001, the *real* devalued 32.4%, 8.5% and 15.7% against the U.S. dollar.

In the event of a significant devaluation of the *real* in relation to the U.S. dollar or other currencies, our ability to meet our foreign currency-denominated obligations could be adversely affected, particularly as our tariff revenues and other sources of income are based solely in *reais*. In addition, because we have

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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\$2,653.4 million at December 31, 2001, and we anticipate that we may incur substantial amounts of foreign currency-denominated indebtedness in the future. For example, our financial expenses and our overall results of operations for 2001 were negatively affected by the 15.7% devaluation of the *real* in 2001.

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

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

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

Inflation, as measured by the *Índice Geral de Preços de Mercado* (the General Price Index-Market, or the IGP-M), was 7.7% in 1997, 1.8% in 1998, 20.1% in 1999 and 10.0% in 2000. For 2001 the inflation rate was 10.4%. However, there can be no assurance that levels of inflation in Brazil will not increase in future years and have a material adverse effect on our business, financial condition, results of operations or prospects.

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

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

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

RISKS RELATING TO THE COMMON SHARES AND THE ADSs

You may not be able to sell your ADSs at the time or the price you desire because an active or liquid market for our ADSs may not develop.

Prior to this offering, there has not been a public market for our ADSs. The ADSs have been approved for listing on the New York Stock Exchange, subject to official notice of issuance. However, we cannot predict whether an active liquid public trading market for our ADSs will develop or be sustained. Active, liquid trading markets generally result in lower price volatility and more efficient execution of buy and sell orders for investors. Liquidity of a securities market is often a function of the volume of the underlying shares that are publicly held by unrelated parties. Although ADS holders are entitled to withdraw the common shares

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underlying the ADSs from the depositary at any time, we do not anticipate that a public market for our common shares will develop in the United States.

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

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

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

If you exchange the ADSs for common shares, you risk losing the ability to remit foreign currency abroad and Brazilian tax advantages.

The Brazilian custodian for the common shares underlying the ADSs must obtain a certificate of registration from the Central Bank of Brazil to be entitled to remit U.S. dollars abroad for payments of dividends and other distributions relating to the common shares or upon the disposition of the common shares. If you decide to exchange your ADSs for the underlying common shares, you will be entitled to continue to rely — for five business days from the date of exchange — on the custodian's certificate of registration. After that period, you may not be able to obtain and remit U.S. dollars abroad upon the disposition of the common shares, or distributions relating to the common shares, unless you obtain your own certificate of registration or register under Resolution No. 2,689, of January 26, 2000, of the National Monetary Council, which entitles registered foreign investors to buy and sell on the Brazilian stock exchanges. If you do not obtain a certificate of registration or register under Resolution No. 2,689, you will generally be subject to less favorable tax treatment on gains with respect to the common shares.

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

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

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

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

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

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

You may face difficulties in protecting your interests as a shareholder, because we are a Brazilian company.

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

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

Sales of a substantial number of common shares after the consummation of these offerings — or the anticipation of such sales — could decrease the trading price of the common shares and the ADSs. Upon consummation of these offerings, we will have 28,479,577,827 common shares outstanding, including 20,541,674,058 shares, or 19,849,385,058 shares if the underwriters' over-allotment option is exercised in full, held by the State of São Paulo. We and the State of São Paulo have agreed that, subject to some exceptions, we and the State of São Paulo will not sell, offer or agree to sell, grant any option to sell or otherwise dispose of, directly or indirectly, any common shares, ADSs or securities convertible into or exchangeable or exercisable for common shares or ADSs or warrants or other rights to purchase common shares or ADSs for a period of 180 days after the date of this prospectus without the prior written consent of UBS Warburg LLC on behalf of the underwriters. As a consequence of the issuance of common shares or sales by the State of São Paulo or other existing shareholders, the market price of the common shares and, by

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extension, the ADSs may decrease significantly. As a result, you may not be able to sell your securities at or above the price you paid for them.

You might be unable to exercise preemptive rights with respect to the common shares underlying the ADSs.

You may not be able to exercise the preemptive rights relating to the common shares underlying your ADSs unless a registration statement under the U.S. Securities Act of 1933 is effective with respect to those rights or an exemption from the registration requirements of the Securities Act is available. We are not obligated to file a registration statement with respect to the common shares relating to these preemptive rights, and we cannot assure you that we will file any such registration statement. Unless we file a registration statement or an exemption from registration is available, you may receive only the net proceeds from the sale of your preemptive rights by the depositary or, if the preemptive rights cannot be sold, they will be allowed to lapse.

You may find it more difficult than our Brazilian shareholders do to exercise your voting rights at our shareholders' meetings.

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

Developments in other emerging market countries, including Argentina, may adversely affect the Brazilian economy and, therefore, the market price of the common shares and the ADSs.

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

In December 2001, amid public demonstrations and after a lengthy recession and the resignation of the President of the Republic, Argentina declared a suspension on payment of its foreign debt. Subsequently, after several brief interim presidencies, Eduardo Duhalde was named as president in early January 2002. With some limitations, President Duhalde's administration has allowed the exchange rate of the Argentine Peso to float, resulting in a 56.9% devaluation of the market rate of the Argentine Peso from January 11 to May 9, 2002. If Argentina's economic environment does not improve, the economy in Brazil, as both a neighboring country and a significant trading partner, could be affected and could experience slower growth than in recent years.

In addition, although economic conditions are different in each country, investors' reactions to adverse developments in one country may affect the market price of securities of issuers in other countries, including Brazil. For example, the 1997 Asian economic crisis and the 1998 Russian debt moratorium and devaluation of the Russian currency triggered market volatility in Latin America and securities markets in

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other emerging market countries. Accordingly, adverse developments in Argentina or in other emerging market countries could lead to a reduction in the demand for, and market price of, the common shares and the ADSs.

The ongoing military action in response to the September 11, 2001 attacks on the United States may have negative and unpredictable effects on the U.S. and global economies and financial markets and the market price of the ADSs.

The ongoing military action in response to the September 11, 2001 terrorist attacks on the United States, including any expansion of hostilities, may have negative and unpredictable effects on the international, U.S. or Brazilian economies or financial markets. We cannot predict what future effects these events may have on investors' perceptions of risk regarding investments in equity securities of issuers in emerging markets or equity securities generally.

Forward-looking statements contained in this prospectus may not be realized.

This prospectus includes forward-looking statements, principally in this "Risk Factors" section and in "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Business." We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends affecting our business. These forward-looking statements are subject to risks, uncertainties and assumptions, including, among other things:

- general economic, political and other conditions in Brazil;
- our management's expectations and estimates concerning our future financial performance;
- our level of indebtedness;
- our capital expenditure program and other liquidity and capital resources requirements;
- the recent drought in Brazil and Brazilian electrical energy crisis;
- the size and growth of our customer base;
- inflation and devaluation;
- existing and future governmental regulation; and
- other risk factors as set forth under this "Risk Factors" section.

The words "believes," "may," "will," "estimates," "continues," "anticipates," "intends," "expects" 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 prospectus might not occur. Our actual results could differ substantially from those anticipated in our forward-looking statements.

We have not taken any action to permit a public offering of the ADSs outside the United States or to permit the possession or distribution of this prospectus outside the United States. Persons outside the United States who come into possession of this prospectus must inform themselves about and observe any restrictions relating to the offering of ADSs and the distribution of this prospectus outside of the United States.

No offer or sale of ADSs may be made to the public in Brazil except in circumstances which do not constitute a public offer or distribution under Brazilian laws and regulations. Any offer or sale in Brazil to non-Brazilian residents may be made only under circumstances that do not constitute a public offer or distribution under Brazilian laws and regulations.

Presentation of Financial Information

In this prospectus, references to “*real*,” “*reais*” or “R\$” are to the Brazilian *real*, the official currency of Brazil. All references to “U.S. dollars” or “US\$” are to United States dollars. Solely for the convenience of the reader, we have translated some of the *real* amounts contained in this prospectus into U.S. dollars at a rate equal (unless otherwise indicated) to R\$2.3204 to US\$1.00, the commercial selling rate at December 31, 2001 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, 1997.

Our audited financial statements at December 31, 2000 and 2001 and for the years ended December 31, 1999, 2000 and 2001 are included in this prospectus. These financial statements have been audited by PricewaterhouseCoopers Auditores Independentes, São Paulo, Brazil.

Our audited financial statements are prepared using the “corporation law method” and are based upon our accounting records which are maintained in *reais* and prepared in accordance with the Brazilian corporation law (Law No. 6,404/76, as amended), the rules and regulations issued by the Comissão de Valores Mobiliários, or the Brazilian securities commission, and the accounting standards issued by the Institute of Independent Auditors of Brazil (Instituto dos Auditores Independentes do Brasil, or IBRACON).

Like other Brazilian companies, we have the option to present our primary financial statements on the basis of accounting principles established under the corporation law method with a reconciliation to generally accepted accounting principles in the United States of America, or U.S. GAAP. Unless otherwise indicated, our financial statements and all financial data included in this prospectus have been prepared using the corporation law method.

The corporation law method differs in significant respects from U.S. GAAP. Note 22 to our audited financial statements provides reconciliation from the corporation law method to U.S. GAAP, for periods presented therein, of our net income (loss) and shareholders’ equity.

The reconciliation to U.S. GAAP includes an adjustment for inflationary accounting for the period from January 1, 1996 to December 31, 1997, when inflationary accounting was prohibited by the corporation law but still required under U.S. GAAP. In addition, as required by U.S. GAAP, the reconciliation from the financial statements prepared under the corporation law method includes an adjustment to reverse the effects of past revaluations of property, plant and equipment and, separately, to recognize the effects of using an independent general price inflation index rather than official government indices which were largely based on consumer price compilations.

We do not have any subsidiaries.

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

Use of Proceeds

We will not receive any proceeds from the sale of the ADSs and common shares being offered in the international and Brazilian offerings.

The State of São Paulo will receive all of the net proceeds from the sale of the ADSs and common shares in these offerings.

Exchange Rates

There are two principal legal foreign exchange markets in Brazil:

- the commercial rate exchange market; and
- the floating rate exchange market.

On January 25, 1999, the Brazilian government announced the unification of the operational limits applicable to both markets. However, each market continues to have a specific regulation. Most trade and financial foreign-exchange transactions are carried out on the commercial rate exchange market. These transactions include the purchase or sale of common shares or the payment of dividends or interest with respect to the common shares. Foreign currencies may only be purchased through a Brazilian bank authorized to operate in these markets. In both markets, rates are freely negotiated but may be strongly influenced by Central Bank intervention.

From March 1995 through January 1999, the Central Bank allowed the gradual devaluation of the *real* against the U.S. dollar. In January 1999, the Central Bank abolished the band system and allowed the *real*/U.S. dollar exchange rate to float freely. Since then, the *real*/U.S. dollar exchange rate has been established mainly by the interbank market, and has fluctuated considerably. Since December 31, 1998 and through May 9, 2002, the *real* has depreciated by approximately 50.7% against the U.S. dollar and at May 9, 2002 the commercial selling rate for U.S. dollars was R\$2.4519 per US\$1.00. The Central Bank has only intervened occasionally to control unstable movements in the foreign exchange rate. At the present time, we cannot predict whether the Central Bank will continue to let the *real* float freely or if the *real* will remain at its present level. The *real* may devalue substantially in the near future.

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

| | Low | High | Average | Period-end |
|--------------------------------|----------------------|--------|---------|------------|
| | (Reais per US\$1.00) | | | |
| Year ended December 31, | | | | |
| 1997 | 1.0395 | 1.1164 | 1.0809 | 1.1164 |
| 1998 | 1.1165 | 1.2087 | 1.1644 | 1.2087 |
| 1999 | 1.2078 | 2.1647 | 1.8514 | 1.7890 |
| 2000 | 1.7234 | 1.9847 | 1.8348 | 1.9554 |
| 2001 | 1.9353 | 2.8007 | 2.3519 | 2.3204 |
| 2002 (through May 9) | 2.2709 | 2.4519 | 2.3631 | 2.4519 |
| Month ended | | | | |
| November 30, 2001 | 2.4604 | 2.6820 | | 2.5287 |
| December 31, 2001 | 2.2930 | 2.4672 | | 2.3204 |
| January 31, 2002 | 2.2932 | 2.4370 | | 2.4183 |
| February 28, 2002 | 2.3482 | 2.4691 | | 2.3482 |
| March 31, 2002 | 2.3236 | 2.3663 | | 2.3236 |
| April 30, 2002 | 2.2709 | 2.3689 | | 2.3625 |

Source: Central Bank

Market Information

MARKET PRICES OF COMMON SHARES

Our common shares are traded on the São Paulo Stock Exchange under the symbol “SBSP3.” At April 30, 2002, we had 2,886 registered holders of common shares.

The table below sets forth, for the periods indicated, the reported high and low closing sale prices in *reais* for common shares on the São Paulo Stock Exchange. The table also sets forth prices per ADS assuming that ADSs had been outstanding on such dates and translated into U.S. dollars at the commercial market rate for the sale of U.S. dollars for each of the respective dates of such quotations. In addition, the table sets forth the average daily trading volume for our common shares. See “Exchange Rates” for information with respect to exchange rates applicable during the periods set forth below.

| | <i>Reais</i> per 1,000 common shares | | U.S. dollar equivalent per ADS | | Average daily trading volume (in lots of 1,000 common shares) |
|--------------------------|--------------------------------------|--------|--------------------------------|-------|---|
| | Low | High | Low | High | |
| 1997 | 89.00 | 361.00 | 21.39 | 80.86 | 12,541 |
| 1998 | 45.00 | 290.99 | 9.54 | 60.23 | 14,930 |
| 1999: | | | | | |
| First quarter | 47.00 | 114.50 | 8.91 | 16.67 | 22,884 |
| Second quarter | 115.90 | 157.00 | 16.68 | 22.40 | 24,628 |
| Third quarter | 120.00 | 153.50 | 15.72 | 19.81 | 9,709 |
| Fourth quarter | 120.00 | 213.00 | 15.05 | 29.61 | 19,870 |
| 2000: | | | | | |
| First quarter | 155.00 | 211.00 | 22.33 | 30.39 | 15,750 |
| Second quarter | 128.50 | 175.79 | 17.39 | 24.33 | 20,051 |
| Third quarter | 137.00 | 197.90 | 18.88 | 26.83 | 27,817 |
| Fourth quarter | 144.00 | 184.00 | 18.20 | 23.59 | 12,807 |
| 2001: | | | | | |
| First quarter | 172.01 | 238.60 | 22.14 | 27.71 | 17,515 |
| Second quarter | 151.00 | 194.49 | 16.14 | 21.04 | 15,722 |
| Third quarter | 104.50 | 176.89 | 9.51 | 16.56 | 10,337 |
| Fourth quarter | 98.00 | 137.50 | 8.95 | 14.87 | 16,363 |
| 2002: | | | | | |
| January | 122.11 | 138.00 | 12.85 | 14.80 | 20,931 |
| February | 121.00 | 141.00 | 12.47 | 14.57 | 22,449 |
| March | 127.99 | 141.00 | 13.53 | 15.04 | 19,852 |
| April | 127.11 | 152.50 | 13.80 | 16.33 | 26,215 |

Our common shares have been listed on the São Paulo Stock Exchange since June 4, 1997 and since April 24, 2002 our common shares have been included on the Novo Mercado segment of that Exchange. Prior to June 4, 1997, our common shares were traded on Sociedade Operadora do Mercado de Acesso (SOMA), an over-the-counter market in Brazil.

On May 9, 2002, the closing sale price for our common shares on the São Paulo Stock Exchange was R\$121.00 per 1,000 shares, which is equivalent to US\$12.34 per ADS when translated into U.S. dollars at the exchange rate in effect on that date. Each ADS will represent 250 common shares.

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Prior to the offerings, there was no public market for our ADSs. There can be no assurance that an active trading market will develop for our ADSs or that our ADSs will trade in the public market subsequent to the offerings at or above the initial public offering price.

TRADING ON THE BRAZILIAN STOCK EXCHANGES

In 2000, the Brazilian stock exchanges were reorganized through the execution of memoranda of understanding by the Brazilian stock exchanges. Pursuant to the memoranda, all securities are now traded only on the São Paulo Stock Exchange, with the exception of electronically traded public debt securities and privatization auctions, which are traded on the Rio de Janeiro Stock Exchange. In 2001, the São Paulo Stock Exchange accounted for 100% of the trading value of equity securities on all Brazilian stock exchanges.

If you were to trade in our common shares on the São Paulo Stock Exchange, your trade would settle in three business days after the trade date without adjustment of the purchase price for inflation. The seller is ordinarily required to deliver the shares to the exchange on the second business day following the trade date. Delivery of and payment for shares are made through the facilities of the clearinghouse, or Companhia Brasileira de Liquidação e Custódia.

Each Brazilian stock exchange is a nonprofit entity owned by its member brokerage firms. Trading on each exchange is limited to member brokerage firms and a limited number of authorized nonmembers. The São Paulo Stock Exchange has two open outcry trading sessions each day from 11:00 a.m. to 1:30 p.m. and from 2:30 p.m. to 5:45 p.m. Brazil local time, except during daylight savings time in the United States. During daylight savings time in the United States, the sessions are from 10:00 a.m. to 1:00 p.m. and from 2:00 p.m. to 4:45 p.m. Brazil local time, to closely mirror New York Stock Exchange trading hours. Trading is also conducted between 11:00 a.m. and 6:00 p.m., or between 10:00 a.m. and 5:00 p.m. during daylight savings time in the United States, on an automated system known as the Computer Assisted Trading System (Sistema de Negociação Assistida por Computador) on the São Paulo Stock Exchange and on the National Electronic Trading System (Sistema Eletrônico de Negociação Nacional). This system is a computerized system which links electronically with the seven smaller regional exchanges. The São Paulo Stock Exchange also permits trading from 6:45 p.m. to 7:30 p.m. on an online system connected to traditional and internet brokers called the “After Market.” Trading on the After Market is subject to regulatory limits on price volatility and on the volume of shares transacted through internet brokers. There are no specialists or officially recognized market makers for our shares.

In order to better control volatility, the São Paulo Stock Exchange adopted a “circuit breaker” system pursuant to which trading sessions may be suspended for a period of 30 minutes or one hour whenever the indices of these stock exchanges fall below the limits of 10% or 15%, respectively, in relation to the index registered in the previous trading session.

The São Paulo Stock Exchange is less liquid than the New York Stock Exchange or other major exchanges in the world. As of May 3, 2002, the aggregate market capitalization of the 413 companies listed on the São Paulo Stock Exchange was equivalent to approximately US\$178.8 billion and the 10 largest companies listed on the São Paulo Stock Exchange represented approximately 47.5% of the total market capitalization of all listed companies. Although any of the outstanding shares of a listed company may trade on a Brazilian stock exchange, in most cases fewer than half of the listed shares are actually available for trading by the public, the remainder being held by small groups of controlling persons, by governmental entities or by one principal shareholder. As of May 3, 2002, we accounted for approximately 0.8% of the market capitalization of all listed companies on the São Paulo Stock Exchange.

Trading on Brazilian stock exchanges by a holder not deemed to be domiciled in Brazil for Brazilian tax and regulatory purposes (a “non-Brazilian holder”) is subject to certain limitations under Brazilian foreign investment legislation. With limited exceptions, non-Brazilian holders may only trade on Brazilian stock

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exchanges in accordance with the requirements of Resolution No. 2,689, of January 26, 2000, of the National Monetary Council. Resolution No. 2,689 requires that securities held by non-Brazilian holders be maintained in the custody of, or in deposit accounts with, financial institutions duly authorized by the Central Bank and the Brazilian securities commission. In addition, Resolution No. 2,689 requires non-Brazilian holders to restrict their securities trading to transactions on Brazilian stock exchanges or qualified over-the-counter markets. With limited exceptions, non-Brazilian holders may not transfer the ownership of investments made under Resolution No. 2,689 to other non-Brazilian holders through a private transaction. See “Taxation—Brazilian Tax Considerations—Taxation of Gains” for a description of certain tax benefits extended to non-Brazilian holders who qualify under Resolution No. 2,689.

Novo Mercado

Since April 24, 2002, our shares have been listed on the Novo Mercado. The Novo Mercado is a listing segment under the São Paulo Stock Exchange designed for the trading of shares issued by companies that voluntarily undertake to abide by some additional corporate governance practices and disclosure requirements in addition to those already imposed by Brazilian law. A company in the Novo Mercado must follow a series of corporate rules known as “good practices of corporate governance.” These rules generally increase shareholders’ rights and enhance the quality of information provided to shareholders. On April 18, 2002, our shareholders approved changes to our by-laws to comply with the Novo Mercado requirements. In addition, the Novo Mercado provides for the creation of a Market Arbitration Chamber for conflicts resolution between investors and companies listed in the Novo Mercado.

In addition to the obligations imposed by current Brazilian law, a company listed on the Novo Mercado is obligated to:

- issue only voting shares;
- hold public offerings of shares in a manner favoring diversification of the company’s shareholder base and broader retail access;
- maintain a minimum free float equal to 25% of the outstanding share capital of the company;
- grant tag along rights for all shareholders in connection with a transfer of control of the company;
- limit the term of all members of the board of directors to one year;
- prepare annual and quarterly financial statements, including cash flow statements, in accordance with U.S. GAAP or International Accounting Standards;
- disclose information on a quarterly basis, including insider share ownership and amount of free float of shares;
- if it elects to delist from the Novo Mercado, hold a tender offer by the company’s controlling shareholder (the minimum price of the shares to be offered will be determined by an appraisal process); and
- make greater disclosure of related party transactions.

REGULATION OF BRAZILIAN SECURITIES MARKETS

The Brazilian securities markets are principally governed by Law No. 6,385, of December 7, 1976, and the Brazilian corporation law, each as amended and supplemented, and by regulations issued by the Brazilian securities commission, which has regulatory authority over the stock exchanges and securities markets generally, the National Monetary Council, and by the Central Bank, which has licensing authority over

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brokerage firms and regulates foreign investment and foreign exchange transactions. These laws and regulations, among others, provide for disclosure requirements applicable to issuers of traded securities, protection of minority shareholders and criminal penalties for insider trading and price manipulation. They also provide for licensing and oversight of brokerage firms and governance of the Brazilian stock exchanges. Nevertheless, the Brazilian securities markets are not as highly regulated and supervised as the U.S. securities markets.

Under the Brazilian corporation law, a company is either public (*companhia aberta*), such as we are, or closely held (*companhia fechada*). All public companies, including us, are registered with the Brazilian securities commission and are subject to reporting requirements. A company registered with the Brazilian securities commission may have its securities traded on the Brazilian stock exchanges or in the Brazilian over-the-counter market. Our common shares are listed and traded on the São Paulo Stock Exchange and may be traded privately subject to some limitations.

To be listed on a Brazilian stock exchange a company must apply for registration with the Brazilian securities commission and the stock exchange where the head office of the company is located.

We have the option to ask that trading in our securities on the São Paulo Stock Exchange be suspended in anticipation of a material announcement. Trading may also be suspended on the initiative of the São Paulo Stock Exchange or the Brazilian securities commission, among other reasons, based on or due to a belief that a company has provided inadequate information regarding a material event or has provided inadequate responses to the inquiries by the Brazilian securities commission or the São Paulo Stock Exchange.

The Brazilian over-the-counter market consists of direct trades between individuals in which a financial institution registered with the Brazilian securities commission serves as intermediary. No special application, other than registration with the Brazilian securities commission, is necessary for securities of a public company to be traded in this market. The Brazilian securities commission requires that it be given notice of all trades carried out in the Brazilian over-the-counter market by the respective intermediaries.

Trading on the São Paulo Stock Exchange by non-residents of Brazil is subject to limitations under Brazilian foreign investment and tax legislation. The Brazilian custodian for the common shares underlying the ADSs must, on behalf of the depositary for the ADSs, obtain registration from the Central Bank of Brazil to remit U.S. dollars abroad for payments of dividends, any other cash distributions, or upon the disposition of the shares and sales proceeds thereto. In the event that a holder of ADSs exchanges ADSs for common shares, the holder will be entitled to continue to rely on the custodian's registration for five business days after the exchange. Thereafter, the holder may not be able to obtain and remit U.S. dollars abroad upon the disposition of the common shares, or distributions relating to the common shares, unless the holder obtains a new registration. See "Description of Share Capital—Regulation of Foreign Investment."

Capitalization

The following table sets forth our total short-term loans and financings and capitalization at February 28, 2002 derived from our unaudited interim financial information prepared in accordance with the corporation law method. You should read this table in conjunction with “Selected Financial Information,” “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and our audited financial statements included elsewhere in this prospectus.

| | <u>At February 28, 2002</u> |
|--|-----------------------------|
| | (in millions) |
| Short-term loans and financings:⁽¹⁾ | |
| <i>Real</i> -denominated loans and financings: | |
| Guaranteed ⁽²⁾ | R\$ 151.0 |
| Unguaranteed | 45.1 |
| Foreign currency-denominated loans and financings: | |
| Guaranteed ⁽²⁾ | 141.0 |
| Unguaranteed | 83.5 |
| Total short-term loans and financings | <u>R\$ 420.6</u> |
| Long-term loans and financings: | |
| <i>Real</i> -denominated loans and financings: | |
| Guaranteed ⁽²⁾ | R\$ 2,892.5 |
| Unguaranteed | 739.3 |
| Foreign currency-denominated loans and financings: | |
| Guaranteed ⁽²⁾ | 1,024.6 |
| Unguaranteed | 1,256.3 |
| Total long-term loans and financings | <u>R\$ 5,912.7</u> |
| Shareholders’ equity: | |
| Paid-in capital | R\$ 3,403.7 |
| Capital reserves | 41.4 |
| Revaluation reserve | 2,937.7 |
| Legal reserves | 104.7 |
| Investment reserve ⁽³⁾ | 1,493.5 |
| Accumulated earnings ⁽³⁾ | 21.0 |
| Total shareholders’ equity | <u>R\$ 8,002.0</u> |
| Total capitalization (long-term loans and financings plus shareholders’ equity) ⁽¹⁾ | <u><u>R\$13,914.7</u></u> |

(1) Includes current portion of long-term loans and financings. As of February 28, 2002, we did not have any short-term loans and financings other than the current portion of long-term loans and financings.

(2) Loans and financings guaranteed by either the Government of the State of São Paulo or the Federal Government of Brazil.

(3) Investment reserve plus accumulated earnings is available for distribution to shareholders.

Of our *real*-denominated loans and financings, R\$3,043.5 million was secured and R\$784.4 million was unsecured as of February 28, 2002. Of our foreign currency-denominated loans and financings, R\$1,165.6 million was secured and R\$1,339.8 million was unsecured as of February 28, 2002.

Selected Financial Information

The following table presents our selected financial information at and for each of the periods indicated. The selected financial information at December 31, 2000 and 2001 and for the three years in the period ended December 31, 2001 are derived from our financial statements audited by PricewaterhouseCoopers Auditores Independentes included in this prospectus.

Our financial statements have been prepared in accordance with the Brazilian corporation law method, which differs in significant respects from U.S. GAAP. You should read the selected financial information in conjunction with our audited financial statements and notes thereto included elsewhere in this prospectus, as well as “Presentation of Financial Information” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” Solely for the convenience of the reader, *real* amounts as at and for the year ended December 31, 2001 have been translated into U.S. dollars at the commercial selling rate at December 31, 2001 of R\$2.3204 to US\$1.00.

| | As at and for the year ended December 31, | | | | | |
|---|--|-------------|-------------|-------------|-------------|--------------|
| | 1997 | 1998 | 1999 | 2000 | 2001 | 2001 |
| | (in millions, except per share and per ADS data) | | | | | |
| Corporation Law Method | | | | | | |
| Statement of Operations Data: | | | | | | |
| Net operating revenue | R\$ 2,902.3 | R\$ 3,101.1 | R\$ 3,235.7 | R\$ 3,355.8 | R\$ 3,434.8 | US\$ 1,480.3 |
| Cost of services rendered | (1,314.6) | (1,421.4) | (1,364.2) | (1,474.1) | (1,590.4) | (685.4) |
| Gross profit | 1,587.7 | 1,679.8 | 1,871.5 | 1,881.7 | 1,844.3 | 794.8 |
| Selling expenses | (366.2) | (247.7) | (278.7) | (332.7) | (332.6) | (143.3) |
| General and administrative expenses | (172.4) | (194.5) | (153.8) | (137.3) | (203.1) | (87.5) |
| Financial expenses, net | (736.4) | (681.3) | (1,529.9) | (737.7) | (1,105.2) | (476.3) |
| Operating profit (loss) | 312.7 | 556.2 | (90.9) | 673.9 | 203.4 | 87.7 |
| Non-operating income (expenses), net | (93.2) | 5.3 | (124.5) | (82.3) | (76.9) | (33.1) |
| Income (loss) before taxes on income | 219.5 | 561.6 | (215.4) | 591.6 | 126.5 | 54.5 |
| Income tax and social contribution | (46.7) | (19.4) | (20.2) | (70.2) | 89.7 | 38.7 |
| Net income (loss) | 279.8 | 542.1 | (235.6) | 521.4 | 216.2 | 93.2 |
| Net income (loss) per 1,000 common shares | 10.09 | 19.46 | (8.28) | 18.31 | 7.59 | 3.27 |
| Net income (loss) per ADS | 2.52 | 4.87 | (2.07) | 4.58 | 1.90 | 0.82 |
| Dividends and interest attributed to shareholders’ equity per 1,000 common shares | 3.86 | 18.47 | — | 18.97 | 17.20 | 7.41 |
| Number of common shares outstanding at year end (in thousands of shares) | 27,736,064 | 27,857,340 | 28,437,155 | 28,479,578 | 28,479,578 | 28,479,578 |
| Balance Sheet Data: | | | | | | |
| Customer accounts receivable, net | R\$ 880.8 | R\$ 877.8 | R\$ 1,078.2 | R\$ 996.4 | R\$ 811.7 | US\$ 349.8 |
| Reimbursement due from State Government for pensions paid | 160.8 | 182.6 | 184.2 | 253.5 | 19.7 | 8.5 |
| Long-term receivables from State Government agreements | — | — | — | — | 649.1 | 279.7 |
| Property, plant and equipment | 12,420.2 | 13,203.4 | 13,298.3 | 13,346.4 | 13,510.0 | 5,822.3 |
| Total assets | 13,818.4 | 14,609.8 | 15,116.9 | 15,192.1 | 15,917.9 | 6,860.0 |
| Total short-term loans and financings | 739.4 | 862.9 | 841.6 | 381.7 | 549.3 | 236.7 |
| Total long-term loans and financings | 3,471.3 | 4,055.3 | 5,023.6 | 5,616.1 | 5,920.6 | 2,551.5 |
| Total liabilities | 5,469.1 | 6,185.3 | 6,845.3 | 6,923.7 | 7,921.2 | 3,413.7 |
| Shareholders’ equity | 8,349.3 | 8,424.5 | 8,271.5 | 8,268.5 | 7,996.7 | 3,446.3 |
| Other Financial Information: | | | | | | |
| Cash provided by operating activities | R\$ — | R\$ 1,701.9 | R\$ 1,874.2 | R\$ 1,744.1 | R\$ 1,700.6 | US\$ 732.9 |
| Cash used in investing activities | — | (1,175.6) | (801.8) | (598.4) | (709.5) | (305.8) |
| Cash used in financing activities | — | (629.0) | (943.4) | (1,098.3) | (763.6) | (329.1) |
| Adjusted EBITDA ⁽¹⁾ | 1,486.0 | 1,637.8 | 1,873.3 | 1,868.6 | 1,785.9 | 769.7 |
| Capital expenditures ⁽²⁾ | — | 1,122.7 | 790.7 | 596.3 | 694.6 | 299.3 |
| Depreciation and amortization | 329.9 | 400.2 | 434.1 | 457.0 | 477.3 | 205.7 |

Selected Financial Information

| | As at and for the year ended December 31, | | | | | |
|---|--|--------------|--------------|--------------|---------------|------------|
| | 1997 | 1998 | 1999 | 2000 | 2001 | 2001 |
| | (in millions, except per share and per ADS data) | | | | | |
| U.S. GAAP | | | | | | |
| Statement of Operations Data: | | | | | | |
| Net operating revenue | — R\$ | 3,101.1 R\$ | 3,235.7 R\$ | 3,355.8 R\$ | 3,434.8 US\$ | 1,480.3 |
| Gross profit | — | 1,445.6 | 1,691.3 | 1,668.6 | 1,613.8 | 695.5 |
| Selling expenses | — | (265.0) | (295.9) | (349.6) | (349.9) | (150.8) |
| General and administrative expenses | — | (247.6) | (198.5) | (184.1) | (214.8) | (92.6) |
| Operating profit (3) | — | 935.4 | 963.2 | 983.0 | 951.1 | 409.9 |
| Financial expenses, net | — | (681.3) | (1,563.2) | (740.6) | (1,107.1) | (477.1) |
| Net income (loss) | — | 301.4 | (449.3) | 284.4 | 16.7 | 7.2 |
| Net income (loss) per 1,000 common shares—basic and diluted | — | 10.82 | (15.95) | 10.00 | 0.59 | 0.25 |
| Net income (loss) per ADS—basic and diluted | — | 2.71 | (3.99) | 2.50 | 0.15 | 0.06 |
| Weighted average number of common shares outstanding (in thousands of shares) | — | 27,856,654 | 28,159,721 | 28,448,607 | 28,479,578 | 28,479,578 |
| Balance Sheet Data: | | | | | | |
| Property, plant and equipment | — R\$ | 15,707.4 R\$ | 15,643.0 R\$ | 15,583.8 R\$ | 15,656.0 US\$ | 6,747.1 |
| Total assets | — | 17,422.6 | 17,493.2 | 17,381.0 | 17,581.8 | 7,577.1 |
| Total short-term debt (including short-portion of long-term debt) | — | 862.9 | 816.5 | 381.7 | 549.3 | 236.7 |
| Total long-term debt | — | 4,055.3 | 5,023.6 | 5,612.2 | 5,873.2 | 2,531.1 |
| Total liabilities | — | 9,513.9 | 9,883.2 | 10,046.5 | 10,688.5 | 4,606.3 |
| Shareholders' equity | — | 7,908.8 | 7,610.0 | 7,334.4 | 6,893.3 | 2,970.7 |

| | At December 31, | | |
|--|-----------------|--------|--------|
| | 1999 | 2000 | 2001 |
| Operating Data (at period end): | | | |
| Number of water connections (in thousands) | 5,242 | 5,535 | 5,717 |
| Number of sewage connections (in thousands) | 3,763 | 3,976 | 4,128 |
| Volume of water billed during period (in millions of cubic meters) | 1,789 | 1,731 | 1,698 |
| Water loss percentage (average)(4) | 31.4% | 31.4% | 32.6% |
| Number of employees | 18,324 | 18,048 | 18,159 |

(1) Adjusted EBITDA means net income (loss) before financial expenses, net, income tax and social contribution (a federal tax on income), depreciation and amortization and non-operating income (expenses), net. Adjusted EBITDA is not a Brazilian corporation law measurement and does not represent cash flow for the periods presented and should not be considered as an alternative to net income (loss), as an indicator of our operating performance or as an alternative to cash flows as a source of liquidity. Our definition of adjusted EBITDA may not be comparable with adjusted EBITDA as defined by other companies. Although adjusted EBITDA, as defined above, does not provide a Brazilian corporation law measure of operating cash flows, it is commonly used by financial analysts in evaluating our business.

(2) Based upon the audited statements of cash flows for the years ended December 31, 2001, 2000 and 1999 included in note 23 to our audited financial statements and the audited statements of cash flows for the year ended December 31, 1998 which are not included in this prospectus.

(3) Under U.S. GAAP, operating profit is determined before financial expenses, net.

(4) Includes both physical and non-physical loss. Water loss percentage represents the quotient of (1) the difference between (a) the total amount of water produced by Sabesp less (b) the total amount of water invoiced by Sabesp to customers *divided by* (2) the total amount of water produced by Sabesp. We exclude from our calculation of water losses the following:

- water discharged for periodic maintenance of water mains and water storage tanks;
- water supplied for municipal uses such as firefighting;
- water we consume in our facilities; and
- estimated water losses associated with water we supply to *favelas* (shantytowns).

Management's Discussion and Analysis of Financial Condition and Results of Operations

The following operating and financial review and discussion of prospects should be read in conjunction with our financial statements included in this prospectus. The financial statements in this prospectus have been prepared in accordance with the corporation law method, which differs in certain significant respects from U.S. GAAP.

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

OVERVIEW OF SABESP

We operate public 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. We also make bulk sales of water to seven 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. The São Paulo Metropolitan Region, which has a population of approximately 18.2 million, accounted for approximately 76.2% and 75.7% of our net operating revenues in 2000 and 2001, respectively. Approximately 75.1% and 72.0% of the property, plant and equipment reflected on our balance sheet at December 31, 2000 and 2001, respectively, is located in this Region. The demand for our water and sewage services has grown steadily over the years, particularly in the São Paulo Metropolitan Region. As a result of a prolonged drought during 2000 and 2001, the demand currently exceeds the available water supplies in this Region. In an effort to respond to the demand in the São Paulo Metropolitan Region and because the Region represents the principal opportunity to increase our net operating revenues, 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.

We experienced major operational and financial problems beginning in the mid-1980s, culminating in 1994. We had some difficulty in meeting all of our debt and other obligations that year. Because we did not have the resources to make necessary capital expenditures to maintain our water and sewage systems, we experienced frequent breakdowns in our water distribution systems such that the weakened condition of these systems exacerbated water shortages and threatened, in some cases, water supplies. See "Business—History."

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 of São Paulo-controlled company;
- anti-inflation measures promulgated by the Brazilian Federal Government from time to time; and
- federal laws that in some circumstances limit to 12% per year the return on the assets of some of our concessions. See "Government Regulation—Tariff Regulation."

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 services rendered and operating expenses and to support our liquidity and capital resource requirements. We were able to increase our tariffs in mid-1998, which primarily accounted for an increase of approximately 6.9% in net operating revenues in that year, and again in mid-1999, which primarily accounted for an increase of

Management's Discussion and Analysis of Financial Condition and Results of Operations

approximately 4.3% in net operating revenues in that year. These tariff increases in 1998 and 1999, as well as earlier tariff increases in 1995, 1996 and 1997, exceeded inflation levels in each of these years. 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 Consumer Price Index. Tariffs have historically been adjusted once a year during June or July. The following table sets forth, for the periods indicated, the percentage increase of our tariffs, as compared to two inflation indices:

| | Year ended December 31, | | | | | | |
|--|-------------------------|-------|------|--------|-------|-------|-------|
| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
| Increase in Average Tariff ⁽¹⁾ | 30.0% | 21.6% | 9.8% | 3.1 % | 15.8% | — | 13.1% |
| <i>Índice Geral de Preços do Mercado IGP-M</i> (General Price Index-Market) | 15.2% | 9.2% | 7.7% | 1.8 % | 20.1% | 10.0% | 10.4% |
| <i>Índice de Preços ao Consumidor—IPC-FIPE</i> (Consumer Price Index) | 23.1% | 10.0% | 4.8% | (1.8)% | 8.6% | 4.4% | 7.1% |

(1) Tariff increases for each year or financial period took effect in mid-June or mid-July of such year or financial period.

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

We believe that our last tariff increases and the continuing implementation of our strategy have, to date, enhanced our business operations and financial performance and should provide the basis for our long-term operational and financial development, although we cannot provide you with any assurances in this regard. See “Business—Strategy.” Any failure to establish or maintain tariffs commensurate with our liquidity and capital resource requirements could have an adverse effect on our results of operations and financial condition.

OVERVIEW OF BRAZILIAN ECONOMIC CONDITIONS

At the end of 1997, in the aftermath of a financial crisis in Asia, Brazil experienced the beginning of an economic crisis brought about by capital flight, pressure on the Brazilian currency and increased interest rates. Before the economy could fully recover from the crisis, Russia devalued its currency in August 1998, and the Brazilian economy deteriorated further as a result of renewed capital flight.

The Brazilian government's measures to mitigate the crisis were unsuccessful, and continued pressure on the currency led the government to devalue the *real* in January of 1999. The *real* was devalued by 31.7% against the U.S. dollar during the first half of 1999, and by 32.4% for the year as a whole. The Central Bank raised base interest rates to approximately 45% in March 1999. The base interest rate is the benchmark interest rate payable to holders of securities issued by the Federal Government and traded at the Sistema Especial de Liquidação e Custódia—SELIC (Special System for Settlement and Custody).

The second half of 1999 brought some improvement in Brazil's economic situation. Base interest rates decreased to approximately 19% in December 1999, and the *real* devalued by 1.1% against the U.S. dollar during the second half of 1999, compared to 31.7% during the first half of the year. Inflation for the year as measured by the *Índice Geral de Preços de Mercado* (the General Price Index—Market, or IGP-M) was 20.1%.

The year 2000 saw additional improvement in the economy. The real gross domestic product grew 4.2% during the year and the value of the *real* remained relatively stable. Inflation fell to 10.0% in 2000, as measured by the IGP-M. The Central Bank gradually reduced base interest rates to 17.5% at June 30, 2000 and further reduced them to 16.5% at December 31, 2000 and to 15.25% at January 17, 2001.

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The growth of the Brazilian economy slowed in 2001, as the effects of the ongoing economic crisis in Argentina and lower levels of economic growth in the United States economy led to declines in investment and consumption in Brazil as well as in other emerging markets. The economic situation was exacerbated by the energy shortage and the resulting measures taken by the Brazilian government to reduce the consumption of electricity. Although the effect of the energy shortage is not yet quantifiable, the measures, when coupled with the Argentine and U.S. economic conditions, contributed to the reduction of the Brazilian government's projections of growth of gross domestic product for 2001.

The *real* depreciated by 15.7% against the U.S. dollar during 2001, as the *real*/U.S. dollar exchange rate fell from 1.9554 *reais* per U.S. dollar at December 31, 2000 to 2.3204 at December 31, 2001. At the same time, the Central Bank increased the base interest rate in 2001 from 15.3% at January 1, 2001, to 19.0% at December 31, 2001. The Central Bank reduced the base interest rate to 18.8% on February 19, 2002 and to 18.5% on March 19, 2002.

During the three-month period ended March 31, 2002, the *real* depreciated 0.1% against the U.S. dollar from R\$2.3204 at December 31, 2001 to R\$2.3236 at March 31, 2002.

The following table shows Brazilian inflation as measured by the IGP-M and IPC-FIPE, devaluation of the *real* against the U.S. dollar and the period-end exchange rates and average exchange rates for the periods indicated:

| | December 31, | | |
|---|--------------|-----------|-----------|
| | 1999 | 2000 | 2001 |
| Inflation (IPC-FIPE) | 8.6% | 4.4% | 7.1% |
| Inflation (IGP-M) | 20.1% | 10.0% | 10.4% |
| Devaluation of the <i>real</i> versus U.S. dollar | 32.4% | 8.5% | 15.7% |
| Period-end exchange rate—US\$1.00 ⁽¹⁾ | R\$1.7890 | R\$1.9554 | R\$2.3204 |
| Average exchange rate—US\$1.00 ⁽²⁾ | R\$1.8019 | R\$1.8313 | R\$2.3531 |

(1) The *real*/U.S. dollar exchange rate as of May 9, 2002 was R\$2.4519.

(2) The average exchange rate is the sum of the closing exchange rates at the end of each month in the period divided by the number of months in the period.

Sources: Fundação Getulio Vargas and the Central Bank.

Our results of operations and financial condition are significantly affected by Brazilian economic conditions, particularly by exchange rate movements, inflation rates and interest rate levels.

We had total foreign currency-denominated indebtedness of R\$2,653.4 million at December 31, 2001, and we anticipate that we may incur substantial foreign currency-denominated indebtedness in the future. 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 tariff and other revenues are based solely in *reais*. In addition, any significant devaluation of the *real* occurring during a financial period will increase our financial expenses as a result of foreign exchange losses that we must record. For example, the 15.7% devaluation of the *real* in 2001 increased our financial expenses and negatively affected our overall results of operations for that year. The 32.4% devaluation of the *real* in 1999 was the primary factor in our net loss for that year.

Inflation affects our financial performance by increasing our costs of services rendered and operating expenses. In addition, most of our *real*-denominated debt is indexed to take into account the effects of inflation. Under this debt, the principal amount increases by the *Taxa Referencial*—TR (a Brazilian government-determined interest rate), so that inflation results in increases in our financial expenses and corresponding debt-service obligations. We cannot assure you that we will be able, in future periods, to increase tariffs to address, in full or in part, the effects of inflation.

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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 above.

EFFECTS OF DROUGHT AND ELECTRICAL ENERGY CRISIS

Much of Brazil experienced a prolonged and severe drought during 2000 and 2001. 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 south of the São Paulo Metropolitan Region, affecting approximately 3.5 million people, or 20% of the total population of this Region. Under this rationing, water was made available to our customers for only two out of every three days. During this period of rationing, we also reduced our total water production by 8%. From April 2001 through January 2002, we rationed water in the west of the São Paulo Metropolitan Region, affecting approximately 300,000 people. Under this rationing, water was made available to these 300,000 customers for only 40 out of every 78 hours. As a result of the drought, our revenues 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. Any reoccurrence of drought for a lengthy period could cause us to again ration water and thereby have a negative effect on our results of operations and financial condition.

Brazil experienced a severe shortage of capacity to generate and transmit electrical power during 2001 and through March 2002, primarily due to the drought affecting the country which affected hydroelectric plants as well as to a lack of investment in power generation. Because our operations require a significant consumption of electrical energy, a substantial shortage of electrical energy could result in an interruption of our services. In addition, as a result of this energy crisis and the increased surcharges for electricity, our customers reduced their use of washing machines, dishwashers and water generally, which affected demand for water services and, consequently, our revenues.

INTEREST ATTRIBUTED TO SHAREHOLDERS' EQUITY

Brazilian corporations are permitted to determine a tax-deductible notional interest expense attributed to shareholders' equity, which is treated as a dividend and distributed in a manner similar to a dividend. The rate at which interest may be paid is limited to the average *Taxa de Juros de Longo Prazo*—TJLP (a long-term interest rate published by the Brazilian government) during the applicable period and the total amount of interest paid cannot exceed the greater of:

- 50% of net income (before taking such distribution and any deductions for income taxes into account) for the period in respect of which the payment is made; and
- 50% of retained earnings.

Distribution of interest attributed to our shareholders' equity is a tax-deductible expense, for both income tax and social contribution purposes. The amount paid to shareholders as interest attributed to 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.

In 1997, 1998, 2000 and 2001, we paid our shareholders interest attributed to shareholders' equity in lieu of dividends. We did not pay interest attributed to shareholders' equity or dividends in 1999, as we were not required to pay a mandatory dividend in light of our net loss in that year.

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Interest attributed to shareholders' equity is recorded as part of, but is immediately reversed under, the financial expenses line item in our statement of operations. See note 15(e) to our audited financial statements. The tax deduction relating to distributions of interest attributed to 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 (loss) in our statement of operations.

CRITICAL ACCOUNTING POLICIES

Critical accounting policies are those that are both (1) important to the portrayal of our financial condition and results 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 discussed below.

Sabesp's discussion and analysis of its financial condition and results of operations are based upon its primary financial statements, which have been prepared in accordance with the Brazilian corporation law method and which vary in some respects from U.S. GAAP. In addition, we have included a discussion on material differences between the Brazilian corporation law method and U.S. GAAP related to each critical accounting policy in our audited financial statements.

Accounts receivable and allowance for doubtful accounts

Revenues for water services are recognized when the water is consumed. Revenues from sewage services are based on water consumed. Revenue is recognized during the month in which service is provided to assure matching of costs on the accrual basis of accounting.

Our accounts receivable from our customers do not generally accrue interest, indexation charges or penalties, except for refinanced agreements. Amounts to be billed refer to water and sewage services provided but not yet billed, which are estimated from the last measurement date to month-end based on the prior month's billings. Our management is confident that an arrangement exists with our customers at a fixed price and collection is reasonably assured.

Customer accounts receivable from bulk sale customers refer to treated water supplied to certain municipal authorities, which are themselves responsible for water distribution, billing and collection. A number of bulk sale customers have been contesting certain tariff increases since mid-1998 and are not paying the amounts disputed. Some of our bulk sale customers are partially depositing the amounts they owe us in court. We have in the past obtained and in the future we expect to continue to obtain judicial orders to ensure that the amounts so deposited are released to us promptly.

We maintain an allowance for doubtful accounts in an amount we consider sufficient to cover any probable losses on realization of our accounts receivable from our customers. Provisions to the allowance for doubtful accounts are included in selling expenses, net of recoveries. The net charge was R\$153.8 million in 2001, R\$190.3 million in 2000 and R\$162.9 million in 1999. The accounting policy adopted by Sabesp for establishing the allowance for doubtful accounts reserve includes:

- accounts receivable balances (excluding accounts receivable from the State Government) more than R\$5,000 and less than \$30,000 overdue more than 360 days are included in the allowance for doubtful accounts;

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- accounts receivable balances (excluding accounts receivable from the State Government) more than \$30,000 overdue more than 360 days, for which legal action has been taken, are included in the allowance for doubtful accounts; and
- accounts receivable balances (excluding accounts receivable from the State Government) less than R\$5,000 overdue more than 180 days are written-off through a direct charge to selling expenses (debts recovered are recorded as a reduction of selling expenses).

We have substantial assets consisting of amounts owed by the State. These consist primarily of accounts receivable for services, reimbursement for pensions paid and amounts due under our December 2001 agreement with the State. We do not reserve against any of these amounts owed by the State due to the following factors:

- (1) Sabesp does not expect to incur losses from these accounts receivable as the State is our controlling shareholder;
- (2) Sabesp has entered into agreements in 1997 and 2001 under which the State Government has committed to settle the outstanding amounts due to us described in these agreements by applying dividends declared by Sabesp to the remaining balance of the accounts receivable owed by the State or its controlled entities; and
- (3) under Brazilian Federal Law No. 9,430, Sabesp is not permitted to write off or record an allowance for doubtful accounts against any amounts owing to us from the State Government or entities controlled by the State Government.

As of December 31, 2001, amounts owed to us by the State were R\$35.8 million in accounts receivable, R\$19.7 million in reimbursement for pensions paid, and R\$649.1 million due under the December 2001 agreement. If we reserved against these amounts, it would adversely affect our adjusted EBITDA and net income.

We expect the amount of accounts receivable from the State and reimbursement for pensions paid to increase. Before the December 2001 agreement, the State owed us R\$358.2 million in accounts receivable and R\$320.6 million in reimbursement for pensions paid. These balances were restructured under the December 2001 agreement, but they are now increasing. We account for these as current assets, regardless of the number of days they are overdue. If we accounted for any part of them as long-term assets, it would adversely affect our level of current assets.

No differences have been identified between accounting policies on accounts receivable and allowance for doubtful accounts adopted under the Brazilian corporation law method and under U.S. GAAP.

Compensation for concession termination

Compensation for concession terminations 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. At December 31, 2001, it amounted to R\$148.8 million.

Under concession agreements Sabesp invests in the construction of water and sewage systems in these municipalities to meet its concession service commitments. Upon the unilateral termination of certain concessions, Sabesp's assets were impounded by the municipal authorities which took on the responsibility of providing water and sewage services in these areas. At that time, Sabesp reclassified its property, plant and equipment balances relating to the impounded assets to long-term assets (compensation for concession termination) and recorded impairment charges to reduce the carrying value of the assets to amounts which Sabesp had contractually agreed as fair compensation with the relevant authorities. Sabesp does not consider these to be contingent assets or indemnification claims but rather as partial reimbursement for investments made under legally binding concession agreements and judicially enforceable contracts. Such

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amounts are recorded as non-current assets. If we treated them as contingent assets or claims, our shareholders' equity would be reduced.

The amount receivable from the municipality of Diadema was determined by an agreement signed between us and the municipality in December 1996, before a court of law, to be received over a 15-year period. In 1996, we recorded a loss on disposal of these assets. The municipality of Diadema failed to pay the first installments and filed an action against us. A final judicial decision is pending.

The amount receivable from the municipality of Mauá relates to the compensation for the fair value of assets, based on an appraisal report, expropriated by the municipality of Mauá in 1995. We filed a legal action in 1996 to recover the value of our concession assets and loss of earnings, at which time the arbitration court appointed an appraisal expert. The appraisal expert's valuation report has yet to be filed in court and a definitive ruling issued. In 1999, when the appraisal report was first made available to us, we recorded a loss on disposal of these assets.

No differences have been identified between accounting policies on compensation for concession termination adopted under the Brazilian corporation law method and under U.S. GAAP.

Property, Plant and Equipment

Valuation of long-lived assets

Under the Brazilian corporation law method, 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. In the event that such operating income is insufficient, within the context of the fixed asset group, to recover the depreciation due to permanent impairment of assets, the assets, or groups of assets, are written-down to recoverable values, preferably, based on the projected discounted cash flows of future operations.

Under U.S. GAAP, SFAS No. 121, "Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to Be Disposed Of," requires companies to periodically evaluate the carrying value of long-lived assets to be held and used, when events and circumstances warrant such a review. The carrying value of long-lived assets is considered impaired when the anticipated undiscounted cash flow from such asset groups is separately identifiable and is less than their carrying value. In that event, a loss is recognized based on the amount by which the carrying value exceeds the fair market value of the assets or discounted cash flows generated by the assets.

We review long-lived assets, primarily buildings and water and sewage systems 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. We assess impairment on the basis of the projected recovery of depreciation charges through results of operations. We write down the carrying value of assets or groups of assets if and when appropriate.

Studies supporting the write-offs for obsolescence and construction-in-progress were concluded by our engineering department in the accounting period of the write-off 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 adjust the net book value to assure future projected operating revenues are 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 possible, depreciation rates are adjusted to take account of changes in estimated prospective depreciable lives as assets are replaced.

No adjustments have been included in the reconciliation from the Brazilian corporation law method to U.S. GAAP to take account of differences between the measurement criteria, because no impairment provisions

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were required based on analysis of cash flows measured at the smallest unit of assets groups for which cash flow data is captured. Loss on 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.

Concessions acquired

Beginning January 1, 1998, 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.

Concession assets 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 to avoid backloading the charge in later years by estimating future disbursement commitments to meet our concession obligations.

No differences have been identified between accounting policies adopted for concessions acquired under the Brazilian corporation law method and under U.S. GAAP.

Contributions of property, plant and equipment

Contributions of property, plant and equipment by third parties (such as property owners) to allow us to supply water and sewage services are recorded in income. Occasionally, we issue common shares at market prices for the purchase of assets, principally from municipal authorities, at fair value, which is recorded as a capital increase. Contributions of assets from our principal shareholder (the State Government) are recorded as a capital reserve.

No differences have been identified between accounting policies adopted for contributions of property, plant and equipment under the Brazilian corporation law method and under U.S. GAAP.

Construction-in-progress and capitalization of interest

Construction-in-progress projects are recorded at cost and are primarily construction projects under contract with third parties. For long-term projects, we capitalize the assets subject to these projects once our engineering department approves that the project milestones have been achieved and we take delivery of the assets. We capitalize interest incurred on borrowings to the extent that borrowings do not exceed construction-in-progress, as a reduction of interest expense. In addition, in 2000 and 1999, we capitalized indexation charges associated with the indexation charges on the real-denominated borrowings and the foreign exchange losses on foreign currency borrowings.

Under U.S. 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. The credit is a reduction of interest expense. Under U.S. GAAP, the amount of interest capitalized excludes the indexation charges associated with the borrowings and the foreign exchange gains and losses on foreign currency borrowings.

Pension Plans

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

Consistent with current accounting practice under the Brazilian corporation law method, we have not recognized our actuarial obligation for pension liabilities in the financial statements. Pension amounts due to the pension plan are treated on an accrual basis as the obligations fall due. However, following issue of an accounting standard, we are required to record the obligation beginning in 2002. We had the option to

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account for the impact at December 31, 2001 either against retained earnings or prospectively as a charge against earnings over five years. The standard requires comprehensive recording of pension expenses and obligations on an actuarial basis instead of, as is currently required, based on the required contributions for the relevant year. We have elected to recognize the liability on a straight line basis through earnings over the five years ending December 31, 2006. We estimate the annual charge to income will be R\$80.0 million.

In addition, Amendment No. 20, dated December 15, 1998, to the Brazilian Federal Constitution and subsequent regulations established thereunder provide that contributions made by state-owned companies to pension plans cannot exceed amounts contributed by beneficiaries under these pension plans. However, these regulations provide for an exception to this rule when a contribution is made by the state-owned company to encourage beneficiaries to change from a defined benefit plan to a defined contribution plan. In this case, the state-owned company is permitted to assume the existing deficit on behalf of the beneficiary. As legal precedents and interpretation of these regulations are not settled, we have not made any amendments to our estimated pension obligations.

Under U.S. GAAP, we have adopted the provisions of SFAS No. 87, "Employers' Accounting for Pensions," and have recognized the actuarial liability, based on the same assumptions used to determine the calculations for Brazilian corporation law method purposes.

For purposes of U.S. GAAP, the provisions of SFAS No. 87 for the purposes of calculating the funded status were applied. The accrued pension cost adjustments under Plan G1 at December 31, 1999 included a deduction for short-term debt owed to SABESPREV which was considered as a negative contribution for SFAS No. 87 calculation purposes. In addition, the Plan G1 amount accrued under the corporation law method for prior services is excluded for U.S. GAAP purposes. The changes introduced by Amendment No. 20 to the Federal Constitution as described above have not been treated as amendments or curtailments for SFAS No. 87 purposes.

Pursuant to a law enacted by the State Government, certain employees who provided service to Sabesp between 1972 and 1974 acquired a legal right to receive supplemental pension payments (which rights are referred to as "Plan G0"); these amounts are paid by us and are claimed as a reimbursement from the State Government. No future obligation is recorded under the Brazilian corporation law method.

For purposes of U.S. GAAP, the liability for the future Plan G0 obligations have been determined under the actuarial criteria stipulated in SFAS No. 87. Consistent with the guidance in SEC Staff Accounting Bulletin Topic 5-T ("SAB No. 5-T"), we recognized as an expense the costs incurred by the State Government on our behalf in respect of the provision of pension costs payments made to these employees in recognition of the services rendered to Sabesp for which such payments are the remuneration therefor. Amounts reimbursed to us 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) was charged off as a deduction to shareholders' equity.

Several statistical and other factors which attempt to anticipate 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 rate of future compensation increases as determined by Sabesp, within certain guidelines. In addition Sabesp's actuarial consultants also use subjective factors such as withdrawal, turnover and mortality rates to estimate these factors. The actuarial assumptions used by Sabesp may differ materially from actual results due to changing market and economic conditions, regulatory events, judicial rulings, higher or lower withdrawal rates or longer or shorter life spans of participants. These differences may result in a significant impact to the amount of pension expense recorded by Sabesp.

Certain Transactions With Controlling Shareholder

Reimbursement due from State Government

Reimbursement due from State Government for pensions paid represent supplementary pensions (Plan G0) and leave benefits (sabbatical paid leave) that we pay, on behalf of the State Government, to former employees of the State Government-owned companies which merged to form Sabesp. These amounts are reimbursed to us by the State Government, as primary obligor. However, these amounts have been outstanding for a long period. As described under “—Accounts receivable and allowance for doubtful accounts” above, we account for these as current assets, and we do not reserve against such accounts receivable as we fully expect to recover these amounts and loss is not considered probable.

For U.S. GAAP purposes, these accounts receivable amounts are charged to income and recognized on a push-down basis as mentioned above.

Accounts receivable from the State Government for water and sewage service provided

Certain accounts receivable from the State Government for water and sewage services provided to State-owned entities, have been overdue for a long period. As described under “—Accounts receivable and allowance for doubtful accounts” above, we account for these as current assets, and we do not reserve against such accounts receivable as we fully expect to recover these amounts and loss is not considered probable.

No differences have been identified between accounting policies on accounts receivable and allowance for doubtful accounts adopted under the Brazilian corporation law method and under U.S. GAAP.

Use of certain assets owned by the State Government

We currently use certain reservoirs in the Alto Tietê System and the Billings and Guarapiranga reservoirs which are owned indirectly by the State Government. We currently do not pay any fees with respect to the use of these reservoirs. We, however, 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 of São Paulo 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 the arrangement, we agreed to fund 100% of the estimated costs of the 1992 agreement equal to R\$27.8 million and 75% 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% 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 such agreement by R\$5.9 million, which has yet to be disbursed.

We have the right to draw water and release emissions in 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 contract is still under construction and once operational will be depreciated for U.S. GAAP purposes over a 30-year period.

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. Sabesp has a right to use these reservoirs so long as Sabesp remains responsible for maintaining and meeting their operating costs.

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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 operating revenue:

| | Year ended December 31, | | |
|--|-------------------------|--------|--------|
| | 1999 | 2000 | 2001 |
| Net operating revenue | 100.0% | 100.0% | 100.0% |
| Cost of services rendered | (42.2) | (43.9) | (46.3) |
| Gross profit | 57.8 | 56.1 | 53.7 |
| Selling expenses | (8.6) | (9.9) | (9.7) |
| General and administrative expenses | (4.8) | (4.1) | (5.9) |
| Financial expenses, net | (47.3) | (22.0) | (32.2) |
| Operating profit (loss) | (2.8) | 20.1 | 5.9 |
| Non-operating income (expenses), net | (3.9) | (2.5) | (2.2) |
| Income (loss) before taxes on income | (6.7) | 17.6 | 3.7 |
| Income tax and social contribution | (0.6) | (2.1) | 2.6 |
| Net income (loss) | (7.3) | 15.5 | 6.3 |

2001 Compared to 2000

Net Operating Revenue

Net operating revenue for 2001 increased by R\$79.0 million, or 2.4%, to R\$3,434.8 million from R\$3,355.8 million for 2000.

Water net operating revenue increased by R\$47.3 million, or 2.4%, to R\$2,042.3 million from R\$1,995.0 million for 2000. This increase was primarily due to an average increase of 13.1% in tariffs, effective on June 1, 2001. The increase in water net operating revenue was partially offset by a decline of 2.6% in volume of water distributed primarily as a result of:

- the Brazilian government electricity rationing program established in the State of São Paulo, as well as in other States, in the second quarter of 2001, which caused a reduction in the average water consumption of our customers; and
- our water conservation educational program to increase public awareness of the importance of preserving water and avoiding waste, begun in 1996, which has been reducing water consumption by our customers (which we refer to as our “water conservation program”).

Our water tariffs for each customer generally increase as and to the extent that the customer's consumption of water increases. As a result of the above-mentioned decrease in average consumption by our customers, our average revenue per customer has also decreased.

Sewage net operating revenue increased by R\$32.2 million, or 2.4%, to R\$1,392.5 million from R\$1,360.8 million for 2000. This increase was due primarily to increases in revenues from water services, because our sewage charges are generally fixed as a function of the monthly water charges. See “Business—Tariffs.”

Net operating revenue did not reflect any tariff increases in 2000 and only reflected a tariff increase from June 1, 2001. We did not increase tariffs in 2000 due to a State policy for that year of not increasing tariff rates for many public services.

Cost of Services Rendered

Cost of services rendered for 2001 increased by R\$116.3 million, or 7.9%, to R\$1,590.4 million from R\$1,474.1 million for 2000. As a percentage of net operating revenue, costs of services rendered increased to 46.3% for 2001 from 43.9% in 2000. This increase was primarily due to the following factors:

- an increase of R\$26.9 million, or 4.9%, in payroll and related costs as a result of the 5.4% increase in salaries which took effect in May 2001 which was partially offset by a R\$10.6 million decrease in profit-sharing from R\$21.9 million for 2000 to R\$11.3 million for 2001;
- an increase of R\$26.6 million, or 15.4%, in the costs of third-party services, mainly for technical maintenance services and technical and professional services;
- an increase of R\$21.0 million, or 4.7%, in depreciation expenses principally related to the commencement of operations of new water and sewage systems in the São Paulo Metropolitan Region in the second half of 2000 and in 2001;
- an increase of R\$16.7 million, or 9.3%, in energy costs mainly due to an increase in electric power tariffs; and
- an increase of R\$13.2 million, or 29.0%, in the costs of materials used in the treatment of water and sewage. The increase in cost was largely a result of the recent drought, which led to lower quality water in 2001 as compared to 2000 and so increased our need for the materials. The increase was also due to an increase in prices of these materials.

Gross Profit

As a result of the above factors, gross profit for 2001 decreased by R\$37.4 million, or 2.0%, to R\$1,844.3 million from R\$1,881.7 million for 2000. As a percentage of net operating revenue, gross profit decreased to 53.7% for 2001 from 56.1% for 2000.

Selling Expenses

Selling expenses for 2001 decreased by R\$0.1 million, or 0.04%, to R\$332.6 million from R\$332.7 million for 2000. As a percentage of net operating revenue, selling expense decreased to 9.7% for 2001 from 9.9% for 2000.

The decrease in selling expenses was primarily due to a R\$36.5 million, or 19.2%, decrease in allowance for doubtful accounts expense in 2001, which is recorded under selling expenses. The lower allowance for doubtful accounts expense in 2001 reflects a 96.6% decrease in direct write-offs (net of recoveries) of overdue accounts receivable from small customers to R\$3.1 million in 2001 from R\$62.4 million in 2000, due to a recovery in the amount of R\$46.0 million received in 2001 from the City of São Paulo.

The lower direct write-off level was partially offset by higher provision (net of recoveries) of approximately R\$150.7 million, or 15.6%, in respect of overdue accounts receivable from large customers as well as municipalities to which we provide water on a bulk basis, as compared to the provision of R\$127.9 million for the corresponding period in 2000.

The decrease in the allowance for doubtful accounts expense was partially offset by the following factors:

- an increase of R\$18.6 million, or 37.4%, in third-party services costs, mainly related to expanded hiring of collection agencies to collect overdue accounts receivable, increased use of outside service providers to read water and sewage meters and deliver bills to customers, technical maintenance of our water and sewage connections and expenses in reforming our commercial layouts;
- an increase of R\$12.3 million, or 18.0%, in payroll and related costs as a result of the salary increases mentioned above; and

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- an increase of R\$4.3 million, or 21.6%, in general expense costs related to a R\$4.8 million provision in connection with a claim for incorrect billing of water and sewage services made by several condominium buildings in the City of São Paulo.

We are continuing our efforts to recover write-offs and other overdue accounts receivable from our customers, including, among other measures, increased use of collection agencies to collect overdue accounts receivable. During 2001, we recovered R\$131.9 million of the total allowance for doubtful accounts provision as compared to R\$88.6 million during the corresponding period in 2000.

General and Administrative Expenses

General and administrative expenses for 2001 increased by R\$65.8 million, or 47.9%, to R\$203.1 million from R\$137.3 million for 2000. As a percentage of net operating revenue, general and administrative expenses increased to 5.9% for 2001 from 4.1% for 2000. This increase primarily reflected:

- an increase of R\$50.5 million, or 161.6%, in payroll and related costs. The increase was largely a result of a reversal of a R\$47.8 million labor-related contingency provision in 2000, which was the result of a favorable judicial decision in litigation that had been brought against us by SINTAEMA, our employees' largest labor union. The increase in payroll and related costs was also due to a 5.4% increase in salaries which took effect in May 2001; and
- an increase of R\$16.6 million in general expense costs. The increase in general expense costs was primarily attributable to a R\$22.3 million provision for a disputed tax on revenues (FINSOCIAL). We established the provision in 2001 in anticipation of a possible adverse judicial decision in this pending tax case that is expected to be rendered in 2002.

Financial Expenses, Net

Net financial expenses 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.

Net financial expenses for 2001 increased by R\$367.5 million, or 49.8%, to R\$1,105.2 million from R\$737.7 million for 2000. As a percentage of net operating revenue, net financial expenses increased to 32.2% for 2001 from 22.0% for 2000.

The absolute and relative increases in net financial expenses were primarily due to a higher foreign exchange loss in 2001 as compared to 2000, reflecting the effects on our foreign currency-denominated debt of the significant devaluation of the *real* against the U.S. dollar in 2001. Foreign exchange loss increased to R\$387.0 million for 2001 as compared to the foreign exchange loss of R\$158.5 million in 2000.

Interest and other charges on *real*- and foreign-currency loans and financings for 2001 increased by R\$81.0 million, or 15.2%, to R\$615.1 million from R\$534.1 million for 2000. This increase was principally due to:

- an increase of R\$34.1 million of interest and other charges related to an increase in foreign-currency denominated indebtedness when translated into *reais* as a result of the depreciation of the *real* against the U.S. dollar in 2001, even though the aggregate principal amount of our U.S. dollar-denominated debt declined during 2001; and
- an increase of R\$46.9 million of interest and other charges related to indexation-based increases in the principal amount of our *real*-denominated debt in 2001.

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At December 31, 2001, approximately R\$3,056.7 million, or 80.1%, of our *real*-denominated debt was inflation-indexed.

Interest income for 2001 increased by R\$2.3 million, or 4.0%, to R\$60.3 million from R\$58.0 million for 2000. This increase was primarily due to higher average balances of cash and time deposits.

In addition, indexation accruals relating to overdue accounts receivable decreased by R\$3.8 million to R\$43.4 million for 2001 as compared to R\$47.2 million for 2000. This decrease was principally due to a renegotiation of existing agreements with some customers to pay overdue accounts receivable over time subject to inflation-based indexation arrangements.

Operating Profit (Loss)

As a result of the above factors (including, in particular, foreign exchange losses), the operating profit for 2001 totaled R\$203.4 million as compared to the operating profit of R\$673.9 million for 2000.

Non-Operating Income (Expenses), Net

Net non-operating expenses for 2001 decreased by R\$5.4 million, or 6.5%, to R\$76.9 million from R\$82.3 million for 2000. As a percentage of net operating revenue, net non-operating expenses decreased to 2.2% for 2001 from 2.5% for 2000. The non-operating expenses were primarily due to a R\$84.9 million net loss on dispositions and write-offs of obsolete and other non-productive fixed assets in 2001 as compared to R\$118.7 million in 2000.

The decrease in net non-operating expenses was partially offset by a decrease of R\$12.2 million, or 51.3%, to R\$11.6 million from R\$23.8 million in non-operating income in 2000. This decrease was, in turn, primarily due to the gain on the sale of investments which were available for sale in the amount of R\$10.1 million in 2000 and the absence of sales of equity investments in 2001.

Income Tax and Social Contribution

For 2001, we had an income tax and social contribution benefit of R\$89.7 million as compared to an income tax and social contribution expense of R\$70.2 million for 2000, although for both 2001 and 2000 we had pre-tax income. This difference was primarily due to the increase, as a percentage of pre-tax income in 2001 as compared to 2000, in our income tax and social contribution benefit from interest attributed to shareholders' equity. For 2001 such benefit amounted to R\$166.5 million, representing approximately 131.6% of the R\$126.5 million pre-tax income. For 2000 such benefit amounted to R\$183.5 million, representing approximately 31.0% of the R\$591.6 million pre-tax income. This tax benefit is directly related to the interest attributed to shareholders' equity paid and or accrued within each year which is not charged to pre-tax income as it is treated in a manner similar to a dividend but generates a tax deductible expense.

Although we had pre-tax income, we had an effective income tax benefit rate of 70.9% in 2001 based upon our income before taxes on income. In 2000 we had an effective income tax expense rate of 11.9% based upon our income before taxes on income. For both 2001 and 2000 the statutory composite tax rate was 34%. Our effective income tax benefit and expense rate principally reflected the tax benefit of paying dividends in the form of interest attributed to shareholders' equity. See "—Interest Attributed to Shareholders' Equity."

Net Income (Loss)

As a result of above factors, we had a net income for 2001 of R\$216.2 million, compared to net income of R\$521.4 million for 2000.

2000 Compared to 1999

Net Operating Revenue

Net operating revenue for 2000 increased by R\$120.0 million, or 3.7%, to R\$3,355.8 million, from R\$3,235.7 million for 1999.

Water net operating revenue for 2000 increased by R\$59.8 million, or 3.1%, to R\$1,995.0 million, from R\$1,935.2 million for 1999. This increase was primarily due to the following factors:

- an average increase of 14.9% in tariffs, effective mid-1999, which was in effect for twelve months in 2000 as compared with six months in 1999; and
- the assumption of the operations in the municipality of Osasco, to which we previously sold water on a bulk basis. In connection with the assumption, those customers which were previously served by Osasco became general customers of Sabesp. As a result, our volume of water services provided to general customers increased by 1.2%. Our tariff rates for general customers are higher than our tariff rates for our bulk sale customers.

This increase was partially offset by a decrease of 3.2% in the total volume of water distributed in 2000. This decrease in volume of water distributed was primarily due to:

- the water rationing program established in parts of the São Paulo Metropolitan Region in the second half of 2000 due to the prolonged drought during that period; and
- the results of our water conservation program.

Sewage net operating revenue for 2000 increased by R\$60.3 million, or 4.6%, to R\$1,360.8 million, from R\$1,300.5 million for 1999. This increase was due primarily to increases in revenues from water services, because, as noted above, our sewage charges are fixed as a function of the monthly water charges.

Cost of Services Rendered

Cost of services rendered for 2000 increased by R\$109.9 million, or 8.1%, to R\$1,474.1 million from R\$1,364.2 million for 1999. As a percentage of net operating revenue, costs of services rendered increased to 43.9% for 2000 from 42.2% for 1999. This increase was primarily due to the following factors:

- an increase of R\$49.3 million, or 37.6%, in energy costs mainly due to an increase in electric power tariffs as well as the commencement of operations of new sewage systems in the São Paulo Metropolitan Region at the end of 1999;
- an increase of R\$36.2 million, or 26.6%, in costs of third-party services, mainly for technical maintenance services and other technical and professional services;
- an increase of R\$28.7 million, or 6.9%, in depreciation expenses primarily relating to the commencement of operations of new sewage systems in the São Paulo Metropolitan Region; and
- an increase of R\$8.5 million, or 23.0%, in the costs of materials used in the treatment of water and sewage as a result of drought conditions and, consequently, lower quality water in the second half of 2000 as compared with the corresponding period in 1999.

Gross Profit

As a result of the above factors, gross profit for 2000 increased by R\$10.1 million, or 0.5%, to R\$1,881.7 million from R\$1,871.6 million for 1999. As a percentage of net operating revenue, gross profit decreased to 56.1% for 2000 from 57.8% for 1999.

Selling Expenses

Selling expenses for 2000 increased by R\$54.0 million, or 19.4%, to R\$332.7 million, from R\$278.7 million for 1999. As a percentage of net operating revenue, selling expenses increased to 9.9% for 2000 from 8.6% for 1999. These increases were due, in large part, to a R\$27.4 million increase in the allowance for doubtful accounts, which is recorded under selling expenses, and which increased to R\$190.3 million in 2000 as compared to R\$162.9 million in 1999.

The higher allowance for doubtful accounts expense in 2000 reflected a 116.6% increase in the provision (net of recoveries) in respect of overdue accounts receivable from large customers and municipalities to which we provide water on a bulk basis to R\$127.9 million for 2000 as compared with R\$59.1 million in 1999. The net provision level in 1999 benefited from the reversal of R\$58.6 million previously provided for against overdue accounts receivable from the municipality of Osasco, which overdue amounts were settled in connection with our assumption of the water and sewage operations of Osasco. We continue to experience significant problems in realizing our accounts receivable owed to us by the State of São Paulo and municipalities. The higher allowance for doubtful accounts expense in 2000 was partially offset by lower direct write-offs (net of recoveries) in respect of overdue accounts receivable from small customers, which decreased to R\$62.4 million in 2000 from R\$103.8 million in 1999. We attribute the decrease in these write-offs to increased recoveries of overdue accounts receivable from small customers due to expanded efforts to collect these receivables, including increased use of third party collection agencies to pursue smaller customers.

Increase in selling expenses also reflected the increase in third-party services of R\$19.8 million, principally related to increase in collection services of overdue accounts receivable.

General and Administrative Expenses

General and administrative expenses for 2000 decreased by R\$16.5 million, or 10.7%, to R\$137.3 million from R\$153.8 million for 1999. As a percentage of net operating revenue, general and administrative expenses decreased to 4.1% for 2000 from 4.8% for 1999. These decreases primarily reflected the reversal in 2000 of a R\$47.8 million labor-related contingency provision following a favorable judicial decision in litigation that had been brought against us by SINTAEMA, our employees' largest labor union. See "Business—Legal Proceedings." The reversal of this provision was partially offset by the increase in third-party services of R\$22.2 million, mainly due to the following factors:

- an increase of R\$11.7 million in promotional expenses relating to our water conservation program; and
- an increase of R\$7.1 million in software maintenance and computer hardware operating lease expenses.

Financial Expenses, Net

Net financial expenses for 2000 decreased by R\$792.2 million, or 51.8%, to R\$737.7 million from R\$1,529.9 million for 1999. As a percentage of net operating revenue, net financial expenses decreased to 22.0% for 2000 from 47.3% for 1999.

The absolute and relative decreases were primarily due to a lower foreign exchange loss in 2000 as compared to 1999, reflecting the effects of lower devaluation of the *real* against the U.S. dollar in 2000. Foreign exchange loss on our foreign currency-denominated debt decreased to R\$158.5 million in 2000 from R\$852.0 million in 1999.

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Interest and other charges on *real*- and foreign-currency loans and financings in 2000 also decreased by R\$26.8 million, or 4.8%, to R\$534.1 million from R\$560.9 million in 1999. This decrease was principally due to:

- a decrease of R\$17.5 million in interest and other charges related to our foreign currency-denominated debt, resulting from lower average principal balances and lower average interest rates for that debt in 2000; and
- a decrease of R\$9.2 million of interest and other charges related to our *real*-denominated debt, resulting from lower average interest rates in 2000.

Inflation-based indexation charges, which comprise part of financial expenses, decreased by R\$90.1 million in 2000, as the magnitude of increases in the principal amount of our *real*-denominated debt declined because of a substantial decrease in that year in the TR rate used for purposes of such indexation. As of December 31, 2000, approximately R\$3,125.9 million, or 87.8%, of our *real*-denominated debt was subject to indexation.

Interest income in 2000 increased by R\$34.4 million, or 145.8%, to R\$58.0 million from R\$23.6 million in 1999. This increase was primarily due to higher average balances of cash and time deposits.

In addition, we had a decrease of R\$43.6 million in indexation accruals relating to agreements to settle overdue accounts receivable to R\$46.3 million in 2000 from R\$89.9 million in 1999. The smaller amount in 2000 principally reflected the decrease in the negotiated amounts of the agreements.

Operating Profit (Loss)

As a result of the above factors, our operating profit for 2000 was R\$673.9 million as compared to an operating loss of R\$90.8 million in 1999.

Non-Operating Income (Expenses), Net

Net non-operating expenses for 2000 decreased by R\$42.2 million, or 33.9%, to R\$82.3 million from R\$124.5 million for 1999. This decrease was primarily due to the following factors:

- the increase in non-operating income of R\$18.8 million mainly from the sales of equity investments;
- the reversal in 2000 of R\$12.7 million of a provision for employee sabbatical leaves that had been established in the past; and
- the absence in 2000 of a provision comparable to a R\$12.0 million provision in 1999 for probable losses relating to tax-incentive investments made in lieu of paying certain income taxes.

In both 2000 and 1999, we incurred substantial losses on write-offs of obsolete and other non-productive assets, which totaled R\$118.7 million in 2000 and R\$116.9 million in 1999.

Income Tax and Social Contribution

For 2000, we had income tax and social contribution of R\$70.2 million as compared to an income tax and social contribution of R\$20.2 million for 1999. This increase in income tax and social contribution was primarily due to our pre-tax income of R\$591.6 million in 2000 as compared to our pre-tax loss of R\$215.3 million in 1999. In addition, our income tax and social contribution benefited by R\$183.5 million in 2000 as a result of our accrual of interest attributed to shareholders' equity for that year. This latter tax benefit in 2000 was partially offset by non-deductible charges of R\$54.2 million relating to the write-off

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and depreciation of certain assets that had been revalued in prior years. The tax benefit of R\$79.7 million attributable to our pre-tax loss in 1999 was more than offset by two factors:

- non-deductible charges of R\$78.8 million relating to the write-off and depreciation of certain assets that had been revalued in prior years, including the Mauá concession assets. See note 11(a) to our audited financial statements; and
- the recognition of the cumulative impact of a change in an accounting policy requiring us to record deferred tax effects of certain temporary tax differences in a total amount of R\$21.7 million. Once the accounting standard had been approved by the Brazilian securities commission, we began complying with the new standard from 1999 onwards. We had not followed the procedure previously, as it had been optional, except for the recognition of the liability for deferral of tax on indexing gains, no amounts had been recorded in the past. Upon adoption of this new accounting standard, a deferred tax charge was recognized directly in income in 1999 relating to prior period deferred taxes effects.

We did not accrue any amounts for interest attributed to shareholders' equity in 1999.

We had an effective tax rate of 11.9% in 2000, which was below the statutory composite rate of 34% applicable for that year because of the reasons discussed above.

Net Income (Loss)

As a result of the above factors, net income for 2000 was R\$521.4 million as compared with a loss for 1999 of R\$235.4 million.

LIQUIDITY AND CAPITAL RESOURCES

Our principal liquidity and capital resources requirements include the following:

- debt-service obligations relating to our indebtedness;
- capital expenditures to maintain, improve and expand our water and sewage systems, including an estimated R\$2,745.2 million during the period from 2002 to 2006;
- payment of pension plan and other employee benefits, including pension plan payments to certain of our former employees on behalf of the State Government; and
- dividend payments and other distributions to our shareholders, including the State of São Paulo.

Our primary sources of liquidity and capital resources consist of the following:

- funds generated by operations;
- borrowings from Brazilian federal and state governmental financial institutions, such as Caixa Econômica Federal (a Brazilian government-owned bank);
- financing from multilateral organizations, such as the World Bank and the Inter-American Development Bank; and
- financings in the domestic and international capital and lending markets.

We believe that we have sufficient sources of liquidity and capital to meet our anticipated debt-service, capital expenditure and other requirements for the next few years, although we cannot assure you in this regard.

We generate substantial funds from our operations. We generated cash provided by operating activities of R\$1,874.2 million in 1999, R\$1,744.1 million in 2000 and R\$1,700.6 million in 2001. Although we

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sustained a R\$235.4 million net loss in 1999, we had net income of R\$521.4 million in 2000 and R\$216.2 million in 2001.

The net cash provided by operating activities does not include a significant portion of our accounts receivable, primarily accounts receivable owed by the State of São Paulo and some municipal governments. We have not immediately realized cash from a significant portion of our accounts receivable, primarily accounts receivable owed by the State of São Paulo and certain municipal governments. We do not reflect these accounts receivable in net cash provided by operating activities until cash is actually received by us.

We signed a protocol of understanding in September 1997 with the State of São Paulo which provides for the settlement of unpaid accounts receivable for water and sewage services due from the State using dividends payable by us to the State as one of our shareholders. We have in the past applied dividends in the form of interest attributed to shareholders' equity due to the State of São Paulo to settle a corresponding amount of unpaid accounts receivable. At a meeting held on January 30, 2002, our Board of Directors declared dividends, in the form of interest attributed to shareholders' equity, in an aggregate amount of R\$489.8 million. This distribution will be paid within 60 days after our annual shareholders meeting, which is scheduled to take place in April 2002, to our shareholders who held shares as of February 7, 2002. Accordingly, the State of São Paulo will be entitled to receive R\$432.7 million of this distribution.

Pursuant to the terms of the existing September 1997 protocol of understanding and the December 2001 agreement described below, Sabesp expects the State to apply approximately R\$287.7 million of this declared dividend payable to the State of São Paulo to settle current and future accounts receivable owed by the State or its controlled entities. We expect to pay approximately R\$145.0 million, the remaining share of the dividend that the State is entitled to, to the State in cash.

In December 2001, we entered into an agreement with the State Government whereby the State, among other things, agreed to transfer the reservoirs in the Alto Tietê System in exchange for the cancellation of a portion of accounts receivable then due from the State and reimbursement then due from the State Government for pensions paid by us. The transfer of assets contemplated by this agreement will be a non-cash transaction. We cannot assure you as to when this transfer of reservoirs and cancellation of accounts receivable will take place or what value will ultimately be assigned to these reservoirs.

We anticipate that net cash provided by operating activities will continue to be the single largest source of liquidity and capital resources in future years and financial periods.

At December 31, 2001, our domestic debt of approximately R\$3,816.5 million consisted primarily of *real*-denominated loans from federal and State Government-owned banks (in particular, Banco do Brasil S.A. and Caixa Econômica Federal), and debentures issued in March 1999 and June 2001. At December 31, 2001, our foreign currency-denominated debt of approximately R\$2,653.4 million consisted principally of US\$424.0 million in loans from the Inter-American Development Bank and US\$78.7 million in loans from the World Bank, US\$275.0 million aggregate principal amount of 10% Notes Due 2005 sold in the international capital markets in July 1997, US\$200.0 million aggregate principal amount of 12% Notes Due 2003 sold in these markets in June 2000 and an aggregate of US\$130.0 million in syndicated loans. See note 9 to our audited financial statements.

At December 31, 2001, we had approximately R\$5,920.6 million in long-term debt outstanding (excluding the current portion of long-term debt), of which approximately R\$2,275.7 million consisted of foreign currency-denominated long-term debt. Substantially all of the foreign currency-denominated debt was denominated in U.S. dollars or baskets of foreign currencies. We anticipate that we may incur substantial amounts of foreign currency-denominated indebtedness in the future, among other things, to refinance a portion of our more expensive *real*-denominated indebtedness, to refinance our foreign currency-denominated debt and to finance our capital expenditure program. In the event of a significant devaluation

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of the *real* in relation to the U.S. dollar or other currencies, the cost of servicing our foreign currency-denominated debt and other obligations could be adversely affected, particularly as our tariff and other revenues are based solely in *reais*.

We had outstanding short-term debt of approximately R\$549.3 million at December 31, 2001, representing the current portion of our long-term debt. At December 31, 2001, approximately R\$377.7 million of this short-term debt was denominated in foreign currencies.

Our outstanding long-term debt at December 31, 2001 included approximately R\$549.3 million due during 2002, approximately R\$816.2 million due during 2003, approximately R\$853.1 million due during 2004 and approximately R\$4,251.4 million due during 2005 or thereafter. We believe that we can service this 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 financial statements.

Substantially 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 *Taxa Referencial*—TR (daily government interest rate) plus an agreed margin. See note 9 to our audited financial statements.

We are subject to covenants under agreements evidencing or governing our outstanding indebtedness, including those set forth in a loan agreement with the Inter-American Development Bank, the indentures relating to the 10% Notes Due 2005 and the 12% Notes Due 2003 and the loan agreements relating to the syndicated loans. Each of these agreements contains, among other provisions, limitations on our ability to incur debt. The indentures relating to the 10% Notes Due 2005 and the 12% Notes Due 2003 are the most stringent of these debt agreements. Both of these indentures prohibit, subject to some exceptions, the incurrence of additional debt in the event that (1) the ratio of Indebtedness to Adjusted Capitalization (as defined therein) is greater than 0.42x or (2) the Debt Service Coverage Ratio (as defined therein) 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 corporation 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 December 31, 2001, our ratio of Indebtedness to Adjusted Capitalization was 0.33x and our Debt Service Coverage Ratio was 2.61x, in each case as calculated in accordance with the above-mentioned indentures.

We are currently in compliance with covenants contained in the agreements evidencing or governing all of our outstanding indebtedness. We previously were not in compliance with some operational and financial covenants, including a covenant relating to the age of overdue accounts receivable, contained in one loan agreement with the World Bank. We obtained waivers in respect of these covenants from the World Bank through year-end 1998, when these covenants ceased to apply to us.

We have a number of agreements with the Caixa Econômica Federal to provide us with an aggregate of approximately R\$533.2 million in financing for our capital expenditure program, of which R\$520.2 million was outstanding at December 31, 2001. We have pledged amounts in certain bank accounts into which customers pay their water and sewage bills as collateral for these loans. We are entitled to draw upon these facilities during the next few years. While we also anticipate that Caixa Econômica Federal will provide additional financing for our capital expenditure program, we have not entered into definitive documentation for these financing facilities. Accordingly, we cannot assure you that these

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facilities will be available to meet a portion of our financing requirements. In addition, in August 2000 we entered into an agreement with the Inter-American Development Bank for US\$200.0 million in loans to be funded through 2005 to finance portions of our capital expenditure program. Under this agreement, we are loaned funds to match our capital expenditures. At December 31, 2001, US\$5.5 million had been drawn down and was outstanding under this agreement.

We are currently negotiating with the Japan Bank for International Cooperation, Banco Nacional de Desenvolvimento Econômico e Social—BNDES (the Brazilian national development bank) and Caixa Econômica Federal for additional loans to finance portions of our capital expenditure program.

Our borrowings from multi-lateral institutions, such as the World Bank, the Inter-American Development Bank and the Japan Bank for International Cooperation, have in the past been, and in the future are likely to be, guaranteed by the Government of the State of São Paulo or the Federal Government. We do not pay fees for these guarantees. We do not have any contractual or other right to continue receiving guarantees of the State or the Federal Government. If we could no longer obtain these guarantees, we would lose access to funding from these sources, which are generally on favorable terms.

On January 30, 2002, our Board of Directors approved the issuance of non-convertible debentures due 2007 in an aggregate amount of up to R\$500 million. On February 25, 2002 our shareholders also approved the issuance of these debentures. We expect that the issuance of these debentures will occur in the second quarter of 2002. We expect to use the proceeds from this issuance to repay some of our debt. However, we believe that we have sufficient liquidity and sources of financing to meet our debt obligations without such an issuance.

Brazilian regulations provide that a state-owned company, such as Sabesp, must, subject to some exceptions, use the proceeds of “external credit operations” (*i.e.*, foreign currency borrowings) to refinance outstanding financial obligations provided that, until so used, these proceeds are 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 World Bank and the Inter-American Development Bank.

Our cash disbursements for purchases of property, plant and equipment under our capital expenditure program totaled approximately R\$694.6 million in 2001, as compared with approximately R\$596.3 million in 2000 and R\$790.7 million in 1999. The lower capital expenditures in 2000 reflected our postponement of several projects due primarily to the difficult economic conditions in Brazil resulting from the devaluation of the *real*. The increase in 2001 was the result of the commencement of new and postponed projects. Our capital expenditure program will require total expenditures by us of approximately R\$2,745.2 million in the period from 2002 through 2006, including approximately R\$583.0 million in 2002 and R\$388.9 million in 2003.

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\$72.8 million in 2001, R\$69.3 million in 2000 and R\$67.0 million in 1999. The State of São Paulo is required to reimburse us for such amounts, but has generally not been paying us on a current basis. The State of São Paulo's obligation to us for these amounts is recorded under reimbursement due from State Government for pensions paid on the balance sheet and totaled R\$326.3 million at December 31, 2001. 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 of São Paulo regarding more timely reimbursement for the special payments to former employees, including the negotiation of the December 2001 agreement described above, we cannot assure you as to when or whether such payments will be made by the State. We may continue to be held

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responsible for these special payments to former employees, even if the State of São Paulo stops reimbursing us with respect to these payments.

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. We recently entered into a new 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 are also required to pay interest on the unpaid balance of this tax liability. At December 31, 2001, the total tax liability to be paid on the installment basis amounted to approximately R\$181.4 million. See "Business—Legal Proceedings—Tax Proceedings" and note 10 to our audited financial statements. Payments in respect of this aggregate tax liability continue to constitute a liquidity and capital resource requirement which must be satisfied.

We may conduct primary offerings of our equity securities in the future to generate proceeds for use by us to satisfy a portion of our liquidity and capital resource requirements. However, we cannot predict whether the State of São Paulo, as our controlling shareholder, will authorize equity offerings by us or whether any such offerings in the future will constitute a significant source of funds for us. We anticipate that the State of São Paulo, which is required by applicable law to hold two-thirds of our common shares, will continue to retain substantial ownership and control of our company.

The following summarizes Sabesp's significant contractual obligations and commitments that impact its liquidity:

| | Up to 1 year | 2 - 3 years | After 3 years | Total |
|--|-----------------|-------------------|-------------------|-------------------|
| | (in millions) | | | |
| Contractual Obligations | | | | |
| (payments due by period) | | | | |
| Long-term debt, including current portion ⁽¹⁾ | R\$549.3 | R\$1,669.3 | R\$4,251.4 | R\$6,470.0 |
| Operating leases ⁽²⁾ | 10.5 | 8.4 | 0.1 | 19.0 |
| Pension plan obligations—Plan G1 ⁽³⁾ | 10.0 | 20.0 | 236.0 | 266.0 |
| Pension plan obligations—Plan G0 ⁽³⁾ | 73.0 | 146.0 | 673.0 | 892.0 |
| Tax Recovery Program (REFIS) ⁽⁴⁾ | 57.3 | 114.6 | 9.5 | 181.4 |
| Capital expenditure commitments ⁽⁵⁾ | 191.2 | 420.7 | 119.1 | 731.0 |
| Total contractual cash obligations | <u>R\$891.3</u> | <u>R\$2,379.0</u> | <u>R\$5,289.1</u> | <u>R\$8,559.4</u> |

(1) Long-term debt is detailed in note 9 to our audited financial statements.

(2) Operating leases are detailed in note 14(f) to our audited financial statements.

(3) Pension plan obligations and actuarial amounts are detailed in note 22 VI(a) and (b) to our audited financial statements.

(4) The REFIS Tax Recovery Program is detailed in note 10 to our audited financial statements.

(5) Capital expenditure commitments are detailed in note 14(e) to our audited financial statements.

MARKET RISKS

We are exposed to various market risks—in particular, foreign currency exchange rate risk and interest rate risk. We are exposed to exchange rate risk because a substantial portion of our financial expenses, net is denominated in foreign currencies (primarily the U.S. dollar) while we generate all of our net operating revenues in *reais*. Similarly, we are subject to interest rate risk based upon changes in interest rates, which affect our financial expenses, net. We do not use derivative instruments, such as foreign exchange forward contracts, foreign currency options or interest rate swaps or forward rate agreements, to manage these market risks. We do not hold or issue derivative or other financial instruments for trading purposes.

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Exchange Rate Risk

At December 31, 2000 and 2001, approximately R\$2,437.4 million, or 40.6%, and R\$2,653.4 million, or 41.0%, respectively, of our debt obligations were denominated in foreign currencies (including debt pegged to baskets of foreign currencies). The basket of foreign currency-pegged debt consists primarily of our debt with the World Bank and the Inter-American Development Bank. As a result, we are exposed to exchange rate risks that may adversely affect our financial condition and results of operations, as well as our ability to meet debt service obligations.

We estimate that the potential loss to us in connection with foreign currency-denominated debt that would have resulted as of December 31, 2000 and 2001 from each hypothetical instantaneous and unfavorable 1% change in the relevant exchange rates against the *real* would have been approximately R\$24.4 million and R\$26.5 million, respectively. Consistent with these estimates, a hypothetical instantaneous and unfavorable 10% change in these exchange rates would have resulted in losses of approximately R\$243.7 million and R\$265.3 million as of December 31, 2000 and 2001, respectively. These estimates do not take into account that the changes in exchange rates comprising the baskets of foreign currencies often present variations different from the devaluation of the *real* in relation to the U.S. dollar.

The devaluation of the *real* in relation to the U.S. dollar and with the World Bank and Inter-American Development Bank basket of currencies, for the years ended December 31, 2000 and 2001, were as follows:

| | Year ended December 31, | |
|--|-------------------------|-------|
| | 2000 | 2001 |
| Devaluation of <i>real</i> in relation to: | | |
| U.S. dollar | 8.5% | 15.7% |
| World Bank basket of currencies | 2.5% | 10.0% |
| Inter-American Development Bank basket of currencies | 4.7% | 12.2% |

At December 31, 2000 and 2001, we partially limited our exposure to foreign currency exchange rate risks by acquiring foreign currency, amounting to R\$73.2 million and R\$82.2 million at December 31, 2000 and 2001, respectively, which were used to repay certain debt obligations, and were deposited in a bank account for such purposes.

We have not entered into financial instruments to mitigate the effects of exchange rates movements.

As of December 31, 2000 and 2001, we did not have any derivative contracts outstanding which limited exposure to variations in foreign currencies.

At December 31, 2000 and 2001, we had no short-term debt outstanding, other than the current portion of long-term debt.

Interest Rate Risk

At December 31, 2000 and 2001, approximately R\$3,106.5 million, or 87.3%, and R\$3,056.7 million, or 80.1%, respectively, of our total debt outstanding balance denominated in *reais*, was based on variable rates of interest based on the *Unidade Padrão de Referência*—UPR (Reference Standard Unit), which is equal to the *Taxa Referencial*—TR (daily Government interest rate). In addition, at December 31, 2000 and 2001, approximately R\$432.4 million, or 12.2%, and R\$736.5 million, or 19.3%, respectively, of our total debt denominated in *reais* was subject to interest rates based on the *Certificado de Depósito Interbancário*, or CDI, rate (benchmark interest rate set by the Brazilian interbank market on a daily basis). At December 31, 2000 and 2001, R\$1,138.9 million and R\$1,166.5 million, respectively, of our foreign-currency denominated debt was based on World Bank and the Inter-American Development Bank variable rates of

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interest, which are determined based on the cost of funding of these multilateral organizations in each period.

At December 31, 2000 and 2001, we did not have any derivative contracts outstanding which limited exposure to changes in the UPR or the CDI or in the World Bank or the Inter-American Development Bank variable rates. However, we are obliged by law to invest our excess cash with financial institutions controlled by the Brazilian government. We invest these excess funds, which totaled R\$118.0 million at December 31, 2000, and R\$281.7 million at December 31, 2001, mainly in short-term instruments. As a result, our exposure to Brazilian interest rate risk is partially limited by our *real*-denominated floating interest time deposits investments, which generally earn the CDI rate. In addition to our exposure with respect to existing indebtedness, we may become exposed to interest rate volatility with respect to indebtedness incurred in the future.

We estimate that we would have suffered a loss over periods of one year, respectively, of up to R\$35.6 million and R\$38.2 million if a hypothetical instantaneous and unfavorable change of 100 basis points in the interest rates applicable to financial liabilities on December 31, 2000 and 2001, respectively, had occurred. Consistent with these estimates, a hypothetical instantaneous and unfavorable 10%, or 1000 basis point, change in these interest rates would have resulted in losses of approximately R\$356.0 million and R\$381.7 million as of December 31, 2000 and 2001, respectively. This sensitivity analysis is based on the assumption of an unfavorable 100 basis point movement of the interest rates applicable to each homogeneous category of financial liabilities and sustained over a period of one year and that such movement may or may not affect interest rates applicable to any other homogenous category of financial liabilities. A homogeneous category is defined according to the currency in which financial liabilities are denominated and assumes the same interest rate movement within each homogeneous category (*e.g.*, U.S. dollars). As a result, our interest rate risk sensitivity model may overstate the effect of interest rate fluctuation on these financial instruments, as consistently unfavorable movements of all interest rates are unlikely.

The tables below provide information about our interest rate-sensitive instruments. For variable interest rate debt, the rate presented is the weighted average rate calculated as of December 31, 2001.

| | At December 31, 2001 | | | | | | Average annual interest rate |
|--|-----------------------------------|-----------------|-----------------|-------------------|-------------------|-------------------|------------------------------|
| | Expected maturity date | | | | | Total | |
| | 2002 | 2003 | 2004 | 2005 | After 2005 | | |
| | (in millions, except percentages) | | | | | | |
| Assets: | | | | | | | |
| Time deposits denominated in <i>reais</i> . . . | R\$281.7 | — | — | — | — | R\$ 281.7 | 98.5% of CDI rate |
| Total assets | <u>R\$281.7</u> | <u>—</u> | <u>—</u> | <u>—</u> | <u>—</u> | <u>R\$ 281.7</u> | |
| Liabilities: | | | | | | | |
| Long-term debt: | | | | | | | |
| Floating rate, denominated in <i>reais</i> indexed by TR or UPR | R\$168.4 | R\$162.5 | R\$176.7 | R\$ 192.2 | R\$2,376.9 | R\$3,087.7 | 8.4% |
| Floating rate, denominated in <i>reais</i> . . . | 3.2 | 2.3 | 515.4 | 102.3 | 116.6 | 739.8 | 1.3% over CDI rate |
| Floating rate, denominated in U.S. dollars | 111.8 | 105.9 | 79.4 | 52.4 | 563.9 | 913.4 | 6.1% |
| Floating rate, denominated in French francs | 1.3 | 1.5 | 1.7 | 1.9 | 2.1 | 8.5 | 5.9% |
| Fixed rate, denominated in U.S. dollars | 264.6 | 544.0 | 79.9 | 718.0 | 125.1 | 1,731.6 | 10.0% |
| Total long-term debt | <u>R\$549.3</u> | <u>R\$816.2</u> | <u>R\$853.1</u> | <u>R\$1,066.8</u> | <u>R\$3,184.6</u> | <u>R\$6,470.0</u> | |

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The percentage of our debt subject to fixed and floating interest rates is as follows:

| | At December 31, | |
|--|-----------------|----------------|
| | 2000 | 2001 |
| Floating rate debt: | | |
| • Denominated in U.S. dollars | 15.90% | 14.12% |
| • Denominated in French francs | 0.14 | 0.13 |
| • Denominated in <i>reais</i> | 59.36 | 58.99 |
| | <u>75.40</u> | <u>73.24</u> |
| Fixed rate debt: | | |
| • Denominated in U.S. dollars | <u>24.60</u> | <u>26.76</u> |
| | <u>24.60</u> | <u>16.76</u> |
| Total | <u>100.00%</u> | <u>100.00%</u> |

DECEMBER 2000 ACCOUNTING STANDARD UNDER THE BRAZILIAN CORPORATION LAW

In December 2000, IBRACON issued a technical standard regarding the recording of pension plan and other post-employment benefits for employees, which establishes the period, method and disclosure requirements for the recognition of costs associated with benefits granted to employees. The standard, which was also approved by the Brazilian securities commission, is effective for 2002 and required disclosure of the impact on our 2001 financial statements. This standard requires comprehensive recording of pension expenses and obligations on an actuarial basis instead of, as is currently required, based on the accrued contributions for the relevant year. We have the option to record the full effects of this change in accounting policy directly against retained earnings at December 31, 2001 or prospectively through earnings over a five year period. We have elected to recognize the liability on a straight line basis through earnings over the five years ending December 31, 2006. The annual charge to earnings for each of the five years to recognize the actuarial liability for our pension plan, Plan G1, is estimated at R\$80.0 million.

In addition, Amendment No. 20, dated December 15, 1998, to the Federal Constitution and subsequent regulations established thereunder provide that contributions made by state-owned companies to pension plans cannot exceed amounts contributed by beneficiaries under these pension plans. However, these regulations do provide for an exception to this rule when a contribution is made by the state-owned company to encourage beneficiaries to change from a defined benefit plan to a defined contribution plan. In this case, the state-owned company is permitted to assume the existing deficit on behalf of the beneficiary. As legal precedents and interpretation of these regulations are not settled, no amendments have been made to Sabesp's estimated pension obligations as of the date of this prospectus.

U.S. GAAP RECONCILIATION

Our net income (loss) in accordance with the corporation law method was R\$(235.4) million in 1999, R\$521.4 million in 2000 and R\$216.2 million in 2001. Under U.S. GAAP, we would have reported net income (loss) of R\$(449.3) million in 1999, R\$284.4 million in 2000 and R\$16.7 million in 2001.

Our shareholders' equity in accordance with the corporation law totaled R\$8,271.5 million at December 31, 1999, R\$8,268.5 million at December 31, 2000 and R\$7,996.7 million at December 31, 2001. Under U.S. GAAP, we would have reported shareholders' equity of R\$7,610.0 million at December 31, 1999, R\$7,334.4 million at December 31, 2000 and R\$6,893.3 million at December 31, 2001.

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The principal differences between the corporation law method and U.S. GAAP that affect our net income (loss) in 1999, 2000 and 2001, as well as shareholders' equity at December 31, 1999, 2000 and 2001, 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 corporation 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 corporation 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 of São Paulo and which are not treated as our expenses under the corporation 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 are currently recognized on an accrual basis only to the extent of required contributions for the relevant year or financial period under the corporation law method, but which would be required to be fully recorded on an actuarial basis under U.S. GAAP; and
- additional accounting items, including, among others, capitalized interest, expensing of deferred charges and deferred taxes.

See note 22 to our audited financial statements for a description of these differences as they relate to us and a reconciliation of net income (loss) and total shareholders' equity from the corporation law method to U.S. GAAP.

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GENERAL

We believe we are one of the largest water and sewage companies in the Americas based upon net revenues in 2001. We operate public water and sewage systems in the State of São Paulo in which the City of São Paulo, Brazil's largest city, is located. According to the Brazilian Institute of Geography and Statistics, or BIGS, the State of São Paulo is Brazil's most populous and economically productive state. We had net operating revenue of R\$3,434.8 million (US\$1,480.3 million) and net income of R\$216.2 million (US\$93.2 million) in 2001. We had total assets of R\$15,917.9 million (US\$6,860.0 million) and shareholders' equity of R\$7,996.7 million (US\$3,446.3 million) at December 31, 2001.

We provide water and sewage services to a broad range of residential, commercial, industrial and governmental customers in the City of São Paulo and in 365 of the 645 other municipalities in the State of São Paulo. We also supply water on a bulk basis to municipalities in the São Paulo Metropolitan Region in which we do not operate water systems. We divide our service territories into three regions: the São Paulo Metropolitan Region, the Interior Region, and the Coastal Region. The São Paulo Metropolitan Region, the Interior Region and the Coastal Region accounted for 76%, 16% and 8% of our sales and services rendered in 2001.

At December 31, 2001, we distributed water to approximately 20.9 million persons, which we believe includes approximately 59% of the urban population of the State of São Paulo, through approximately 53.3 thousand kilometers of water pipes and mains to more than 5.7 million water connections. We provided sewage services to approximately 16.2 million persons, or 78% of our water customers, through approximately 32.6 thousand kilometers of sewer lines to approximately 4.1 million sewage connections. In addition, we sell water in bulk to seven other municipalities having an estimated population of approximately 3.7 million persons.

The State of São Paulo, our controlling shareholder, is required by State law to own at least two-thirds of our common (voting) shares. At April 30, 2002, approximately 88.3% of our outstanding common shares was owned by the State of São Paulo. After giving effect to the offerings, the State of São Paulo will own approximately 72.1%, or 69.7% if the over-allotment option is exercised in full, 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 Water Secretariat of the State of São Paulo as part of the overall strategic planning for the State of São Paulo. The members of the Board of Directors and the Executive Committee of Sabesp are nominated by the Conselho de Defesa de Capitais do Estado de São Paulo—CODEC (State Council for Protection of Capital of the State of São Paulo), a State agency presided over by the Secretary of the State Treasury and reporting directly to the Governor.

In addition, our capital expenditure budget is subject to approval by the State Legislature and is approved in conjunction with the budget of the Water 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 Tribunal de Contas (State Accounts Tribunal), as are all accounts of the State of São Paulo.

THE STATE OF SÃO PAULO

The State of São Paulo is one of 26 states that, together with the Federal District of Brasília, constitute the Federative Republic of Brazil. The State is located in the southeastern region of the country, which is, according to BIGS, the most developed and economically active region of Brazil, which includes the states of

Minas Gerais, Espírito Santo and Rio de Janeiro. The State lies between the states of Rio de Janeiro and Minas Gerais to the north, the state of Paraná to the south, Mato Grosso do Sul to the west and the Atlantic Ocean to the east.

The State of São Paulo occupies 3% of Brazil's land mass and encompasses an area totaling approximately 96,000 square miles. According to BIGS, the State is the most populous state in Brazil, with an estimated population at December 31, 2001 of 37.8 million.

At December 31, 2001, the City of São Paulo, the State's capital, had an estimated population of 10.5 million, with 18.2 million inhabitants in the greater metropolitan region of São Paulo. The São Paulo Metropolitan Region encompasses 39 cities, the second largest metropolitan area in the Americas and among the four largest metropolitan areas in the world according to the United Nations' World Urbanization Prospects, 1999 Revision. The São Paulo Metropolitan Region accounted for approximately 48% of the population of the State.

According to BIGS, in 1999, the most recent year for which this data is available, the GDP of the State of São Paulo was approximately R\$337 billion, representing approximately 35.0% of Brazil's total GDP, making it the largest economy of any state in Brazil, based on GDP. The State is the leading Brazilian state in terms of manufacturing and industrial activity, according to BIGS, with a strong position in car manufacturing, pharmaceuticals, computer production, steel making and plastics, among others, as well as the leading position in the banking and financial services industries. The State is the most important exporting state in Brazil, according to the Brazilian Ministry of Development, Industry and Foreign Trade.

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 Companhia Cantareira de Água e Esgotos and formed the Repartição de Água e Esgotos (Office of Water and Sewers), a governmental agency. Since that time, water and sewage services in the São Paulo Metropolitan Region have been administered by the government of the State of São Paulo. Historically, water and sewage services in substantially all other municipalities of the State of São Paulo were administered by the municipalities directly either by municipal water and sewage departments or through *autarquias* of the municipal government. *Autarquias* are relatively autonomous public bodies with separate legal standing, assets and revenues, created by law to undertake administration of public services, which are considered to be better managed by a decentralized administrative and financial structure.

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

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

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de Saneamento de São Paulo, or SANESP, to provide sewage treatment services for the São Paulo Metropolitan Region. All assets previously owned by the Department of Water and Sewers in connection with such activities were transferred to SANESP.

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

Recovery Program

We experienced significant operational and financial problems beginning in the mid-1980's, which culminated in 1994. These problems were due, in part, to adverse economic conditions in Brazil prior to implementation of the Real Plan in mid-1994 but also to our position as a state-controlled enterprise whose financial performance was only a secondary consideration of the State of São Paulo. The tariff structure then in place did not generate sufficient revenues to enable Sabesp to provide adequate service to existing or new customers or to satisfy its liquidity and capital requirements, but instead was reflective of political considerations which viewed water and sewage services as a public entitlement.

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

During 1995, we, in conjunction with the current administration of the State of São Paulo, initiated a "recovery" program designed to restore our business operations and financial condition, including the Organizational Restructuring, the implementation of the initial stages of our strategy and the development of a new "for-profit" orientation. Under the Organizational Restructuring, we reordered our organizational structure into eight divisions and sixteen business units in an effort to be more responsive to the requirements of the customers and municipalities served.

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

STRATEGY

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

Our overall strategy is based upon three guiding principles:

- **Marketing Strategy:** to improve and expand water and sewage service for our customers and to obtain water and sewage concessions in additional municipalities in the State of São Paulo;
- **Economic/Financial Strategy:** to enhance our financial condition and for-profit orientation by, among other things, reducing water loss and operating costs, increasing productivity and diversifying sources of financing; and
- **Political/Institutional Strategy:** to develop closer relationships with municipal governments by means of decentralized business units and increased participation of municipal mayors in decisions affecting their municipalities.

These three principles of the overall strategy are reflected in the following seven elements:

- **Continue to Improve and Expand Water and Sewage Services**—Our goal is to improve and expand our water services in order to attend to the demand for these services in the areas we serve and to improve and expand our sewage collection and treatment services. Our capital expenditure program, which will require total expenditures by Sabesp of approximately R\$2,745.2 million in the period from 2002 through 2006, is designed to achieve this goal.
- **Reduce Water Losses**—As one of our central goals, we seek to reduce both physical water losses (due primarily through leakage from our water system) and non-physical water losses (due to meter errors that prevent proper accounting of water use, improper classification of customers, fraud and illegal connections). We are continuing our efforts to reduce physical water losses through, among other things, replacement and repair of water mains and pipes and installation of probing and other equipment. We are continuing our program of strategically installing valves throughout our water system which regulate water pressure in the water mains at a variable rate corresponding to consumption in the regulated sector. We are also striving to lower physical water losses by continuing to reduce the average time to repair leaks in our systems.

We are reducing non-physical water losses through the upgrading and replacing of inaccurate water meters and the increased outsourcing to third party contractors of meter reading activities. In particular, we are replacing the water meters for our industrial and commercial customers as well as increasing the rate at which we read the meters for these customers to minimize losses.

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

- *Obtain Additional Municipal Water and Sewage Concessions*—We regularly explore the possibility of obtaining water and sewage concessions in municipalities in the State of São Paulo in which we currently have no operations or to which we currently supply water solely on a bulk basis. We evaluate possible expansion opportunities in terms of proximity to our existing service areas and projected positive contributions to our financial performance. Since January 1, 1997, we have obtained 29 additional concessions to provide water and sewage services in municipalities in the State of São Paulo, including the municipality of Osasco, which was one of our bulk sales customers.
- *Improve Collection of Overdue Accounts Receivable*—We are continuing efforts to improve our collection of overdue accounts receivable from municipalities that we provide water on a bulk basis, the State of São Paulo and some governmental entities. Some of the municipalities that we provide water on a bulk basis do not pay for our services in full or on a timely basis. We are actively pursuing these municipalities for these amounts overdue and exploring opportunities to take over the concessions of these municipalities. With regard to overdue accounts receivable from the State of São Paulo and some State entities, we are taking advantage of a protocol of understanding that we have with the State which, in effect, permits us to apply dividends, including dividends in the form of interest attributed to shareholders' equity, declared by Sabesp and otherwise payable to the State to offset these accounts receivable.
- *Diversify Sources of Financing*—Our goal is to continue to identify and secure diverse sources of financing, both public and private, with an emphasis on borrowing in local currency to reduce our exposure to foreign currency risk. Currently, we are negotiating with the Japan Bank for International Cooperation, the Brazilian National Social and Economic Development Bank (BNDES) and Caixa Econômica Federal (a bank owned by the Brazilian government) regarding loans to finance our capital expenditure program. We are also exploring and pursuing various structured finance alternatives.
- *Develop Closer Relationships with Municipal Governments and Customers*—We are seeking to develop closer relationships with the municipal governments and customers that we serve. We meet regularly with the mayors of municipalities and organize regional management commissions comprised of mayoral representatives and our officers to discuss water and sewage service, capital expenditure, tariff and other issues. We are also working to improve customer relations by shortening response times for customer installations as well as through a focused public relations program to enhance our image.

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

CORPORATE ORGANIZATION

We have eight divisions, each of which is supervised by one of our executive officers:

- *President's Office*—is responsible for coordinating our Divisions in accordance with the policies and directives established by our Board of Directors and Executive Committee and is directly responsible for tariff policies, marketing and communication.
- *Corporate Affairs Division*—is responsible for strategic planning and procurement, corporate administration, auditing, human resources, legal affairs, data processing and information technology.
- *Economic and Finance Division*—is responsible for financial and accounting matters, financial and economic planning and investor relations. This Division also monitors, and acts as controller for, our other Divisions.

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- *Technical and Environmental Division*—is responsible for monitoring the design of our larger investment projects, analyzing the environmental impact of our operations and expansion projects, and ensuring that our activities comply with applicable environmental laws and regulations. This Division also has a technological development and research unit that services our other Divisions.
- *Metropolitan Production Division*—is responsible for production of water and the treatment of sewage for the São Paulo Metropolitan Region. The Metropolitan Production Division is made up of two business units, one of which provides water and the other provides sewage treatment services. This Division is also responsible for supplying water on a bulk basis to seven municipalities in the São Paulo Metropolitan Region.
- *Metropolitan Distribution Division*—is responsible for the operation and maintenance of water distribution and sewage collection in the São Paulo Metropolitan Region. This Division is made up of five business units, which service each of the north, east, south, west and central areas of the Region.
- *Interior Division*—is responsible for production of water and the operation and maintenance of water and sewage systems in the municipalities in the Interior Region. This Division is made up of six business units, each of which corresponds to a particular group of water basins.
- *Coastal Division*—is responsible for production of water and the operation and maintenance of water and sewage systems in the municipalities in the Coastal Region, as well as municipalities in the Vale do Ribeira region located in the Interior Region. This Division is made up of three business units, each of which corresponds to a particular water basin.

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

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

CONCESSIONS

Under the Brazilian Constitution, the authority to develop public water and sewage systems is shared by the states and municipalities, with the municipalities having primary responsibility for providing water and sewage services to their residents. The State Constitution provides that the State of São Paulo shall assure conditions for the correct operation, necessary expansion and efficient administration of water and sewage services in the State of São Paulo by a company under its control. Under applicable law, we are responsible for planning basic water and sewage services and operating the related systems in the State of São Paulo, 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 such services.

We do not hold a formal concession to provide water and sewage services in the City of São Paulo, which accounts for a substantial majority of our sales and services rendered, or in 42 other municipalities in the State of São Paulo. None of these other municipalities has a significant population, other than Santos, which has a population exceeding 400,000. We believe that we have a vested right to provide water and sewage

services based upon, among other things, our ownership of the water and sewage systems serving the City of São Paulo and these other municipalities and certain succession rights resulting from the merger which formed Sabesp.

We also provide water and sewage services in 323 additional municipalities in the State of São Paulo pursuant to concessions granted by the municipalities. Substantially all of these concessions have 30-year terms, one of which expires in 2004 and the rest of which expire between 2005 and 2030. Each of these concessions is automatically renewable for a period equal to its initial term, unless the municipality or we exercise the right to terminate the concession prior to the six-month period ending on the expiration date of the concession.

The concessions are based on a standard form of contract between Sabesp and the relevant municipality. The form contract has received the prior approval of the legislative councils of the municipalities. The principal terms of the concession contracts are as follows:

- We assume all responsibility for providing water and sewage services in the municipality;
- We may determine and collect the tariffs for our services without prior authorization of the municipality;
- The assets comprising the existing municipal water and sewage systems are transferred from the municipality to Sabesp. Until 1998, we acquired municipal concessions and the existing water and sewage assets in exchange for our common shares issued at book value. Since 1998, we have acquired concessions and water and sewage assets by paying to the municipality an amount equal to the present value of 30 years of estimated cash-flows, assuming at least a 12% return to Sabesp, from the concession being acquired. Payment is made with a mix of cash and common shares issued at market value;
- We are exempt from municipal taxes and no royalty is payable to the municipality in respect of the concession;
- We are granted rights of way on municipal property for the installation of water pipes and mains and sewage lines; and
- At termination of the concession, or upon cancellation for any reason, we are required to return to the municipality the assets comprising the municipality's water and sewage system. 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.

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

Municipalities have the inherent power under Brazilian law to terminate concessions prior to their contractual expiration dates for reasons of public interest. Diadema and Mauá, two municipalities previously served by Sabesp, terminated their concessions to Sabesp in February 1995 and December 1995, respectively. Diadema terminated its concession to Sabesp after asserting that we did not provide adequate water and sewage services, while Mauá did so with the consent of Sabesp. We have commenced legal action

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to collect payments due from Diadema which is currently pending. We entered into a settlement agreement with Mauá at the time the concession was terminated in which Mauá agreed to make the payments owed to Sabesp in connection with the return of water and sewage systems. However, to date Mauá has not yet made any payments to Sabesp under the settlement agreement. We commenced legal action in December 1996 against Mauá which is also currently pending.

Each of Diadema and Mauá are currently operating their own water and sewage systems, and we are supplying them with water on a bulk basis. At December 31, 2001, both Diadema and Mauá were in arrears with respect to amounts owed to Sabesp for the sale of water on a bulk basis prior to 1997, as well as for a portion for the sale of water since 1997.

In addition, in 1997, the municipality of Santos enacted a law expropriating the water and sewage systems of Sabesp in Santos. In response, Sabesp filed an action seeking an injunction against this expropriation which was denied by the lower court. This decision was later reversed by the Court of Appeals of the State of São Paulo, which issued a preliminary order suspending that law. A final decision on this matter has not yet been rendered by the Court of Appeals, and we can give no assurance that the final decision will be favorable to us. Despite the pending lawsuit, we continue to provide water and sewage services to Santos.

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

WATER OPERATIONS

The supply of water by Sabesp to our customers generally involves abstraction of water from various sources, subsequent treatment and distribution to customers' premises. In 2001, we produced approximately 2,696 million cubic meters of water.

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

| | Year ended December 31, | | |
|--|-------------------------------|----------------|----------------|
| | 1999 | 2000 | 2001 |
| | (in millions of cubic meters) | | |
| <i>Produced</i> | | | |
| São Paulo Metropolitan Region | 1,968.5 | 1,967.7 | 1,989.4 |
| Interior Region | 435.8 | 450.0 | 447.2 |
| Coastal Region | 260.6 | 261.6 | 259.4 |
| Total | <u>2,664.9</u> | <u>2,679.3</u> | <u>2,696.0</u> |
| <i>Invoiced</i> | | | |
| São Paulo Metropolitan Region ⁽¹⁾ | 1,311.0 | 1,251.2 | 1,225.8 |
| Interior Region | 307.3 | 314.9 | 309.8 |
| Coastal Region | 165.0 | 165.1 | 163.0 |
| Total | <u>1,783.3</u> | <u>1,731.2</u> | <u>1,698.6</u> |

(1) Includes water invoiced to bulk sales customers of 387.2 in 1999, 317.7 in 2000 and 322.4 in 2001, each in millions of cubic meters.

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The difference between the amount of water produced and the amount of water invoiced generally represents both physical and non-physical water loss. 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 initially invoiced and subsequently credited back to customers in connection with adjustments to such customers' accounts;
- water we consume in our facilities; and
- estimated water losses associated with water we supply to *favelas* (shantytowns).

The São Paulo Metropolitan Region experiences its highest levels of demand during the summer months when water use increases. Water use generally decreases significantly during the winter months. The summer months, when demand is highest, coincide with the rainy season, while the winter, when demand for water is lowest, corresponds to the dry season in the São Paulo Metropolitan Region. The Interior Region experiences seasonality in demand similar to the São Paulo Metropolitan Region. 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 sales and services by geographic region:

| | Year ended December 31, | | |
|---|-------------------------|-------------------|-------------------|
| | 1999 | 2000 | 2001 |
| | (in thousands) | | |
| São Paulo Metropolitan Region | R\$2,564.1 | R\$2,633.9 | R\$2,682.0 |
| Interior Region | 502.7 | 542.8 | 565.7 |
| Coastal Region | 267.5 | 281.3 | 295.8 |
| Total sales | <u>R\$3,334.3</u> | <u>R\$3,458.0</u> | <u>R\$3,543.5</u> |

Water Resources

We can abstract water only to the extent permitted by the Departamento de Águas e Energia Elétrica do Estado de São Paulo (Department of Water and Energy of the State of São Paulo). We currently abstract substantially all of our water supply from rivers and reservoirs, with a small portion being abstracted from groundwater. Our reservoirs are filled by impounding water from rivers and streams, by diverting flow from nearby rivers or by a combination of these sources.

In order to supply the São Paulo Metropolitan Region with water, we operate 19 reservoirs located in eight water production systems. The average total production capacity in such region is 63.1 cubic meters per second and should increase to 66.6 cubic meters per second in 2005 with the completion of planned improvements to the water system. The total production capacity currently reaches 67.7 cubic meters per second during peak demand periods. We estimate that demand for water currently averages 63.0 cubic meters per second and will reach an average up to 65 cubic meters per second by 2005. The main water production systems for the São Paulo Metropolitan Region are Cantareira and Guarapiranga, which collectively supply approximately 71% of the water produced by Sabesp for the São Paulo Metropolitan Region.

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

| <u>System</u> | <u>Production⁽¹⁾</u> (in cubic meters per second) |
|---|---|
| Cantareira | 30.4 |
| Guarapiranga | 13.5 |
| Alto Tietê | 8.6 |
| Rio Claro | 3.4 |
| Rio Grande (Billings Reservoir) | 4.2 |
| Alto Cotia | 0.8 |
| Baixo Cotia | 0.9 |
| Ribeirão da Estiva | 0.1 |
| Total production | <u>61.9</u> |

(1) Average of the twelve months ended December 31, 2001.

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 are owned by other companies controlled by the State of São Paulo. We currently do not pay any fees with respect to the use of these reservoirs. In December 2001, we entered into an agreement with the State whereby the State, among other things, agreed to transfer the remaining reservoirs in the Alto Tietê System to us. We cannot assure you as to when this transfer of reservoirs will take place. See “Related Party Transactions.”

Because of limited rainfall during 2000 and 2001, the São Paulo Metropolitan Region faced its worst drought in 65 years. From mid-June to mid-September in 2000, we rationed water in the south of the São Paulo Metropolitan Region, affecting approximately 3.5 million people, or 20% of the total population of this region. Under this rationing, water was made available to our customers for only two out of every three days. During this period of rationing, we also reduced our total water production by 8%.

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

In the largest municipalities of the Interior Region, the principal source of water for Sabesp consists of surface water from nearby rivers. In the smaller municipalities of the Interior Region, we draw water primarily from wells. The Coastal Region is provided water principally by surface water from rivers and streams.

Statewide, we estimate that we are able to supply nearly all of the demand for water in the areas where we operate. In 2000 and 2001, we were able to supply 100% of the demand for water in the São Paulo Metropolitan Region, primarily as a result of our water conservation program, reductions in water loss, the installation of 361,174 new water connections from 1999 through 2001 as well as the introduction of the new tariff structure which helped reduce average consumption and demand.

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

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We are implementing as part of our capital expenditure program the Metropolitan Water Program, which involves substantial investments in reservoirs, water treatment facilities, water mains and the distribution network in the São Paulo Metropolitan Region to increase water production and to improve capacity of the Metropolitan Aqueduct System. The Metropolitan Water Program consists of a series of projects which will require approximately R\$680.0 million in investments from 2001 through 2005 in the São Paulo Metropolitan Region.

Water Treatment

We treat all water at our water treatment facilities prior to placing it into our water distribution network. We operate over 192 treatment facilities, of which the seven largest located in the São Paulo Metropolitan Region typically account for approximately 70% of all water supplied by Sabesp. The type of treatment used depends on the nature of the source and quality of the untreated water. Water abstracted from rivers requires extensive treatment, while water drawn from groundwater sources requires less treatment.

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

Water Distribution

Water is distributed by Sabesp through networks of water pipes and mains, ranging in size from 2.5 meters to 100 millimeters in diameter. As of December 31, 2001, our water network contained approximately 53,311 kilometers of water pipes and mains and 5,717 million water connections.

Approximately 90% of the water pipes and mains in our water distribution network are made of cast iron or polyvinylchloride (PVC), with most of the remainder being made of steel. Distribution pipes at customers' residences typically are made from high density polyethylene tubing while large distribution mains are made of steel. Our aqueducts are mostly made of steel, cast iron and concrete.

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

We have a program to install valves to regulate water pressure throughout the water mains to correspond to downstream consumption needs during each day. These valves are programmed to respond automatically to variations in demand. During peak usage, the flow of water in the pipes is at its highest point; however, when demand decreases, pressure builds up in the water mains and the resulting stress on the network can cause significant water loss through cracks and an increase in ruptures of the pipes. The intelligent valves are equipped with probes programmed to feed data to the valve to reduce or increase water supply to the water mains as water usage fluctuates. Through December 31, 2001, we had installed 504 valves at strategic points in the network and plan to install an additional 196 valves in 2002.

As of December 31, 2001, our water distribution pipes and mains included approximately:

- 25,455 kilometers in the São Paulo Metropolitan Region;
- 20,729 kilometers in the Interior Region; and
- 7,127 kilometers in the Coastal Region.

We have 177 storage tanks in the São Paulo Metropolitan Region with a total capacity of 1.8 million cubic meters, 1,439 storage tanks in the Interior Region and 178 storage tanks in the Coastal Region. We have 192 treated water pumping stations in the São Paulo Metropolitan Region, including stations at treatment facilities, intermediate trunk transfer pumping stations and small booster stations serving local areas.

In the São Paulo Metropolitan Region, water derived from our water sources is relatively non-corrosive to pipe materials. As a result, structural weaknesses or leakage arising from internal pipe corrosion has not been a serious problem for Sabesp. Operational experience suggests that loss of flow capacity caused by pipe encrustation in the older cast iron pipes has been a problem for Sabesp. In addition, fractures in the pipes making up the distribution network caused by heavy vehicular traffic loads in the streets of the São Paulo Metropolitan Region have been a further problem for Sabesp.

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

In the Interior Region and the Coastal Region, water derived from our varied water sources is relatively non-corrosive to pipe materials. As a result, structural weaknesses or leakage arising from internal pipe corrosion is not a serious problem for Sabesp nor is loss of flow capacity due to pipe encrustation. Operational experience suggests that there is a relatively low incidence of external corrosion of pipe materials in the Coastal Region as a whole. External factors contribute to brittle fractures which are triggered by heavy vehicular traffic loads. These fractures occur most frequently in smaller pipes and house connections.

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

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

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

- first, a reduction in the level of physical losses, which result primarily from leakage; and
- second, the reduction of non-physical losses, which result primarily from the inaccuracy of our water meters installed at our customers' premises and at our water treatment facilities, as well as from clandestine and illegal use by customers.

We are taking measures to decrease physical losses by reducing response time to broken pipes and mains to less than 24 hours and by better monitoring of non-visible water main fractures. We currently repair approximately 36,000 broken pipes and mains per month. Among other measures we have adopted to reduce physical water losses are:

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

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

in each case helping to reduce overall water losses.

Non-physical losses are being reduced by:

- monitoring and better accounting of the water connections of some customers, some of which are accounted for by Sabesp as inactive when they are in fact active, and others which service non-residential customers that are accounted for as residential and therefore are billed at a lower rate;
- measures to fight fraud and the use of new, more sophisticated water meters that are more accurate and less prone to tampering;
- installation of water meters where none are present;
- outsourcing meter reading services; and
- preventive maintenance of existing and newly installed water meters.

Water Quality

We believe that we supply high quality treated water that is consistent with standards set in the United States and Europe. Under current law in effect in Brazil and the State of São Paulo, we have significant statutory obligations regarding the quality of treated water. These laws set certain standards that govern water quality.

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

We have 15 laboratories that monitor water quality and purity as required by standards set by Sabesp and as required by law, which employ approximately 200 technicians, biologists, engineers and chemists. Our laboratories average 130,000 analyses per month. Our central laboratory located in the City of São Paulo is responsible for organic compound analysis by chromatographic and spectrometric methods, as well as heavy metals analysis by atomic absorption technique. Five of our laboratories have obtained ISO 9002 certification and one has obtained ISO Guide 25 certification.

In addition, we have implemented the “Real Time Water Quality Monitoring System for the São Paulo Metropolitan Region.” Under this system, the water of some reservoirs located in the São Paulo Metropolitan Region is tested by sensors attached to buoys which are set at different depths. This equipment permits Sabesp to make 26,000 analyses per month.

Guarapiranga Reservoir

The Guarapiranga Reservoir located in the São Paulo Metropolitan Region is our second largest reservoir, supplying approximately 20% of the Region’s water requirements. Guarapiranga is a lake that has been polluted by, among other things, untreated sewage from squatters living adjacent to the reservoir in violation of laws intended to protect the watershed. As a tropical lake with high summer temperatures, Guarapiranga is a natural environment for algae growth. The problem is exacerbated by the discharge of raw sewage into the reservoir on which the algae feed.

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

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

Fluoridation

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

SEWAGE OPERATIONS

We are responsible for the collection of sewage through our sewage systems and for its subsequent disposal with or without prior treatment. At December 31, 2001, we collected 80%, 85% and 47% of all the sewage produced in the municipalities in which we operate in the São Paulo Metropolitan Region, the Interior Region and the Coastal Region, respectively, accounting for 76% of all the sewage produced in the municipalities in which we operate in the State of São Paulo.

Sewage System

The primary function of our sewage system is to collect, convey and treat sewage. As of December 31, 2001, we were responsible for the operation and maintenance of approximately 32,608 kilometers of sewer lines, of which approximately 17,352 kilometers are located in the São Paulo Metropolitan Region, 13,646 kilometers are located in the Interior Region and 1,610 kilometers are located in the Coastal Region.

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

Industrial sewage can vary in nature and concentration of contaminants. The standards for disposal of industrial effluents are set by Article 19A of State Decree No. 8,468 of September 8, 1976, as modified by State Decree 15,425 of July 23, 1980, and broadly correspond to the standards for such disposal set by the U.S. Environmental Protection Agency. The basic premise of these standards is that industrial effluents interfere with the natural biological process occurring at sewage treatment facilities and, therefore, such effluents must be treated so that the final effluent meets the parameters set forth in State Decree No. 8,468. This decree requires industries that produce industrial sewage to pre-treat such sewage so that levels of certain parameters, such as pH, temperature, sediments, grease, oil and metals are reduced to environmentally sound levels prior to release into our sewer lines. To ensure compliance with Article 19A, we periodically analyze sewage produced by each industrial customer to check whether the customer has complied with the requirements of the decree.

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 Interior Region and the Coastal Region. To counteract the effects of deterioration, we maintain a continuing program for the maintenance of sewage lines intended to deal with anticipated fractures arising from obstructions caused by system overloads.

In the Interior Region and the Coastal Region, the structural condition of our sewer lines is considered generally to be good. Unlike the São Paulo Metropolitan Region, the Interior Region does not generally suffer obstructions caused by sewage system overload. The Coastal Region experiences obstructions in its sewer lines primarily due to infiltration of sand, especially during the rainy season in the summer months. In addition, the Coastal Region's sewage connections are significantly lower than in the other regions serviced by Sabesp, with only 47% 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 of water lines. We assume the cost of installation for the first fifteen meters of sewer lines from the sewage network to residential and commercial customer's sewage connection. Industrial customers are responsible for the entire cost of extension and connection to the sewage network.

Sewage Treatment and Disposal

For 2001 approximately 65%, 50% and 97% of the sewage collected by Sabesp in the São Paulo Metropolitan Region, the Interior Region and the Coastal Region, or 64% of the sewage collected by Sabesp in the State of São Paulo, was treated at our treatment facilities and discharged to inland waters and the Atlantic Ocean. Our sewage treatment facilities have a finite capacity. Flows in excess of such capacity are discharged directly, untreated, to inland waters and the Atlantic Ocean. We operate 406 sewage treatment facilities and seven 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, which stipulates maximum concentrations of certain substances prior to discharge into the environment. Although the flow and composition of sewage arriving at sewage treatment facilities varies, on average more than 98% of its content is water. Our sewage treatment relies essentially on physical separation processes and on natural biological processes to break down organic matter and reduce the amount of harmful organisms and chemicals.

The primary treatment process is the principal separation process for suspended solid material present in 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 Sabesp, 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 which are continuously replenished with recirculated 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 seven activated sludge treatment facilities, each of which also contains a primary treatment facility. The five activated sludge 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 Interior Region consists largely of aeration ponds where the organic matter is aerobically digested and the treated sewage is discharged to receiving waters. There are also two secondary

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treatment facilities in the Interior Region which have treatment capacity of approximately four cubic meters of sewage per second.

A majority of sewage collected in the Coastal Region receives secondary treatment and disinfection and then is discharged into rivers and into the Atlantic Ocean. We have 54 sewage treatment facilities in the Coastal Region.

Our main sewer lines are currently not sufficiently extensive to transport all sewage collected by Sabesp to our treatment facilities. As a result, a portion of the sewage collected by Sabesp is released untreated into receiving waters, resulting in high levels of pollution in such bodies of water. Our capital expenditure plan includes projects to increase the amount of sewage that we treat.

Sludge Disposal

Sludge removed from the primary and secondary treatment processes typically contains water and a very small proportion of solids. We use belt pressing and centrifugation machines to extract the water from the sludge. In 2001, we produced approximately 46,000 tons of sludge dry base, of which 44,800 tons were discharged into landfills and the remainder was used for agricultural purposes.

CUSTOMERS

General

We currently operate water and sewage systems for 366 of 645 municipalities in the State of São Paulo.

The following table provides information regarding volumes of water and sewage invoiced, by customer category, for the periods presented.

| | Year ended December 31, | | | | | |
|------------------------|-------------------------|---------------|-----------------------|---------------|-----------------------|---------------|
| | 1999 | | 2000 | | 2001 | |
| | Volume ⁽¹⁾ | % | Volume ⁽¹⁾ | % | Volume ⁽¹⁾ | % |
| <u>Water</u> | | | | | | |
| Residential | 1,155.6 | 64.8% | 1,177.1 | 68.0% | 1,156.8 | 68.1% |
| Commercial | 157.1 | 8.8 | 153.4 | 8.8 | 141.4 | 8.3 |
| Industrial | 34.1 | 1.9 | 33.5 | 1.9 | 30.7 | 1.8 |
| Governmental | 49.3 | 2.8 | 49.5 | 2.9 | 47.3 | 2.8 |
| Subtotal | 1,396.1 | 78.3 | 1,413.5 | 81.6 | 1,376.2 | 81.0 |
| Bulk sales | 387.2 | 21.7 | 317.7 | 18.4 | 322.4 | 19.0 |
| Total | <u>1,783.3</u> | <u>100.0%</u> | <u>1,731.2</u> | <u>100.0%</u> | <u>1,698.6</u> | <u>100.0%</u> |
| <u>Sewage</u> | | | | | | |
| Residential | 862.2 | 81.5% | 872.3 | 81.5% | 868.4 | 82.4% |
| Commercial | 130.6 | 12.3 | 129.1 | 12.0 | 121.6 | 11.5 |
| Industrial | 27.7 | 2.6 | 30.7 | 2.9 | 27.3 | 2.6 |
| Governmental | 37.7 | 3.6 | 38.0 | 3.6 | 36.5 | 3.5 |
| Total | <u>1,058.2</u> | <u>100.0%</u> | <u>1,070.1</u> | <u>100.0%</u> | <u>1,053.8</u> | <u>100.0%</u> |

(1) In millions of cubic meters.

In addition to serving residential, commercial, industrial and governmental customers in municipalities in which we hold concessions, we make bulk sales of water to seven municipalities having a total estimated population of 3.7 million persons.

Tariffs

Although we have the power to set our tariffs for water and sewage services, we traditionally have consulted with the Governor of the State of São Paulo prior to setting new tariff rates. 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 Sabesp to more aggressively set tariffs and to more realistically cover water production costs. In addition, the new tariff regulations eliminate onerous policies that did not allow Sabesp to collect adequate fees or to control water supply to shantytowns that had previously resulted in unregulated water use and excessive waste in such areas.

We recently established a new tariff schedule, effective in May 2002, for commercial and industrial customers that (1) consume at least 5,000 cubic meters of water per month and (2) enter into demand agreements with Sabesp for at least one-year terms.

We establish separate tariff schedules for our services in each of the São Paulo Metropolitan, Interior and Coastal Regions. Each tariff schedule incorporates cross-subsidies pursuant to which certain customers, in effect, subsidize the provision of water and sewage services to other customers. Customers with high monthly water consumption rates pay higher tariffs than our costs of providing such 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 sub-divided into basic residential, popular and *favela* (shantytown). The latter two sub-categories were instituted to assist lower income customers by providing lower tariffs for consumption. The non-residential category consists of:

- privately-owned companies, government entities and industrial 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 Sabesp and pay 75% of the prevailing non-residential tariff.

Sewage charges in each region are fixed as a function of the monthly water charges. 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. Bulk water rates are established separately for each municipality served. In addition, various industrial customers pay an additional sewage charge, depending on the characteristics of the sewage they produce.

Tariffs have historically been adjusted once a year during the months of June or July. However, we did not increase tariffs in 2000 due to a State policy described above. We did raise tariffs again in June 2001. The following table sets forth the water and sewage services tariffs by customer category charged during the years presented in the São Paulo Metropolitan Region, which accounted for approximately 76% of our net operating revenues in 2001.

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Annual Water and Sewage Tariffs for the São Paulo Metropolitan Region

| Customer Category Consumption (in cubic meters per month) | At December 31, | | |
|--|------------------------------------|---------|---------|
| | 1999 | 2000 | 2001 |
| | (reais/cubic meter) ⁽¹⁾ | | |
| Residential: | | | |
| Basic Residential: | | | |
| 0-10 ⁽²⁾ | R\$0.66 | R\$0.66 | R\$0.75 |
| 11-20 | 1.03 | 1.03 | 1.16 |
| 21-50 | 2.57 | 2.57 | 2.91 |
| above 50 | 2.84 | 2.84 | 3.21 |
| Popular: | | | |
| 0-10 ⁽²⁾ | R\$0.30 | R\$0.30 | R\$0.30 |
| 11-20 | 0.46 | 0.46 | 0.52 |
| 21-30 | 1.62 | 1.62 | 1.83 |
| 31-50 | 2.31 | 2.31 | 2.61 |
| above 50 | 2.55 | 2.55 | 2.88 |
| Favela (shantytown): | | | |
| 0-10 ⁽²⁾ | R\$0.23 | R\$0.23 | R\$0.23 |
| 11-20 | 0.23 | 0.23 | 0.26 |
| 21-30 | 0.76 | 0.76 | 0.86 |
| 31-50 | 2.31 | 2.31 | 2.61 |
| above 50 | 2.55 | 2.55 | 2.88 |
| Non-Residential: | | | |
| Commercial/Industrial/Governmental: | | | |
| 0-10 ⁽²⁾ | R\$1.33 | R\$1.33 | R\$1.50 |
| 11-20 | 2.57 | 2.57 | 2.91 |
| 21-50 | 4.97 | 4.97 | 5.62 |
| above 50 | 5.17 | 5.17 | 5.84 |

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

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

In 2001, the Interior Region accounted for approximately 16% of our net operating revenues. The average annual tariffs in the Interior Region in 2001 for all customer categories were 10% to 28% below the tariffs for the São Paulo Metropolitan Region (as set forth in the above table). In some municipalities we serve in the Interior Region, our tariff for sewage services is 80% of the tariff we charge for water services.

In 2001, the Coastal Region accounted for approximately 8% of our net operating revenues. The average annual tariffs in 2001 in the Coastal Region for all customer categories were 10% below the tariffs for the São Paulo Metropolitan Region (as set forth in the above table).

See “Government Regulation—Tariff Regulation” 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.

Payment of water and sewage bills can be paid at any bank in the State of São Paulo. The banks pay over such funds to Sabesp. The banks began charging service fees of between R\$0.30 and R\$0.92 per transaction to collect and remit payments.

Customers must pay their water and sewage bills within ten days of the billing date. We charge a penalty fee and interest on late bill payments, which currently ranges from 2% to 9%, depending on the number of days the payment is overdue. However, we do not assess a penalty fee or interest in respect of governmental customers. In 1999, 2000 and 2001 we received payment of 88.3%, 92.7% and 91.5% of the amount billed to our retail customers, and 92.7%, 94.2% and 96.0% of the amount billed to these customers other than governmental entities, within 30 days after the due date. Almost all of the amount not paid within 30 days is owed by governmental customers. With respect to bulk sales, in 2001 we received payment of only 64.6% of the amount billed within 30 days.

In the São Paulo Metropolitan Region we monitor water meter readings by use of hand-held computers. The system allows the meter reader to input the gauge levels on the meters into the computer and automatically print the water and sewage bill for the customer. The hand-held computer tracks water consumption and sewage 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. As of the last quarter of 2001, we are implementing automated water meter reading in some municipalities that we serve in the Interior Region.

ELECTRICITY CONSUMPTION

The use of electricity is integral to our operations, and as a result we are one of the largest users of electricity in the State of São Paulo. We obtain electricity primarily from Eletropaulo Metropolitana Eletricidade de São Paulo S.A., Elektro Eletricidade e Serviços S.A., Bandeirante Energia S.A. and CPFL—Companhia Paulista de Força e Luz pursuant to long-term contracts on commercially favorable terms. Each of these companies has been privatized by the State of São Paulo. To date, we have not experienced any major disruptions in electric supply. Any significant disruption of electricity to Sabesp could have a material adverse effect on our business, financial condition, results of operations or prospects. Furthermore, fluctuations in electricity voltage supplied to Sabesp have in the past, and may in the future, cause major damage to our water and sewage systems.

In May 2001, the Brazilian government announced measures aimed at an average reduction of 20% in electricity consumption in a number of regions of Brazil, including areas in which we operate. However, companies that render “essential services,” such as companies like Sabesp that render water and sewage services, were not subject to these measures other than with respect to their administrative buildings, which were required to reduce electricity consumption by 35%. As a result of higher levels of rainfall, as of March 2002, the Brazilian government eliminated all electricity consumption restrictions.

CAPITAL EXPENDITURE PROGRAM

From 1998 through 2001, our capital expenditure program included capital expenditures totaling R\$3,204.3 million in the aggregate, primarily to build up our infrastructure. We have budgeted capital

expenditures totaling R\$2,745.2 million in the aggregate during the period 2002 through 2006. There can be no assurance that the amount budgeted will be spent during this time period.

Currently, our capital expenditure program is designed to improve and expand our water and sewage system and to increase and protect water sources in order to meet the growing demand for water and sewage services in the State of São Paulo. It has three specific targets in the municipalities we serve:

- to continue to meet the maximum demand for treated water;
- to expand the percentage of households connected to our sewer system; and
- to increase the treatment of sewage collected.

The following is a brief description of each of the principal projects in our capital expenditure program.

Metropolitan Water Project

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.” Accordingly, we implemented the Metropolitan Water Project to improve regular water supply to the entire São Paulo Metropolitan Region. The Metropolitan Water Project increased production capacity from approximately 59.7 cubic meters of water per second in 1994 to approximately 67.7 cubic meters of water per second at the end of 2001. Through implementation of this project, we eliminated widespread rotation in September 1998.

The project involved construction of new water abstraction facilities and increasing the capacity of existing treatment facilities, development of new reservoirs in the São Paulo Metropolitan Region and water mains to interconnect the systems within the Region, and construction, renovation and enlarging of 30 water storage tanks to store treated water in order to meet higher demand during peak periods. In addition, in order to relieve pressure on reservoirs, such as the Guarapiranga Reservoir and some reservoirs of the Alto Tietê System, where we have over-exploited water supplies, we built water mains from the Billings Reservoir into the Guarapiranga Reservoir and from the Tietê River into the reservoirs of the Alto Tietê System. To date, we have installed new mains with higher capacity to deliver a greater volume of water to the City of São Paulo as part of the project. Portions of this project were financed by the World Bank and Caixa Econômica Federal as well as by Sabesp’s own resources. Regarding the remainder of the Metropolitan Water Project, we have budgeted for additional capital expenditures of approximately R\$780.0 million from 2002 through 2006.

Tietê Project

The Tietê River crosses the São Paulo Metropolitan Region and receives most of the Region’s run-off and wastewater. The Tietê Project is designed to reduce pollution of the Tietê River by constructing sewage collection lines along the banks of the Tietê River and its tributaries. These lines collect raw sewage and deliver it to our sewage treatment facilities. In connection with the first phase of the Tietê Project, in June 1998, we completed construction of three additional sewage treatment plants. Currently, raw sewage is delivered to our secondary treatment facilities along the Tietê River and the Tamanduateí River before treated sewage is discharged into those rivers. We plan to build additional collection lines to direct more raw sewage to our treatment facilities.

In addition, we completed the construction of the main sewage collection pipes on the banks of the Pinheiros River, the Interceptor Pinheiros Leopoldina, which cost approximately US\$36.0 million and

increases the amount of sewage treated in existing sewage treatment plants. The Caixa Econômica Federal has provided financing to complete construction of the Interceptor Pinheiros Leopoldina.

The first phase of the Tietê Project commenced in 1992, was suspended in 1994 due to lack of funding, resumed in 1995 and was completed in December of 1998. We now provide secondary treatment to 62% of the sewage collected in the São Paulo Metropolitan Region, about 90% of which is discharged into the Tietê River basin. The five principal sewage treatment plants 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.

We made capital expenditures with respect to the first phase of the Tietê Project of US\$900.0 million. Of that amount, US\$450.0 million was financed by the Inter-American Development Bank and US\$450.0 million was funded by Sabesp. At December 31, 2001, we owed US\$348.6 million, including accumulated interest, to the Inter-American Development Bank regarding this financing agreement.

In July 2000, we commenced work on the second phase of the Tietê Project to reduce pollution affecting the Tietê River. The main objectives of this second phase is to increase the number of sewage connections in the São Paulo Metropolitan Region so that 90% of the population in the region will be connected to our sewage system and to treat 70% of the sewage collected by Sabesp in the region. For this second phase we have budgeted for additional capital expenditures of approximately US\$400.0 million from 2000 through 2005, US\$200.0 million of which will be financed by the Inter-American Development Bank. Through December 31, 2001, we have spent US\$18.0 million.

Interior and Coastal Region Investment Programs

We currently have a number of projects in progress and planned for the Interior Region, including projects relating to abstraction of water and collection and treatment of sewage. We spent approximately R\$150.8 million and R\$149.3 million on such projects in 2000 and 2001, respectively, and we have budgeted for additional capital expenditures of approximately R\$530.3 million in the period from 2002 through 2006.

We also have a number of projects in progress and planned for the Coastal Region, principally in the areas of distribution of water and collection and treatment of sewage. We spent approximately R\$123.3 million and R\$188.2 million in 2000 and 2001, respectively, on such projects and we have budgeted for additional capital expenditures of approximately R\$654.1 million, including R\$606.0 million for the program described below, in the period from 2002 through 2006.

As part of our Coastal Region Investment Program, we are currently negotiating with the Japan Bank for International Cooperation to help finance our Environmental Recovery Program of the Santos Metropolitan Region, which we expect to begin in 2002. The main goals of this program are to improve and expand our water and sewage systems in the municipalities making up the Santos Metropolitan Region.

Guarapiranga Project

The Guarapiranga Reservoir, the second largest reservoir serving the São Paulo Metropolitan Region, has been polluted by the inhabitants of *favelas* located in the area surrounding the Reservoir in violation of current laws intended to protect watersheds. This population releases untreated sewage into the Reservoir. In addition, the untreated sewage introduced by our own sewage collection system into rivers that feed the Guarapiranga Reservoir has contributed to the pollution of the Reservoir.

The recovery of the Guarapiranga Reservoir involved the expansion of the wastewater collection network, sewage treatment facilities and solid waste collection, as well as monitoring, environmental education and watershed restoration. Additional measures to reduce pollution directly in the water bodies include the use

of wetland treatment and flotation technologies and the reversal of highly polluted small tributaries that lead into the Guarapiranga Reservoir. This project has cost approximately US\$329.8 million through December 31, 2001, of which US\$119.0 million was financed by the World Bank, US\$81.3 million by the State of São Paulo, US\$45.7 million by Sabesp and US\$83.8 million by the City of São Paulo.

For information concerning the sources of financing for our capital expenditure program, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources.”

COMPETITION

We do not face any competition in the municipalities in which we provide water and sewage services, as we believe that in those municipalities we have an exclusive right to provide such services. We do not serve 279 municipalities in the State of São Paulo that operate their own water and sewage systems and that collectively have a population of approximately 15.1 million, or 40% of the population of the State. In addition, three private water companies provide three municipalities with water and sewage services pursuant to concessions from such municipalities.

Under current Brazilian law, a municipality may terminate a concession at any time prior to its contractual expiration date for reasons of “public interest,” although we have the right to continue providing service until the municipality has paid all indemnification payments due to Sabesp. Termination of a concession must be initiated by the mayor and approved by the municipal chamber of representatives by means of a law approved by a majority of the municipal representatives. The municipality itself or another concessionaire could then replace Sabesp and would then be in competition with Sabesp. The loss of concessions could have a material adverse effect on our business, results of operations, financial condition or prospects and on our competitive position in the State of São Paulo, depending on the geographic area covered and the population served. Although we believe we generally have good relationships with the municipalities served and are in the process of developing closer relationships, we cannot assure you that such relationships will continue to be satisfactory or that municipalities will not seek to rescind their concessions to Sabesp.

We face some competition with respect to the supply of water to industrial customers. Several large industrial customers located in municipalities served by Sabesp use their own wells to supply themselves with water. However, we do not experience any competition with respect to the sewage collection services we provide to industrial customers.

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, Companhia de Tecnologia de Saneamento Ambiental—CETESB (State Company of Environmental Sanitation Technology), which is a delegate agency of the State of São Paulo, 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, in particular, by State Decree No. 8,468 of September 8, 1976, as modified by State Decree No. 15,425 of July 23, 1980.

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 Brazilian 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.

Since 1995, we have maintained a division responsible for developing environmental impact studies and programs. We believe that we are in material compliance with all relevant environmental laws and regulations.

Our procedure for constructing and operating water and sewage facilities involves the mandatory compliance with environmental legal requirements. First, for those projects which have a significant environmental impact, studies are prepared by outside 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 licenses:

- to define the exact location and scope of work;
- to begin construction; and
- to operate the facility.

In order to obtain the environmental licensing of those undertakings that have a significant environmental impact, and, based on the results of the environmental impact assessments, environmental agencies may impose on Sabesp the obligation of establishing a nature conservation area. In order to fulfill such 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.

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 therewith could increase substantially from current levels.

INSURANCE

We maintain insurance covering fire or other damage to our property, plant and equipment, third-party liability and injuries to employees relating to on-the-job accidents. We currently obtain our insurance policies through public bids involving major Brazilian and international insurance companies in Brazil. 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 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

Labor Proceedings

In October 1989, the Sindicato dos Trabalhadores em Água, Esgoto e Meio Ambiente de São Paulo (the São Paulo Water, Sewage and Environment Service Workers Union, or SINTAEMA) commenced a lawsuit, on behalf of our employees, against Sabesp in the Justiça do Trabalho (the Labor Court), alleging that we had violated Brazilian labor laws and collective bargaining contracts when we ceased making certain payments to 21,337 of our 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, we 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 Sabesp. We appealed the decision of the Labor Court and in April 1997 lost the appeal. We appealed this decision to the Tribunal Superior do Trabalho (Superior Labor Court) and the Superior Court ruled against us. However, we filed a motion to vacate (*ação rescisória*), seeking the annulment of the Superior Court ruling and obtained a favorable final decision.

On January 9, 1990, SINTAEMA initiated a lawsuit against Sabesp, 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 Sabesp, 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 Sabesp. We also filed a writ of mandamus seeking a court decision establishing that the penalty imposed against Sabesp is excessive since it exceeds the principal amount by a large margin. We cannot currently predict the amount that we will be required to pay to SINTAEMA, but we do not believe that the final outcome of this matter will have a material adverse effect on our business, results of operations, financial condition or prospects.

We are party to a large number of other lawsuits and administrative proceedings involving SINTAEMA, our present and former employees. We do not believe that any liabilities relating to such other lawsuits or administrative proceedings will have a material adverse effect on our business, results of operations, financial condition or prospects. At December 31, 2001, we had established a provision totaling R\$15.3 million with respect to potential damages in lawsuits and administrative proceedings involving present and former employees, including the lawsuit described in the preceding paragraph, based on calculations made by our legal and human resources departments.

Tax Proceedings

In 1997, we settled a legal proceeding that we had initiated to challenge certain federal income tax and social contribution assessments during the period from 1991 to mid-1996. In the settlement, we agreed to pay the amounts due in installments ending in February 2003. However, in March 2000, we included the amounts owing under the settlement agreement in a tax recovery program called REFIS, which is an alternative payment plan for taxes owed. In accordance with the REFIS program, we are paying amounts subject to the settlement agreement in monthly installments, ending in 2005. On December 31, 2001, the amount due under the REFIS program was R\$181.4 million.

On May 28, 1999, we filed a lawsuit challenging a law enacted in 1998 which expanded the definition of revenue subject to PASEP taxes, as well as increasing the COFINS rate. Pending resolution of this proceeding, we have obtained a preliminary injunction providing protection against fines as we pursue the claim without paying the tax in the terms determined by the law enacted in 1998. As of December 31, 2001, we have established a provision totaling R\$111.0 million with respect to this lawsuit.

On June 12, 1991, we filed a lawsuit against the Brazilian government alleging that Sabesp should not be required to make payments under Finsocial, a sales tax. In connection with our reevaluation of this lawsuit,

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in the second half of 2001, we increased our provision for this lawsuit from R\$8.2 million to R\$51.8 million. The amount of the increased provision is based on the estimated total amount which we would have paid had we paid the Finsocial sales tax between April 1991 and April 1992.

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 of São Paulo 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 Sabesp. 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, many property owners bring lawsuits against Sabesp seeking higher condemnation awards. At December 31, 2001, we estimated that we will be required to make payments totaling R\$55.9 million with respect to all condemnation matters. We do not believe that the pending condemnation proceedings will, individually or in the aggregate, have a material adverse effect on our business, results of operations, financial condition or prospects.

Proceedings Initiated by the Municipality of Ferraz de Vasconcelos

We are 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\$22.8 million, which are allegedly owed by Sabesp 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. Although we are not able to predict the final outcome of the lawsuits, we believe that they will not have a material adverse effect on our business, results of operations, financial condition or prospects.

Other Legal Proceedings

On December 2, 1997, the municipality of Santos enacted a law expropriating the water and sewage systems in Santos from Sabesp. In response, we filed an action seeking an injunction against this expropriation which was denied by the lower court. This decision was later reversed by the Court of Appeals of the State of São Paulo, which issued a preliminary order suspending that law. A final decision on this matter has not yet been rendered by the Court of Appeals, and we can give no assurance that the final decision will be favorable to us.

In connection with discussions we had with the municipality of Presidente Prudente, we filed a suit against the municipality seeking a court decision determining the continuation of the concession agreement that we have with that municipality until the indemnification payment owed to Sabesp in connection with the return of water and sewage system of Presidente Prudente is made. A final decision has not yet been rendered but the lower court has issued a preliminary decision in our favor.

In addition, we are party to a number of proceedings with 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 one of these cases, a decision has been rendered against Sabesp. However, in all the other proceedings, we have received decisions in our favor. We do not believe that the final outcome of these proceedings will have a material adverse effect on our business, results of operations, financial condition or prospects.

We have become aware of a civil public action brought by the Public Ministry of the State of São Paulo which seeks reparation and cessation of environmental damage caused by Sabesp dumping sludge into certain receiving waters. A judge has preliminarily ordered that Sabesp immediately cease such dumping and established a daily R\$50,000 fine for not complying with such order. We currently are unable to

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evaluate the extent or cost of any remedy that we may be responsible for in connection with any final judicial decision against Sabesp in connection with this matter.

We are 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 and a range of other matters. We have not established provisions with respect to these other legal proceedings and do not believe that such proceedings will, individually or in the aggregate, have a material adverse effect on our business, results of operations, financial condition or prospects.

EMPLOYEES

At December 31, 2001, we had 18,159 full-time employees. During 2001, we had an average of 797 trainees.

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:

| | At December 31, | | |
|---|-----------------|--------|--------|
| | 1999 | 2000 | 2001 |
| Total number of employees | 18,324 | 18,048 | 18,159 |
| Number by category of activity: | | | |
| Technical and operations | 12,858 | 11,005 | 11,527 |
| Administration | 2,978 | 3,314 | 3,079 |
| Finance | 643 | 693 | 692 |
| Marketing | 1,845 | 3,036 | 2,861 |
| Number of employees by geographic location: | | | |
| Head office | 1,861 | 1,578 | 1,505 |
| São Paulo Metropolitan Region | 9,080 | 9,069 | 9,183 |
| Interior Region | 5,514 | 5,565 | 5,637 |
| Coastal Region | 1,869 | 1,836 | 1,834 |

The average tenure of our employees is approximately 12 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.

Substantially all of our non-managerial employees are members of unions. The three main unions that represent our employees are SINTAEMA, the Sindicato dos Trabalhadores da Região Urbana de Santos, São Vicente, Baixada Santista Litoral Sul e Vale Ribeira, or SINTIUS, and the Sindicato dos Engenheiros do Estado de São Paulo, or SEESP. Every year we negotiate collective bargaining agreements, which establish the level of compensation and other benefits of our employees. However, in 1999, we were not able to agree with the unions on collective bargaining agreements for that year. As a result, some benefits which employees enjoyed under the prior collective bargaining agreements were rolled back to those prescribed by applicable law.

Our most recent collective bargaining agreements, which became effective on May 1, 2001 and expired on April 30, 2002, generally did not contemplate any job protection for our employees. We expect to negotiate new collective bargaining agreements during May 2002. However, we have a separate formal understanding with the unions that represent our employees that we will not dismiss more than 2% of our current employees before April 30, 2002.

The only labor strikes we have experienced in the last 17 years have been a two-day strike in May 1994, a one-day strike in May 1996, a two-day strike in December 1999, a five-day strike in January 2000, a two-day strike in June 2000, a one-day strike in September 2001 and a one-day strike in November 2001, none of which interrupted essential services. Under Brazilian law, our non-administrative employees are considered “essential employees” and therefore are limited in their right to strike. There are numerous labor disputes outstanding against Sabesp, most of which involve former employees. We believe that, if determined adversely to Sabesp, these disputes will not, individually or in the aggregate, have a material adverse effect on our results of operation or financial condition.

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 Sabesp. 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, Sabesp, after negotiations with the employee labor unions, sets 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 two months and are made to the extent of achievement of such targets. 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 was 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 semi-annually. We made total profit-sharing payments (including accrued amounts payable) of R\$61.2 million in respect of 1997, R\$60.1 million in respect of 1998 and R\$30.3 million in 2000. We believe that the profit-sharing plan has, in the past, contributed to increased employee productivity.

We have established SABESPREV—Fundação SABESP de Seguridade Social, 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\$10.0 million in 1999, R\$9.6 million in 2000 and R\$10.2 million in 2001. See note 12 to our audited financial statements.

On May 29, 2001, a Federal law was enacted which, among other things, limits the amount mixed capital companies, like Sabesp, may contribute to their pension plans. Specifically, the ordinary contributions made by Sabesp to its pension plans may not exceed the contributions made by the beneficiaries of such plans.

PROPERTIES

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. At December 31, 2001, we owned 192 water treatment facilities and approximately 53,311 kilometers of water pipes and mains, as well as 406 sewage treatment facilities and approximately 32,608 kilometers of sewer lines.

We own our headquarters building and other major administrative buildings. We have pledged some of our properties, including our headquarters and some of our other administrative buildings and water storage tanks, as collateral to the Brazilian Federal Government in connection with certain long term financing transactions we have entered into with the World Bank and the Inter-American Development Banks that the Brazilian Federal Government has guaranteed.

At December 31, 2001, the total net book value of our property, plant and equipment was R\$13,510.0 million.

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

Government Regulation

In Brazil, water and sewage services are rendered by a broad variety of companies, most of which are state-owned companies, controlled either by the states or the municipalities. Under Brazilian law, the operation of water and sewage systems are considered to be of public interest because the capacity to provide drinking water and collect sewage influences public health, ensuring drinking water capacity and production requires the rational use of water resources, and our operations produce environmentally hazardous substances which must be properly disposed. Accordingly, we are subject to extensive Brazilian federal, state and, in certain respects, local laws and regulations governing, among other things,

- the granting of rights and concessions to provide water and sewage services;
- public bidding requirements;
- water usage;
- water quality and environmental protection;
- tariffs for water and sewage services; and
- governmental restrictions on the incurrence of indebtedness (which are applicable to state-controlled companies).

GENERAL

Pursuant to Article 23 of the Brazilian Constitution, water and sewage services are the common responsibility of the Brazilian government, the states and the municipalities.

Article 216 of the State Constitution provides that, by law, the State of São Paulo 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 the formation of Sabesp to plan, provide and operate water and sewage services in the State of São Paulo 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

Proposed legislation, the *Lei do Saneamento Básico* (Sanitation Law), which has been under discussion in the Brazilian House of Representatives, would introduce the creation of a legal framework to govern water and sewage services. Under the proposed legislation, the organization of water and sewage services would take into consideration the existing water basins as well as the network structures of municipalities and the Agência Nacional de Águas—ANA (National Water Agency) would be responsible for the regulation of the provision of water and sewage services. In addition, it is expected that the proposed legislation, if and when approved, will define the party responsible for granting the concessions of water and sewage services within the metropolitan regions, including the São Paulo Metropolitan Region.

The legislature of the State of São Paulo is also considering adopting a law which would establish a State regulatory agency responsible for regulating and controlling public sanitation services in the State. This proposed agency would be part of the Secretariat of Water Resources, Sanitation and Works of the State of São Paulo.

Government Regulation

The State legislature of the State of São Paulo is also debating new legislation that would establish procedures for the collection of fees related to the use of water.

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 federal, 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 substantial portion of our concessions is automatically renewable unless notice of rescission 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. The State Constitution provides that, if we are replaced as the concessionaire by any municipality, the municipality must reimburse Sabesp for the unamortized economic value of its investments. See “Business—Concessions” for a further description of our concessions.

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 State of São Paulo 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 canceled 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 Sabesp in the future. In February 1998, the Attorney General of the State of São Paulo, in response to a request made by Sabesp, delivered an opinion that any municipality of the State of São Paulo may grant to Sabesp a concession to operate such 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. There can be no assurance that the Brazilian courts will continue to interpret the concessions laws to allow municipalities to grant concessions without a public bidding process. We have authority to grant sub-concessions to entities involved in our build, operate and transfer, or BOT, projects.

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The provisions of the State Concessions Law parallel the provisions of the Federal Concessions Law.

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 Sabesp in the event that we seek to secure new concessions. Moreover, these bidding laws currently apply to Sabesp 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 in order to develop the National System for Water Resources Management. Under proposed legislation, the National Water Agency would be responsible for the coordination of the regulatory aspects involved in the rendering of water and sewage services. See “—Pending Legislation.”

Under existing law, Federal Governmental agencies are authorized to collect fees from persons that either abstract water from, or dump sewage into, water resources controlled by these agencies. In most cases, the fees have yet to be established by implementing regulations, but, for one specific watershed, recent legislation was enacted requiring Sabesp to pay the Federal Government or an agency in respect of the use of water.

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 having priority;

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

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

Pursuant to an executive order of the Governor of the State of São Paulo, the Departamento de Águas e Energia Elétrica (Department of Water and Energy) of the State of São Paulo 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 of São Paulo and (2) plans, studies and projects related to the integral use of water resources, directly or by means of agreements with third parties. The Department of Water and Energy has established the standards which regulate abstraction of water from water resources in the State of São Paulo.

State law provides 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 controlled by such agencies. Although governmental water agencies in the State of São Paulo currently do not charge fees for any of the water which Sabesp abstracts, there can be no assurance that such fees will not be charged in the future. See "Risk Factors—Risks Relating to Sabesp—We may become subject to substantial water- and sewage-related charges imposed by governmental water agencies of the State of São Paulo and of the Federal Government" for more information.

WATER QUALITY

An ordinance issued by the Ministério da Saúde (Ministry of Health) of the Brazilian government, sets forth the standards of potability of all water for human consumption in Brazil. This ordinance is patterned after the U.S. Safe Drinking Water Act and regulations promulgated by the U.S. Environmental Protection Agency thereunder. The Secretaria de Estado da Saúde (Secretariat of Health) of the State of São Paulo has also set minimum standards for the potability of water for human consumption which are more restrictive than the national ordinance.

We analyze test samples at our laboratories to determine compliance with Ordinance No. 1,469 and state law using "Standard Methods" (18th Edition) procedures established by the American Water Works Association.

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.

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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.

Companhia de Tecnologia de Saneamento Ambiental—CETESB (Environmental Sanitation Technology Company, or CETESB), a mixed capital company controlled by the Secretariat of the Environment of the State of São Paulo, is authorized under state law to monitor discharges of pollutants in public waters and to enforce the requirements of state law. CETESB has the power to grant consents to entities which are discharging pollutants in receiving waters. Although we have not received formal authorization from CETESB to discharge untreated sewage into waters, we continue to discharge such sewage with the knowledge of, and after having made disclosure to, CETESB. 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.

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

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

TARIFF REGULATION

As a concessionaire of public service, the tariffs set by Sabesp for its services are subject to federal and State regulation to some extent.

In 1991, involvement of the Brazilian government in the establishment of tariff rates for the provision of water and sewage services ended pursuant to a federal executive order dated September 5, 1991. In addition, on December 16, 1996, the Governor of the State of São Paulo issued a decree, which approved the existing tariff system and allowed Sabesp to continue to set its 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. Furthermore, this decree directs Sabesp to apply the following criteria in determining its tariffs:

- category of use;
- capacity of the water meter;
- characteristics of consumption;
- volume consumed;
- fixed and floating costs;

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- seasonal variations; and
- social and economic conditions of residential customers.

The costs associated with the exploitation of water resources, depreciation, provision for bad debts, amortization of expenses and adequate remuneration for the investments also may be considered by Sabesp in determining tariffs. We usually submit new tariffs to the Governor of the State of São Paulo for approval, although we are not required by law to do so.

We currently maintain three different tariff schedules, depending upon whether a customer is located in the São Paulo Metropolitan Region, the Interior Region or the Coastal Region. 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 bulk basis.

Tariffs must be published in the *Diário Oficial do Estado de São Paulo* (Official Gazette of the State of São Paulo).

We are 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 upon our financial statements prepared in accordance with the corporation law method. We continue to 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 limitation in setting tariffs under our newer concessions or for the City of São Paulo and other municipalities in which we operate without formal concessions. The above return on assets limitation does not apply to renewals of existing concessions. In any event, our tariffs have been set in the past, and continue to be set, at levels well below the return on assets limitation discussed above.

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 of states, the Federal District, municipalities and their respective *autarquias* (agencies), foundations and non-financial companies, including Sabesp. This resolution provides, among other things, that, with certain exceptions for the importation of goods and services,

- the proceeds of external credit operations must be used to refinance outstanding financial obligations of the issuer, with preference given to those obligations having a higher cost or shorter term than the external debt and, pending application, remain on deposit, as directed by the Central Bank, in a pledged account, and
- the total amount of the contractual obligation be subject to monthly deposits in a pledged account, with each monthly deposit to be 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 Japan Bank for International Cooperation. The Central Bank circular implementing this resolution, provides, among other things, that the account referred to in the first clause above must be an escrow account opened in a federal financial institution, which is to hold such funds until released for purposes of refinancing outstanding obligations of the issuer. The circular further provides that

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the escrow account described in the second clause 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 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 commercial market for foreign exchange. Nevertheless, to facilitate the conduct of monetary policy and to eliminate imbalances in Brazil's balance of payments, the Central Bank from time to time introduces restrictions on inflows and remittances abroad of foreign capital.

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

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 Sabesp. Financing of projects which are put up for international bid 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.

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

The Conselho Estadual de Saneamento (State Sanitation Council) 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 corporation law, we are managed by our Board of Directors, which currently consists of seven directors, and a *Diretoria*, or Executive Committee, which currently consists of seven executive officers.

As the majority shareholder of Sabesp, the Government of the State of São Paulo has the ability to control the election of the Board of Directors and, therefore, the direction and future operations of Sabesp. Elections for the Governor of the State of São Paulo are scheduled for October 2002. Upon the election of a new Governor and any resulting change in the administration of the Government of the State of São Paulo, all or some of the members of the Board of Directors, including the Chairman and certain executive officers, may be replaced by designees of the new administration. In addition, the current Governor of the State of São Paulo has recently appointed new senior members of his government, including Mr. Mauro Guilherme Jardim Arce, as the new Secretary of the Water, Sanitation and Public Works Secretariat, or Water Secretariat, of the State of São Paulo. Mr. Arce became Chairman of our Board of Directors in January 2002.

BOARD OF DIRECTORS

Our by-laws provide for a minimum of five and a maximum of 10 directors. The members of our Board of Directors are elected at a general meeting of shareholders to serve renewable one-year terms. Pursuant to the Brazilian corporation law, each member of our Board of Directors must be a shareholder of Sabesp and, pursuant to our by-laws, a resident of Brazil. 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 Sabesp. Currently, our employees have not elected a director. In addition, pursuant to the Brazilian corporation law, at least one member of the Board of Directors of mixed capital companies, such as Sabesp, must be appointed by the minority shareholders.

The current members of our Board of Directors were elected in April 2001, with the exception of Mr. Fernando Carvalho Braga, who was elected in July 2001, and Mr. Mauro Guilherme Jardim Arce, who was elected in January 2002. The tenure of the directors will end upon the election of the new members at the annual shareholders' meeting to be held by April 2003. Historically, the Chairman of our Board of Directors has been the Secretary of the Water Secretariat, and the Vice-Chairman of our Board of Directors has been the President and Chief Executive Officer of Sabesp.

Our Board of Directors ordinarily meets twice 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. Although our by-laws contain no specific provisions regarding a director's power to vote on a proposal, arrangement or contract in which that director has a material interest, under the Brazilian corporation law, a director is prohibited from voting in any meeting or with respect to any transaction in which that director has a conflict of interest with the company.

Management

The following are the current members of our Board of Directors and their respective positions:

| <u>Director</u> | <u>Position</u> |
|---------------------------------------|-----------------|
| Mauro Guilherme Jardim Arce | Chairman |
| Ariovaldo Carmignani | Vice-Chairman |
| Fernando Carvalho Braga | Director |
| Andrea Sandro Calabi | Director |
| Fernando Maida Dall'Acqua | Director |
| José Guimarães Monforte | Director |
| Gustavo de Sá e Silva | Director |

EXECUTIVE COMMITTEE

Our Executive Committee is comprised of seven 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.

Executive Committee meetings are held weekly in the case of ordinary meetings or when called by the President in the case of special or extraordinary meetings. Members of our Executive Committee have individual responsibilities established by our Board of Directors and our by-laws. The current members of our Executive Committee were appointed in April 2001, and their terms expire in April 2003.

The following are the current members of our Executive Committee and their respective positions:

| <u>Executive Officer</u> | <u>Position</u> |
|--|---|
| Ariovaldo Carmignani | President and Chief Executive Officer |
| Paulo Domingos Knippel Galletta | Economic and Financial Officer and Investor Relations Officer |
| Sérgio Pinto Parreira | Director of Corporate Affairs |
| João Jorge da Costa | Technical and Environmental Director and Vice-President, Metropolitan Region Distribution |
| Plínio Xavier de Mendonça Júnior | Vice-President, Interior Region |
| Oswaldo Aly | Vice-President, Coastal Region |
| Antônio Marsiglia Neto | Vice-President, Metropolitan Region Production |

BIOGRAPHICAL INFORMATION

The following is basic biographical information, including age, of each of the members of our Board of Directors and our Executive Committee.

Mauro Guilherme Jardim Arce (60). Mr. Arce has been the Chairman of the Board of Directors and Secretary of the Water Secretariat since January 2002 and Secretary of the Energy Secretariat of the State of São Paulo since February 1999. He holds a degree in electric engineering from the Universidade Mackenzie and also studied electric systems engineering at Pontifícia Universidade Católica do Rio de Janeiro. He has a masters degree in power engineering from the Rensselaer Polytechnic Institute in Troy, New York. From January 1995 to February 1998, Mr. Arce was Director of Production and Transmission of Energy at Companhia Energética de São Paulo—CESP. He was Adjunct Secretary of Energy of the State of São Paulo

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from February 1998 to January 1999. Mr. Arce's business address is Rua Butantã, 285, São Paulo, SP, Brazil.

Ariovaldo Carmignani (58). Mr. Carmignani has been Vice-Chairman of the Board and President and Chief Executive Officer since January 1995. He holds a degree in business administration from Pontifícia Universidade Católica—São Paulo. Mr. Carmignani has also been President of Newport Steel Comercial Importadora Ltda. since October 1993. Prior to joining Sabesp, Mr. Carmignani was a Superintendent at Ciadea do Brasil S.A. from September 1992 to October 1993, Director at Protmet Indústria e Comércio Ltda. from May 1992 until February 1997, and Director of Development and Corporate Planning at Cofap S.A. from August 1991 to August 1992. Mr. Carmignani also held executive positions at Electrolink Indústria e Comércio S.A., AC Projetos e Empreendimentos and Mangels Industrial S.A. Mr. Carmignani's business address is Rua Costa Carvalho, 300, São Paulo, SP, Brazil.

Fernando Carvalho Braga (49). Mr. Braga has been a member of the Board of Directors since July 2001. He holds a degree in economics from Mackenzie University in São Paulo. Mr. Braga has been a member of the Secretaria de Economia e Planejamento of the State of São Paulo since 1995. Mr. Braga is also a member of the board of directors of Banco Nossa Caixa S.A., Drogasil S.A., Companhia Energética de São Paulo—CESP, Companhia de Transmissão de Energia Elétrica Paulista-CTEEP, Empresa Metropolitana de Águas e Energia S.A.-EMAE and Empresa Paulista de Transmissão de Energia Elétrica S.A.—EPTÉ. Mr. Braga is the Executive Secretary of the State Privatization Program in the State of São Paulo since June 1996. Mr. Braga's business address is Avenida Morumbi, 4500, São Paulo, SP, Brazil.

Andrea Sandro Calabi (56). Mr. Calabi has been a member of the Board of Directors since April 2001. He holds a degree in economics from the Universidade de São Paulo-USP, a master in economics from USP and a master of arts and a PhD in economics from University of California, Berkley. Mr. Calabi is a member of the board of directors of Caixa Econômica Federal S.A.—CEF, Companhia de Seguros do Estado de São Paulo S.A.—COSESP, Empresa Brasileira de Aeronáutica S.A.—EMBRAER and CAEMI—Companhia Auxiliar de Empresas de Mineração S/A. Mr. Calabi was an executive secretary of the Ministry of Planning of the Brazilian government from January 1995 to September 1996. Mr. Calabi was a member of the board of directors of BNDES and Banco do Brasil S.A. during 1995 and 1996. From December 1996 to December 1998, he was a member of the Companhia Paulista de Ativos-CPA and from May 1998 until December 1998, he was a member of the board of directors of BANESPA-Banco do Estado de São Paulo S.A. From January 1999 to July 1999, Mr. Calabi was the President of Banco do Brasil S.A. and chairman of BRASILPREV Previdência Privada, BRASILCAP Capitalização S.A., BrasilSaúde Companhia de Seguros, Companhia de Seguros Aliança do Brasil and BrasilVeículos Companhia de Seguros, all affiliates of Banco do Brasil S.A. From July 1999 to February 2000, Mr. Calabi was the President and a member of the board of directors of BNDES, FINAME and BNDES Participações S.A.—BNDESPAR and a member of the board of directors of Petróleo Brasileiro S.A.—Petrobras. Mr. Calabi's business address is Rua Viradouro, 63, São Paulo, SP, Brazil.

Fernando Maida Dall'Acqua (53). Mr. Dall'Acqua has been a member of the Board of Directors since September 1997. He holds a degree in agronomy from Escola Superior de Agricultura Luis de Queiróz da Universidade de São Paulo, a Ph.D. in economics from Wisconsin University and a master's degree in business administration/economics from Escola de Administração de Empresas de São Paulo—Fundação Getulio Vargas. Mr. Dall'Acqua currently is Secretary at the Secretaria da Fazenda do Governo do Estado de São Paulo. Mr. Dall'Acqua is also a member of the Board of Directors of Desenvolvimento Rodoviário S.A.—DERSA, Companhia Paulista de Obras e Serviços—CPOS and Companhia de Processamento de Dados do Estado de São Paulo—PRODESP. Mr. Dall'Acqua has been a professor at Escola de Administração de Empresas de São Paulo—Fundação Getulio Vargas since 1992. Mr. Dall'Acqua's business address is Avenida Rangel Pestana, 300, São Paulo, SP, Brazil.

Management

José Guimarães Monforte (54). Mr. Monforte has been a member of the Board of Directors since April 2001. Mr. Monforte was elected as a director by our minority shareholders in accordance with our by-laws. He holds a degree in economics from the Universidade Católica de Santos. Mr. Monforte is currently Chairman of the board of directors of Bell Canada do Brasil and Piniweb S.A., Vice-Chairman of the board of directors of Klicknet S.A., and a member of the board of directors of Americel S.A., Telet S.A., Natura Cosméticos S.A. He is also a member of the Executive Committee of Flora Medicinal. Mr. Monforte was Chairman of the Associação Nacional dos Bancos de Investimento—ANBID from 1992 to 1994. Mr. Monforte's business address is Rua Amauri, 255, São Paulo, SP, Brazil.

Gustavo de Sá e Silva (77). Mr. Silva has been a member of the Board of Directors since April 2001. Mr. Silva holds a degree in economics and business administration from the Faculdade de Ciências Econômicas de São Paulo da Fundação Silvio Alvares Penteado and a master's degree in business administration from Michigan State University. Mr. Silva is the President of GSV—Consultoria Empresarial S/C Ltda., a member of the board of directors of Companhia Energética de São Paulo—CESP, EMAE—Empresa Metropolitana de Água e Energia S.A., CTEEP—Companhia de Transmissão de Energia Elétrica Paulista and EPTE—Empresa Paulista de Transmissão de Energia Elétrica S.A., a member of the Consultant Board of Fundação Antonio and Helena Zerrener and of the Board of Associação ALUMNI. Mr. Silva was a professor of the Marketing Department of the business administration school of Fundação Getulio Vargas from 1954 to 1994. Mr. Silva's business address is Alameda Joaquim Eugenio de Lima, 680, São Paulo, SP, Brazil.

Paulo Domingos Knippel Galletta (54). Mr. Galletta has been Economic and Financial Officer of Sabesp since 1995 and Investor Relations Officer since 1995. He holds a degree in economics from the Universidade de São Paulo and a master's degree in business administration from the Fundação Getulio Vargas. Mr. Galletta was previously Economic and Financial Director of Sabesp from April 1991 to March 1992. Prior to joining Sabesp, Mr. Galletta was Administrative and Finance Director of the Companhia Paulista de Trens Metropolitanos—CPTM from April 1994 to January 1995 and a consultant for the Instituto de Economia do Setor Público de São Paulo—IESP from 1984 to 1994. In addition, Mr. Galletta was Assistant Secretary for the Grupo de Privatização e Projetos Prioritários do Governo de São Paulo from October 1992 to December 1993 and Executive Assistant at the Secretaria da Fazenda do Estado de São Paulo from April 1992 to October 1992. Mr. Galletta's business address is Rua Costa Carvalho, 300, São Paulo, SP, Brazil.

Sérgio Pinto Parreira (58). Mr. Parreira has been Director of the Corporate Affairs of Sabesp since June 1997. He holds a degree in industrial engineering from the Faculdade de Engenharia Industrial de São Paulo—PUC and a master's degree in business administration from the Fundação Getulio Vargas in São Paulo. From April 1996 until assuming his current position, Mr. Parreira was Assistant to the President in charge of overseeing the Planning and Administration, Audit, Human Resources, Legal Affairs, Marketing and Communications, Information Technology and Strategic Acquisitions Departments of Sabesp. Mr. Parreira was Superintendent for Planning and Administration at Sabesp from 1991 through April 1996. Mr. Parreira's business address is Rua Costa Carvalho, 300, São Paulo, SP, Brazil.

João Jorge da Costa (54). Mr. Costa has been Technical and Environmental Director since March 1999 and Vice-President, Metropolitan Region Distribution since December 2001. He holds a degree in civil engineering from Faculdade de Engenharia da Fundação Armando Álvares Penteado and a post graduate degree from Escola Politécnica da Universidade de São Paulo. He has been with Sabesp since 1976 in several positions and was the Cabinet Chief to the President for the four years prior to 1999. He is currently Vice President of AIDIS—Asociación Interamericana de Ingeniería Sanitaria. Mr. Costa's business address is Rua Costa Carvalho, 300, São Paulo, SP, Brazil.

Management

Plínio Xavier de Mendonça Júnior (62). Mr. Mendonça Júnior has been Vice-President, Interior Region since March 1999. He holds a degree in Civil Engineering from Escola Politécnica da Universidade de São Paulo—USP. Prior to assuming his current position Mr. Mendonça Júnior was Director of Harza-Hidrobrasileira Engenharia e Projetos Ltda. from October 1996 to November 1997 and Director of Hidrobrasileira S.A. Engenharia e Consultoria Técnica from 1976 to 1996. Mr. Mendonça Junior’s business address is Rua Costa Carvalho, 300, São Paulo, SP, Brazil.

Oswaldo Aly (73). Mr. Aly has been Vice-President, Coastal Region since 1996. He holds a degree in civil engineering from Escola Politécnica da Universidade de São Paulo. Prior to joining Sabesp, Mr. Aly was Municipal Secretary for Metropolitan Matters of the Prefeitura Municipal de Santos from 1993 until 1995 and Director and President of EPF Engenharia Limitada from 1960 until 1995. Mr. Aly was also Vice President of the Conselho de Desenvolvimento da Região Metropolitana da Baixada Santista in 1998 and has been a member of this organization since 1990. Mr. Aly’s business address is Rua Costa Carvalho, 300, São Paulo, SP, Brazil.

Antônio Marsiglia Neto (66). Mr. Marsiglia has been Vice-President, Metropolitan Region Production since March 1999. He holds a degree in industrial engineering from Faculdade de Engenharia Industrial de São Paulo—PUC and a master’s degree in business administration from the Fundação Vanzolini da Universidade de São Paulo. Prior to joining Sabesp, Mr. Marsiglia was Secretary of Sanitation at the Secretaria de Bem Estar Social from 1992 to 1993 and Vice-President, Metropolitan Region Distribution from January 1995 to April 1999. Mr. Marsiglia’s business address is Rua Costa Carvalho, 300, São Paulo, SP, Brazil.

AUDIT COMMITTEE

Our *Conselho Fiscal*, or Audit Committee, which generally meets once a month, consists of five members and five alternates elected at the annual shareholders meeting for renewable one-year terms. The primary responsibility of the Audit Committee, which is independent from the management of Sabesp and from the external auditors appointed by our Board of Directors, is to review our financial statements and report on them to our shareholders.

The following are the current members and alternate members of our Audit Committee:

| <u>Audit Committee Member</u> | <u>Alternate</u> |
|---|-----------------------------------|
| Francisco Martins Altenfelder Silva | Vanildo Rolando Neubauer |
| Maria de Fátima Reitembach de Castro . | Bruno Bellissimo Netto |
| Sandra Lúcia Fernandes Marinho | Sandra Maria Giannella |
| Arthur Correa de Mello Neto | Volnir Pontes Júnior |
| Luiz Nelson Porto Araújo | Alexandre Luiz Oliveira de Toledo |

COMPENSATION

Our shareholders are responsible for establishing the compensation we pay to the members of our Board of Directors and the executive officers.

For the fiscal year ended December 31, 2001, the aggregate compensation, including benefits in kind granted, that we paid to members of our Board of Directors and the executive officers for services in all capacities was approximately R\$1.3 million. In addition, in 2001 the executive officers received pension benefits of approximately R\$0.3 million. The members of our Board of Directors did not receive any such benefits. As of December 31, 2001, we have set aside R\$0.3 million to provide pension benefits to our executive officers.

Management

None of our directors and executive officers is party to an employment contract providing for benefits upon termination of employment.

PROFIT SHARING AND PENSION PLANS

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 Sabesp. 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 two months and are made to the extent of achievement of such targets. 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 was 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 semi-annually. We made total profit-sharing payments of R\$60.1 million in respect of 1998, R\$30.3 million in respect of 2000 and R\$15.9 million in respect of 2001. In 1999 we did not pay any profit-sharing amounts to our employees as a result of a State decree prohibiting any profit-sharing payments in 1999 to employees of state-controlled companies, including Sabesp. We believe that the profit-sharing plan has, in the past, contributed to increased employee productivity.

We have established SABESPREV—Fundação SABESP de Seguridade Social, 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\$10.0 million in 1999, R\$9.6 million in 2000 and R\$10.2 million in 2001. See note 12 to our audited financial statements.

On May 29, 2001, a Federal law was enacted which, among other things, limits the amount mixed capital companies, like Sabesp, may contribute to their pension plans. Specifically, the ordinary contributions made by Sabesp to its pension plans may not exceed the contributions made by the beneficiaries of such plans.

AUDITORS

The audited financial statements herein have been audited by PricewaterhouseCoopers Auditores Independentes, our independent accountants. Their offices are located at Avenida Francisco Matarazzo, 1700, 05001-400 São Paulo, SP, Brazil. They are members of the Conselho Regional de Contabilidade (Regional Board of Accountants of São Paulo) and their registration number is CRC2SP000160/O-5.

Principal Shareholders and Selling Shareholder

Our outstanding share capital at April 30, 2002 consisted of 28,479,577,827 common shares, without par value. Under our by-laws, the State of São Paulo is required to own at least a majority of our outstanding common shares, and under the laws of State of São Paulo, the State is required to own at least two-thirds of our outstanding common shares. All of our shareholders, including the State of São Paulo and the State-owned entities that own our shares, have the same voting rights.

The following table sets forth share ownership information for each of our shareholders that beneficially owned 5% or more of our common shares and for our officers and directors, individually and as a group, at April 30, 2002.

| | Common shares beneficially owned prior to the offerings | | Common shares offered in the offerings | | Common shares beneficially owned after the offerings ⁽³⁾ | |
|--|---|--------------|--|-------------|---|--------------|
| | Shares | (%) | Shares | (%) | Shares | (%) |
| State of São Paulo | 25,156,934,058 | 88.3 | 4,615,260,000 | 16.2 | 20,541,674,058 | 72.1 |
| Director and executive officers of Sabesp ⁽¹⁾ | 16 | — | — | — | 16 | — |
| Others | 3,322,643,753 | 11.7 | — | — | 7,937,903,753 | 27.9 |
| Total ⁽²⁾ | <u>28,479,577,827</u> | <u>100.0</u> | <u>4,615,260,000</u> | <u>16.2</u> | <u>28,479,577,827</u> | <u>100.0</u> |

(1) The directors and executive officers of Sabesp own less than 0.1% of the outstanding common shares of Sabesp.

(2) As of April 30, 2002, the outstanding common shares of Sabesp were held by 2,886 registered shareholders.

(3) Share amounts do not reflect the exercise of the underwriters' over-allotment option.

Our common shares have been listed on the São Paulo Stock Exchange since June 4, 1997 and since April 24, 2002 our common shares have been included on the Novo Mercado segment of that Exchange. Prior to June 4, 1997, our common shares were traded on Sociedade Operadora do Mercado de Acesso-SOMA, an over-the-counter market in Brazil.

SELLING SHAREHOLDER

The State of São Paulo intends to sell in the international and Brazilian offerings 4,615,260,000 common shares, or 5,307,549,000 common shares if the over-allotment option is exercised in full. Except for these offerings, the State has agreed not to sell, offer or agree to sell, grant any option to sell or otherwise dispose of, directly or indirectly, any common shares, ADSs or securities convertible into or exchangeable or exercisable for common shares or ADSs or warrants or other rights to purchase common shares or ADSs without the consent of UBS Warburg LLC for a period of 180 days after the date of this prospectus.

The principal executive offices of the State of São Paulo are located at Palácio dos Bandeirantes, Avenida Morumbi, 4500, São Paulo, SP, Brazil.

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 is our largest customer, it owns some of the facilities we use in our business, it is one of the governmental entities that regulates our business, and it has assisted us in obtaining financing on favorable terms. There is no express requirement under Brazilian law or our by-laws that the terms of our transactions with the State be “arm’s-length” or otherwise fair to us or to our other shareholders.

Many of our transactions with the State of São Paulo reflect policies of the State Government 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 scheduled for October 2002. Among the practices that could change are those described below concerning the application of distributions to offset accounts receivable from the State, the provision of State guarantees, and the terms on which we use state-owned reservoir facilities. Although the State has not expressed any present intention to change its practices in these matters, we cannot assure you that the State will not change its practices on these or other matters in ways that would adversely affect our interests and those of our shareholders.

Provision of services

We provide water and sewage services to the Federal Government, the State Government and municipal governments and government entities in the ordinary course of our business. Sales of water and sewage services to the State Government, including State entities, totaled approximately R\$242.1 million during the year ended December 31, 2001. In addition, as required by law, we invest our cash and cash equivalents with government financial institutions in short-term securities. Our accounts receivable from the State totaled R\$378.3 million at December 31, 2001.

Payment of pensions

Pursuant to a law enacted by the State Government, certain former employees of some State Government-owned companies which merged to form Sabesp, who provided service to us between our inception and 1974, when such 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 Government, and are claimed by us as reimbursements from the State Government, as primary obligor. During 2001, we made payments to former employees of R\$72.8 million in respect of Plan G0. The State did not make any reimbursements in these periods. See note 6 to our audited financial statements. The amount owed to us by the State for reimbursement of these costs was R\$326.3 million at December 31, 2001.

Agreements with the State

In September 1997, we and the State of São Paulo entered into a protocol of understanding providing that we would, in effect, apply dividends declared by Sabesp and otherwise payable to the State of São Paulo to offset accounts receivable in connection with the provision to the State of São Paulo, or its controlled entities, of water and sewage services. In 1998, 2000 and 2001 we applied dividends, in the form of interest attributed to shareholders’ equity, in an aggregate amount equal to R\$1,215.6 million due to the State of São Paulo in respect of its shareholding in Sabesp to settle a portion of the unpaid accounts receivable from the State. In 1999, we did not pay dividends or other distributions.

Related Party Transactions

On December 11, 2001, we entered into an agreement with the State of São Paulo 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 to Sabesp amounts it owes Sabesp in respect of:

- water and sewage services provided by Sabesp to governmental agencies, state-owned autonomous entities and foundations through December 1, 2001 in the amount of R\$358.2 million; and
- supplemental retirement and pension benefits paid by Sabesp from March 1986 to November 2001 on behalf of the State to former employees of the State Government-owned companies which merged to form Sabesp in the amount of R\$320.6 million.

As a result, R\$649.1 million of such amounts owing by the State became a long-term receivable from the State Government in our financial statements at December 31, 2001.

The agreement provides that the State Department of Water and Energy will transfer to Sabesp ownership of the Taiaçupeba, Jundiá, Biritiba, Paraitinga and Ponte Nova reservoirs, which make up the Alto Tietê System, and that the fair value of these assets will reduce the amounts owed to Sabesp by the State.

A State-owned construction company and an independent appraisal firm chosen by Sabesp will appraise the fair value of the reservoirs. An arithmetic average of these appraisals will determine the fair value of these reservoirs. In the event there is a difference between these two appraisals of more than 10%, a third arbitrator will determine the fair value. Under the terms of the agreement, for amounts due in excess of the fair value of the reservoirs, the State will make payments in 114 consecutive monthly installments, the first payment to be made upon the latest of (1) 210 days after the date of the agreement, (2) the 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 the State owes will not be indexed to inflation or earn interest if there is a delay in concluding the appraisal of fair value. The installments will be indexed on a monthly basis by the IGP-M, plus an interest rate of 6% per year, starting on the date the first installment becomes due.

At a meeting held on January 30, 2002, our Board of Directors unanimously declared dividends, in the form of interest attributed to shareholders' equity, in an aggregate amount of R\$489.8 million. This distribution will be paid within 60 days after our annual shareholders meeting, which is scheduled to take place in April 2002, to our shareholders who held shares as of February 7, 2002. Accordingly, the State of São Paulo will be entitled to receive R\$432.7 million of this distribution.

Sabesp expects the State to apply approximately R\$287.7 million of this declared dividend payable to the State of São Paulo to settle current and future accounts receivable owed by the State or its controlled entities. We expect to pay approximately R\$145.0 million, the remaining share of the dividend that the State is entitled to, to the State in cash. At a meeting, our Board of Directors reviewed our 2002 budget, which incorporated the cash payment of this amount, and one of our directors voted against Sabesp making this cash payment to the State. 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.

Investment of liquid assets

Our cash and cash equivalents invested with government financial institutions in short-term securities amounted to R\$319.7 million at December 31, 2001.

Related Party Transactions

Government guarantees of financing

In some situations, the Federal Government, the State Government or government agencies guarantee our performance under debt- and project-related agreements. On December 17, 1992, the State of São Paulo entered into a loan agreement with the World Bank in the amount of US\$119 million. This loan was guaranteed by the Federal Government of Brazil and its proceeds were designated to finance the environmental clean-up of the Guarapiranga basin. Pursuant to this agreement, Sabesp would receive approximately US\$42.5 million 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, the State of São Paulo and Sabesp entered into an agreement pursuant to which the State transferred to Sabesp US\$42.5 million of this loan. We have pledged three of our properties as collateral for this financing. On December 31, 2001 our outstanding debt relating to this loan was approximately US\$20.4 million.

The State of São Paulo has guaranteed a portion of our repayment obligations under loan agreements that we entered into with the Federal Government in 1994 and with Caixa Econômica Federal from 1996 to 1998. The State Government has provided guarantees for a portion of amounts owing to the Federal Government under loan agreements signed with Banco do Brasil, totaling R\$2,533.8 million at December 31, 2001. Our obligations under the loan agreements we entered into with Caixa Econômica Federal amounted to R\$520.2 million at December 31, 2001.

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 of São Paulo. We currently do not pay any fees with respect to the use of these reservoirs. We are, however, responsible for maintaining and meeting the operating costs of these reservoirs. 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 State incurs no operating costs on our behalf.

The arrangement not to pay any fees to the State of São Paulo 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 the arrangement, we agreed to fund 100% of the estimated costs of the 1992 agreement equal to R\$27.8 million and 75% of the 1997 agreement equal to R\$63.5 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% 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 such agreement by R\$5.9 million, which has yet to be disbursed.

We have the right to draw water and release emissions in 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 contract is still under construction and once operational will be depreciated for U.S. GAAP purposes over a 30-year period.

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. Sabesp has a right to use these reservoirs so long as Sabesp remains responsible for maintaining and meeting their operating costs.

Related Party Transactions

Water use incentive agreements

We have entered into agreements with public entities, including state entities and municipalities, that manage approximately 5,000 properties under which we provide these entities with a 25% 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% in water consumption. The amounts involved in these agreements represented less than 1% of our revenues for 2001. 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 and therefore revoke the 25% tariff reduction.

Reimbursement agreement

On September 10, 2001, we entered into an agreement with the State of São Paulo in which the State agreed to reimburse us up to R\$3.0 million for advances we make to the underwriters for their expenses in connection with this offering. Under the terms of the underwriting agreement, the underwriters have agreed to reimburse us and the selling shareholder for the amounts advanced by Sabesp.

TRANSACTIONS WITH SABESPREV PENSION FUND

SABESPREV—Fundação SABESP de Seguridade Social is the funded defined-benefit pension plan that we established to provide our employees with retirement and pension benefits. SABESPREV's assets are held independently of Sabesp, but we nominate the majority of directors of SABESPREV. Both we and our employees make contributions to the pension plan. We contributed R\$10.2 million during 2001 to the pension plan. We occasionally borrow funds from SABESPREV. See note 12 to our audited financial statements for a further description of these contributions.

On May 29, 2001, a Federal law was enacted which, among other things, limits the amount mixed capital companies, like Sabesp, may contribute to their pension plans. Specifically, the ordinary contributions made by Sabesp to its pension plans may not exceed the contributions made by the beneficiaries of such plans.

Description of Share Capital

The following is a summary of the material terms of our common shares, including related provisions of our by-laws and the Brazilian corporation law. This description is qualified by reference to our by-laws and to Brazilian law. Information on the trading market for the common shares is set forth under “Market Information,” and information on ownership of our common shares is set forth under “Principal Shareholders and Selling Shareholder.”

GENERAL

We are a mixed capital company duly organized under the laws of Brazil with unlimited duration. We have the legal status of a *sociedade de economia mista*, a mixed capital company with limited liability, operating under the Brazilian corporation law. As set forth in Article 2 of our by-laws, our corporate purpose is to plan, execute, and operate basic sanitation services throughout the territory of the State of São Paulo, including the capitation, adduction, processing and distribution of water, as well as the collection, removal, processing and final disposal of sewage.

On December 31, 1998, our capital was R\$3,314.9 million. Our share capital at that date consisted of 27,857,339,553 outstanding common shares without par value. This total does not include 110,197,613 shares issued at the price of R\$124.82 per 1,000 shares through a capital increase approved by our shareholders on December 4, 1998.

On January 7, 1999, our shareholders approved a capital increase of R\$14.5 million, which we used to acquire the municipal water and wastewater systems of the municipalities of Agudos, Miguelópolis and Itararé. We issued an aggregate of 159,236,283 common shares to these municipalities at a price of R\$91.14 per 1,000 shares. Further, on November 23, 1999 our shareholders approved a capital increase of R\$31.1 million, which we used to pay 50% of the price for a 30-year concession to operate the water and wastewater system of the municipality of Osasco. We issued 197,211,289 common shares to this municipality at a price of R\$157.82 per 1,000 shares. On December 27, 1999, our shareholders approved a capital increase of R\$22.6 million, which we used to purchase a 30-year concession to operate the water and wastewater systems of the municipalities of Campo Limpo Paulista, Várzea Paulista, Sandovalina and Santa Maria da Serra. We issued an aggregate of 113,170,585 common shares to these municipalities at a price of R\$199.52 per 1,000 shares.

On April 4, 2000, our shareholders approved a capital increase of R\$2.0 million, which we used to purchase a 30-year concession to operate the water and wastewater systems of the municipality of Conchas. We issued 12,141,070 shares to this municipality at a price of R\$164.27 per 1,000 shares. On July 18, 2000, our shareholders approved a capital increase of R\$1.2 million, which we used to purchase a 30-year concession to operate the water and wastewater systems of the municipalities of Marabá Paulista and Duartina. We issued an aggregate of 7,871,725 shares to these municipalities at a price of R\$155.89 per one thousand shares. On December 15, 2000, our shareholders approved a capital increase of R\$3.6 million, which we used to purchase a 30-year concession to operate the water and wastewater systems of the municipality of Serra Negra. We issued 22,409,709 shares to this municipality at a price of R\$159.13 per 1,000 shares.

We made no changes in our share capital from January 1, 2001 through December 31, 2001. At December 31, 2001, our paid-in capital was R\$3,403.7 million. Our share capital at such dates consisted of a total of 28,479,577,827 outstanding common shares without par value.

Under our by-laws, our authorized capital is R\$4,100.0 million, representing 40,000,000,000 common shares without par value. All our outstanding common shares are fully paid. Our shareholders must

Description of Share Capital

approve at a shareholders' meeting any capital increase that exceeds the above-referenced authorized amounts. Under our by-laws and the Brazilian corporation law, if we issue additional common shares in a private transaction, the existing shareholders have preemptive rights to subscribe for common shares on a *pro rata* basis according to their current holdings. See “—Preemptive Rights.”

COMMON SHARES

Each common share entitles the holder thereof to one vote at our annual and special shareholders' meetings. The Brazilian corporation law requires that all our shareholders' meetings be called by publication of a notice in the *Diário Oficial do Estado de São Paulo*, the official government publication of the State of São Paulo, and in a newspaper of general circulation in our principal place of business, currently the City of São Paulo, at least fifteen days prior to the meeting. In addition, the Brazilian Securities Commission may also require the first call for a shareholders' meeting to be up to 30 days before such shareholders' meeting. The quorum to hold shareholders' meetings on first call is generally 25% of the shares entitled to vote and on second call the meetings can be held with the presence of any number of the shares entitled to vote.

Under the Brazilian corporation law, our common shares are entitled to dividends or other distributions made in respect of the common shares in proportion to their share of the amount available for the dividend or distribution. See “Dividends and Dividend Policy” for a more complete description of payment of dividends and other distributions on our common shares. In addition, upon any liquidation of Sabesp, the common shares are entitled to return of capital in proportion to their share of our net worth.

In principle, a change in shareholder rights of shareholders, such as the reduction of the compulsory minimum dividend, is subject to a favorable vote of the shareholders representing at least one half of our voting shares. Under some circumstances that may result in a change in the rights of shareholders, such as the creation of preferred shares, the Brazilian corporate law requires the approval of a majority of the shareholders who would be adversely affected by the change present in a special meeting called for such reason. The Brazilian corporate law specifies other circumstances where the dissenting shareholder may also have appraisal rights.

According to the Brazilian corporation law, neither a company's by-laws nor actions taken at a general meeting of shareholders may deprive a shareholder of some specific rights, such as:

- the right to participate in the distribution of profits;
- the right to participate equally and ratably in any remaining residual assets in the event of liquidation of the company;
- the right to supervise the management of the corporate business as specified in the Brazilian corporation law;
- the right to preemptive rights in the event of a subscription of shares, debentures convertible into shares or subscription bonuses (except in some specific circumstances under Brazilian law); and
- the right to withdraw from the company in the cases specified in the Brazilian corporation law.

Pursuant to the Brazilian corporation law and our by-laws, each of our common shares carries the right to one vote at a general meeting of shareholders. Sabesp may not restrain or deny that right without the consent of the holders of a majority of the shares affected.

Neither the Brazilian corporation law nor our by-laws expressly addresses:

- staggered terms for directors;
- cumulative voting, except as described below; or

Description of Share Capital

- measures that could prevent a takeover attempt.

However, under our by-laws, the State of São Paulo is required to own at least a majority of our outstanding common shares, and under the laws of the State of São Paulo, the State is required to own at least two-thirds of our outstanding common shares.

According to the Brazilian corporation law, shareholders representing at least one-tenth of the voting capital may request that a multiple voting procedure be adopted to entitle each share to as many votes as there are Board members and to give each shareholder the right to vote cumulatively for only one candidate or to distribute their votes among several candidates. Pursuant to the Brazilian corporation law, shareholder action must be taken at a shareholders meeting duly called and not by written consent.

REGULATION OF FOREIGN INVESTMENT

There are no restrictions on ownership of common shares by individuals or legal entities domiciled outside Brazil. However, the right to convert dividend payments and proceeds from the sale of common shares into foreign currency and to remit such amounts outside Brazil is subject to restrictions under foreign investment legislation which generally requires, among other things, the registration of the relevant investment with the Central Bank.

Under Resolution No. 2,689, foreign investors registered with the Brazilian securities commission may buy and sell shares on the São Paulo Stock Exchange without obtaining a separate certificate of registration for each transaction. Investors under these regulations are also generally entitled to favorable tax treatment.

Annex V to Resolution No. 1,289, as amended, of the National Monetary Council, also known as the Annex V Regulations, provides for the issuance of depositary receipts in foreign markets in respect of shares of Brazilian issuers.

Following the closing of these offerings, an electronic certificate of registration will be made in the name of the depositary with respect to the ADSs sold in the international offering and will be maintained by the Brazilian custodian for the common shares on behalf of the depositary. This electronic registration is carried on through the Central Bank Information System. Pursuant to the registration, the custodian and the depositary will be able to convert dividends and other distributions with respect to the common shares represented by ADSs into foreign currency and remit the proceeds outside Brazil. In the event that a holder of ADSs exchanges such ADSs for common shares, the holder will be entitled to continue to rely on such electronic registration for five business days after the exchange. Thereafter, unless the common shares are held pursuant to Resolution No. 2,689 by a duly registered investor, or, if not a registered investor under Resolution No. 2,689, a holder of common shares applies for and obtains a new certificate of registration from the Central Bank, the holder may not be able to convert into foreign currency and remit outside Brazil the proceeds from the disposition of, or distributions with respect to, the common shares, and the holder, if not registered under Resolution No. 2,689, will be subject to less favorable Brazilian tax treatment than a holder of ADSs. In addition, if the foreign investor resides in a “tax haven” jurisdiction, the investor will be also subject to less favorable tax treatment.

See “Risk Factors—Risks Relating to the Common Shares and the ADSs—If you exchange the ADSs for common shares, you risk losing the ability to remit foreign currency abroad and Brazilian tax advantages” and “Taxation—Brazilian Tax Considerations.”

PREEMPTIVE RIGHTS

Each of our shareholders has a general preemptive right to subscribe for shares or securities convertible into shares in any capital increase, in proportion to its shareholding, except in the event of the grant and exercise

Description of Share Capital

of any option to acquire shares of our share capital. A period of at least 30 days following the publication of notice of the issuance of shares or securities convertible into shares is allowed for exercise of the right, and the right is negotiable. Under the Brazilian corporation law, we may amend our by-laws to eliminate preemptive rights or to reduce the exercise period in connection with a public offering of shares or an exchange offer made to acquire another company. Currently our by-laws provide our shareholders with preemptive rights with respect to any offering.

In the event of a capital increase by means of the issuance of new shares, holders of ADSs, or of common shares, would, except under circumstances described above, have preemptive rights to subscribe for any class of our newly issued shares. However, you may not be able to exercise the preemptive rights relating to the common shares underlying your ADSs unless a registration statement under the Securities Act is effective with respect to those rights or an exemption from the registration requirements of the Securities Act is available. See “Risk Factors—Risks Relating to the Common Shares and the ADSs—You might be unable to exercise preemptive rights with respect to the common shares underlying the ADSs” and “Description of American Depositary Shares.”

REDEMPTION AND RIGHTS OF WITHDRAWAL

The Brazilian corporation law provides that, under limited circumstances, a shareholder has the right to withdraw his or her equity interest from the company and to receive payment for the portion of shareholder’s equity attributable to his or her equity interest. This right of withdrawal may be exercised by dissenting shareholders of Sabesp in the event that at least half of all voting shares outstanding authorize us:

- to create preferred shares;
- to reduce the mandatory distribution of dividends;
- to merge into another company or to consolidate with another company, subject to the conditions set forth in the Brazilian corporation law;
- to participate in a centralized group of companies as defined under the Brazilian corporation law and subject to the conditions set forth therein;
- to change our corporate purpose;
- to split up, subject to the conditions set forth in the Brazilian corporation law;
- to transform into another type of company;
- to transfer all of our shares to another company or to receive shares of another company in order to make the company whose shares are transferred a wholly owned subsidiary of such company, known as *incorporação de ações*; or
- to acquire control of another company at a price which exceeds the limits set forth in the Brazilian corporation law.

The right of withdrawal lapses 30 days after publication of the minutes of the shareholders’ meeting that approved the corporate actions described above. We would be entitled to reconsider any action giving rise to withdrawal rights within 10 days following the expiration of such rights if the withdrawal of shares of dissenting shareholders would jeopardize our financial stability. The Brazilian corporation law allows companies to redeem their shares at their economic value, subject to the provisions of their by-laws and certain other requirements. Our by-laws currently do not provide that our capital stock will be redeemable at its economic value and, consequently, any redemption pursuant to the Brazilian corporation law would be made based on the book value per share, determined on the basis of the last balance sheet approved by

Description of Share Capital

the shareholders. However, if a shareholders' meeting giving rise to redemption rights occurred more than 60 days after the date of the last approved balance sheet, a shareholder would be entitled to demand that his or her shares be valued on the basis of a new balance sheet dated within 60 days of such shareholders' meeting.

In addition, the rights of withdrawal in the third, fourth and eighth bullet points above may not be exercised by holders of shares if such shares (1) are liquid, defined as being part of the São Paulo Stock Exchange Index or other stock exchange index (as defined by the CVM), and (2) are widely held, such that the controlling shareholder or companies it controls have less than 50% of our shares. Our common shares are included on the São Paulo Stock Exchange Index.

This right of withdrawal may also be exercised in the event that the entity resulting from a merger, *incorporação de ações*, as described above, consolidation or spin-off of a listed company fails to become a listed company within 120 days of the shareholders' meeting at which such decision was taken.

OPTIONS

There are currently no outstanding options to purchase any of our common shares.

CHANGES TO THE BRAZILIAN CORPORATION LAW

On October 31, 2001, Law No. 10,303 amended the Brazilian corporation law. Pursuant to this law:

- disputes among our shareholders will be subject to arbitration if provided for in our by-laws, which were recently amended to provide that disputes arising out of rules of the Novo Mercado will be resolved by arbitration. See "Market Information—Trading on the Brazilian Stock Exchanges—Novo Mercado";
- a tender offer at a purchase price equal to fair value for all outstanding shares will be required upon a delisting or a substantial reduction in liquidity of our shares as a result of purchases by the controlling shareholders;
- non-controlling shareholders representing at least 15% of the voting capital of the company will have the right to elect one Board member and his or her alternate by separate vote;
- we may redeem shares held by non-controlling shareholders if our controlling shareholder increases its participation in our total share capital to more than 95%;
- Board members elected by the non-controlling shareholders may have veto rights with respect to specified matters if our by-laws provide for supermajority Board approval of those matters;
- any sale of control will require the purchaser to offer to purchase the minority shareholders' common shares, and the minority shareholders' preferred shares, if the preferred shares, if any, have voting rights, at a purchase price at least equal to 80% of the price per share paid to the controlling shareholder. According to our by-laws, which were amended to conform to the requirements of the Novo Mercado, we will be obligated to grant tag along rights equal to the price per share paid to the controlling shareholder;
- shareholders will be entitled to withdraw from us upon a spin-off only if it entails a change in the corporate purpose, a reduction in mandatory dividends or the participation in a centralized group of companies;
- our controlling shareholders, the shareholders that elect members to our Board of Directors and audit committee, the members of our Board of Directors and Audit Committee and our executive officers

Description of Share Capital

will be required to disclose any purchase or sale of our shares to the Brazilian securities commission and the São Paulo Stock Exchange;

- the chairman of any shareholders' or Board of Directors meeting will be entitled to enforce the voting provisions of any shareholders' agreement if that agreement has been duly filed with Sabesp; and
- the first and second calls for shareholders' meetings will have to be made 15 and eight days, respectively, before such meeting, except that the Brazilian securities commission can also require the first call up to 30 days before a shareholders' meeting.

In addition, pursuant to Law No. 10,303, mixed capital companies, such as Sabesp, are subject to the same bankruptcy procedures as privately owned companies. We will also be permitted to satisfy our Brazilian information disclosure requirements through the Internet.

We have conformed our by-laws to meet the provisions of the amended Brazilian corporation law and the requirements of the Novo Mercado. See "Market Information—Trading on the Brazilian Stock Exchanges—Novo Mercado."

Dividends and Dividend Policy

AMOUNTS AVAILABLE FOR DISTRIBUTION

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

- the legal reserve; and
- a contingency reserve for anticipated losses.

We are required to maintain a legal reserve, to which we must allocate 5% of net profits for each fiscal year until the amount for such reserve equals 20% of our paid-in capital. However, we are not required to make any allocations to our legal reserve in respect of any fiscal year in which it, when added to our other established capital reserves, exceeds 30%, of our capital. Net losses, if any, may be charged against the legal reserve. At December 31, 2001, the balance of our legal reserve was R\$104.7 million, which was equal to 3.1% of our paid-in capital.

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

Under the Brazilian corporation law, any company may, as a term in its by-laws, create a discretionary reserve. By-laws which authorize the allocation of a percentage of a company's net income to the discretionary reserve must also indicate the purpose, criteria for allocation and maximum amount of the reserve. We may also allocate a portion of our net profits for discretionary appropriations for plan expansion and other capital investment projects, the amount of which would be based on a capital budget previously presented by management and approved by shareholders. Under Law No. 10,313 of October 3, 2001, capital budgets for more than one year must be revised at each annual shareholders' meeting. After completion of the relevant capital projects, we may retain the appropriation until the shareholders vote to transfer all or a portion of the reserve to capital or retained earnings. At December 31, 2001, we had an investment reserve of R\$1,493.5 million.

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

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

MANDATORY DISTRIBUTION

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

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

PAYMENT OF DIVIDENDS

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

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

In general, shareholders who are not residents of Brazil must register with the Central Bank to have dividends, sales proceeds or other amounts with respect to their shares eligible to be remitted outside of Brazil. The common shares underlying the ADSs will be held in Brazil by Banco Itaú S.A., also known as the custodian, as agent for the depositary, which will be the registered owner on the records of their registrar for our shares. Our current registrar is Banco Itaú S.A. The depositary will electronically register the common shares underlying the ADSs with the Central Bank and, therefore, will be able to have dividends, sales proceeds or other amounts with respect to these shares eligible to be remitted outside Brazil. See "Description of Share Capital—Regulation of Foreign Investment."

Payments of cash dividends and distributions, if any, will be made in Brazilian currency to the custodian on behalf of the depositary, which will then convert such proceeds into U.S. dollars and will cause such U.S. dollars to be delivered to the depositary for distribution to holders of ADSs. See "Description of Share Capital—Regulation of Foreign Investment" and "Description of American Depositary Shares." Under current Brazilian law, dividends paid to shareholders who are not Brazilian residents, including holders of ADSs, will not be subject to Brazilian withholding income tax, except for dividends declared based on profits generated prior to December 31, 1995. See "Taxation—Brazilian Tax Considerations."

Dividends and Dividend Policy

RECORD OF DIVIDEND PAYMENTS AND INTEREST ATTRIBUTED TO SHAREHOLDERS' EQUITY

Law No. 9,249, dated December 26, 1995, as amended, provides for distribution of interest attributed to shareholders' equity to shareholders as an alternative form of payment to shareholders. Such interest is limited to the daily *pro rata* variation of the *Taxa de Juros de Longo Prazo*, or TJLP (the Brazilian government's long-term interest rate). We may treat these payments as a deductible expense for corporate income tax and social contribution purposes, but the deduction cannot exceed the greater of:

- 50% of net income (before taking into account such distribution and any deductions for income taxes and after taking into account any deductions for social contributions on net profits) for the period in respect of which the payment is made; and
- 50% of retained earnings.

Any payment of interest on shareholders' equity to holders of ADSs or common shares, whether or not they are Brazilian residents, is subject to Brazilian withholding income tax at the rate of 15% or 25% if the beneficiary is resident in a tax haven. See "Taxation—Brazilian Tax Considerations." The amount paid to shareholders as interest attributed to shareholders' equity, net of any withholding tax, may be included as part of any mandatory distributable amount. Under Brazilian law, we are obligated to distribute to shareholders an amount sufficient to ensure that the net amount received by them, after payment by us of applicable Brazilian withholding taxes in respect of the distribution of interest attributed to shareholders' equity, is at least equal to the mandatory distributable amount. When we distribute interest attributed to shareholders' equity, and that distribution is not accounted for as part of the mandatory distribution, Brazilian withholding tax will apply. All payments to date were accounted for as part of the mandatory distribution.

The following table sets forth the distributions out of net income that we made or will make to our shareholders in respect of our 1999, 2000 and 2001 net income. All these amounts distributed or to be distributed were or will be in the form of interest attributed to shareholders' equity.

| Distributions out of net income | | | | | | |
|---------------------------------|---------------------------|------------------|--------------------------------|--------------------|---|---------------------------------|
| Year ended December 31, | Net income ⁽¹⁾ | Payment dates | Payment per 1,000 shares | Payment per ADS | Aggregate amount distributed ⁽¹⁾ | Pay-out ratio ⁽²⁾ |
| 1999 | R\$(235.4) | — | R\$ — | R\$— | R\$ — | —% |
| 2000 | 521.4 | (3) | 18.97 | 4.74 | 539.6 | 103.5 |
| 2001 | 216.2 | (4) | 17.20 | 4.30 | 489.8 | 226.6 |

(1) In millions of *reais*.

(2) Represents distributions divided by net income.

(3) November 22, 2000 and December 26, 2000.

(4) To be paid within 60 days after approval by our shareholders at our annual shareholders meeting, which took place on April 25, 2002.

At a meeting held on January 30, 2002, our Board of Directors declared dividends, in the form of interest attributed to shareholders' equity, in an aggregate amount of R\$489.8 million. This distribution will be paid within 60 days after our annual shareholders meeting, which took place on April 25, 2002, to our shareholders who held shares as of February 7, 2002. Therefore, if you decide to buy ADSs in this offering, you will not be eligible for this distribution.

The State of São Paulo will be entitled to receive R\$432.7 million of this distribution. Sabesp expects the State to apply approximately R\$287.7 million of this declared dividend payable to the State of São Paulo to

Dividends and Dividend Policy

settle current and future accounts receivable owed by the State or its controlled entities. We expect to pay approximately R\$145.0 million, the remaining share of the dividend that the State is entitled to, to the State in cash.

At a meeting held on April 29, 2002, our Board of Directors declared dividends, in the form of interest attributed to shareholders' equity, in an aggregate amount of R\$108.2 million. This distribution will be paid within 60 days after our 2003 annual shareholders meeting to shareholders who held shares as of June 27, 2002. Therefore, if you hold ADSs on June 27, 2002, you will be eligible for this distribution.

DIVIDEND POLICY

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

Description of American Depositary Shares

AMERICAN DEPOSITARY SHARES

The Bank of New York, the depositary, has been appointed by Sabesp, pursuant to a deposit agreement among Sabesp, the depositary and you, as an ADR holder, to act as the depositary for the American Depositary Shares. The depositary's Corporate Trust Office is located at 101 Barclay Street, New York, New York 10286. The depositary's principal executive office is located at One Wall Street, New York, New York 10286. American Depositary Shares are frequently referred to as ADSs and represent ownership interests in securities that are deposited with the depositary's custodian. ADSs are normally represented by certificates that are commonly known as American Depositary Receipts or ADRs. The depositary's custodian is Banco Itaú S.A., located at Rua Boa Vista, 176, São Paulo, SP, Brazil.

A copy of the deposit agreement is on file with the Securities and Exchange Commission as an exhibit to a Registration Statement on Form F-6. You may obtain a copy of the deposit agreement from the Commission's Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. You should refer to Registration Number 333-86118 when retrieving your copy.

We are providing you with a summary description of the material terms of the ADSs and of your material rights as an owner of ADSs. Please remember that summaries by their nature lack the precision of the information summarized and that a holder's rights and obligations as an owner of ADSs will be determined by the terms of the deposit agreement and not by this summary. You should review the deposit agreement in its entirety.

Each ADS represents the right to receive 250 of our common shares on deposit with the custodian. An ADS will also represent the right to receive any other property received by the depositary or the custodian on behalf of the owner of the ADS but that has not been distributed to the owners of ADSs because of legal restrictions or practical considerations.

If you become an owner of ADSs, you will become a party to the deposit agreement and therefore will be bound by its terms and by the terms of the ADR that represents your ADSs. The deposit agreement and the ADR specify our rights and obligations as well as your rights and obligations as owner of ADSs and those of the depositary. Because the depositary will actually hold the common shares, you must rely on it to exercise the rights of a shareholder. The deposit agreement and the ADRs are governed by New York law. However, our obligations to the holders of common shares will continue to be governed by the laws of Brazil, which may be different from the laws in the United States.

As an owner of ADSs, you may hold your ADSs either directly by means of an ADR registered in your name or indirectly through a brokerage account. If you decide to hold your ADSs through your brokerage or safekeeping account, you must rely on the procedures of your broker or bank to assert your rights as an ADS owner. Please consult with your broker or bank to determine what those procedures are. This summary description assumes you have opted to own the ADSs directly by means of an ADR registered in your name and, as such, we will refer to you as the "holder." When we refer to "you," we assume the reader owns ADSs and will own ADSs at the relevant time.

DIVIDENDS AND OTHER DISTRIBUTIONS

The depositary has agreed to pay to you the cash dividends or other distributions it or the custodian receives on common shares or other deposited securities after deducting its fees and expenses. You will receive these distributions in proportion to the number of common shares your ADRs represent.

Description of American Depositary Shares

Cash. The depositary will convert any cash dividend or other cash distribution we pay on the common shares into U.S. dollars, if it can do so on a reasonable basis and can transfer the U.S. dollars to the United States. If that is not possible or if any approval from the Brazilian government is needed and cannot be obtained, the agreement allows the depositary to distribute the *reais* only to those ADR holders to whom it is possible to do so. It will hold the *reais* it cannot convert for the account of the ADR holders who have not been paid. It will not invest the *reais* and it will not be liable for the interest.

Before making a distribution, any withholding taxes that must be paid under Brazilian law will be deducted. See “Taxation—Brazilian Tax Considerations—Taxation of Dividends.” The depositary will distribute only whole U.S. dollars and cents and will round fractional cents to the nearest whole cent. If the exchange rates fluctuate during a time when the depositary cannot convert *reais*, you may lose some or all of the value of the distribution.

Common shares. The depositary may distribute new ADRs representing any common shares we may distribute as a dividend or free distribution, if we furnish it promptly with satisfactory evidence that it is legal to do so. The depositary will only distribute whole ADRs. It will sell common shares which would require it to use a fractional ADR and distribute the net proceeds in the same way as it does with cash. If the depositary does not distribute additional ADRs, it and we may modify the ADR-to-common share ratio, in which case each ADR will also represent the new common shares.

Rights to receive additional common shares. If we offer holders of our common shares any rights to subscribe for additional common shares or any other rights, the depositary may make these rights available to you. We must first instruct the depositary to do so and furnish it with satisfactory evidence that it is legal to do so. If we do not furnish this evidence and/or give these instructions and the depositary decides it is practical to sell the rights, the depositary will sell the rights and distribute the proceeds, in the same way as it does with cash. The depositary may allow rights that are not distributed or sold to lapse. In that case, you will receive no value for them.

If the depositary makes rights available to you, upon instruction from you, it will exercise the rights and purchase the common shares on your behalf. The depositary will then deposit the common shares and issue ADRs to you. It will only exercise rights if you pay it the exercise price and any other charges you are required to pay in respect of the rights.

U.S. securities laws may restrict the sale, deposit, cancellation and transfer of the ADRs issued after exercise of rights. For example, you may not be able to trade the ADRs freely in the United States. In this case, the depositary may issue the ADRs under a separate restricted deposit agreement which will contain the same provisions as the deposit agreement, except for the changes needed to put the restrictions in place.

Other Distributions. The depositary will send to you anything else we distribute on deposited securities by any means it thinks is legal, fair and practical. If it cannot make the distribution in that way, the depositary has a choice. It may decide to sell what we distributed and distribute the net proceeds in the same way as it does with cash or it may decide to hold what we distributed, in which case the ADRs will also represent the newly distributed property.

The depositary is not responsible if it decides that it is unlawful or impractical to make a distribution available to any ADR holders. We have no obligation to register ADRs, common shares, rights or other securities under the Securities Act. We also have no obligation to take any other action to permit the distribution of ADRs, common shares, rights or anything else to ADR holders. This means that you may not receive the distribution we make on our common shares or any value for them if it is illegal or impractical for us to make them available to you.

Description of American Depositary Shares

DEPOSIT, WITHDRAWAL AND CANCELLATION

The depositary will issue ADRs if you or your broker deposit common shares or evidence of rights to receive common shares with the custodian. Upon payment of its fees and expenses and of any taxes or charges, such as stamp taxes or stock transfer taxes or fees, the depositary will register the appropriate number of ADRs in the names you request and will deliver the ADRs at its office to the persons you request.

You may turn in your ADRs at the depositary's office. Upon payment of its fees and expenses and of any taxes or charges, such as stamp taxes or stock transfer taxes or fees, the depositary will deliver (1) the underlying common shares to an account designated by you and (2) any other deposited securities underlying the ADR at the office of the custodian. Or, at your request, risk and expense, the depositary will deliver the deposited securities at its office.

VOTING RIGHTS

You will not be entitled to attend shareholders' meetings. However, you may instruct the depositary to vote the common shares underlying your ADRs but only if we ask the depositary to ask for your instructions. Otherwise, you will not be able to exercise your right to vote unless you withdraw the common shares. However, you may not know about the meeting enough in advance to withdraw the common shares. For information about the voting rights of holders of our common shares, see "Description of Share Capital—Common Shares."

If we ask for your instructions, the depositary will notify you of the upcoming vote and arrange to deliver our voting materials to you. The materials will (1) describe the matters to be voted on and (2) explain how you, on a certain date, may instruct the depositary to vote the common shares or other deposited securities underlying your ADRs as you direct. For instructions to be valid, the depositary must receive them on or before the date specified. The depositary will try, as far as practical, subject to Brazilian law and the provisions of our by-laws, to vote or to have its agents vote the common shares or other deposited securities as you instruct. The depositary will only vote or attempt to vote as you instruct.

We cannot assure you that you will receive the voting materials in time to ensure that you can instruct the depositary to vote your common shares. In addition, the depositary and its agents are not responsible for failing to carry out voting instructions or for the manner of carrying out voting instructions. This means that you may not be able to exercise your right to vote and there may be nothing you can do if your common shares are not voted as you requested.

RECORD DATES

The depositary may fix record dates for the determination of the ADR holders who will be entitled:

- to receive a dividend, distribution or rights; or
- to give instructions for the exercise of voting rights at a meeting of holders of common shares or other deposited securities;

all subject to the provisions of the deposit agreement.

REPORTS AND OTHER COMMUNICATIONS

The depositary will make available for inspection by ADR holders any written communications from Sabesp which are both received by the custodian or its nominee as a holder of deposited securities and made

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generally available to the holders of deposited securities. These communications will be furnished in English when so required by any rules or regulations of the Commission.

BOOKS OF DEPOSITARY

The depositary or its agent will maintain a register for the registration, registration of transfer, combination and split-up of ADRs. You may inspect such records at the depositary's Corporate Trust Office during regular business hours but solely for the purpose of communicating with other holders in the interest of business matters relating to the deposit agreement.

The depositary will maintain facilities to record and process the issuance, cancellation, combination, split-up and transfer of ADRs. These facilities may be closed from time to time, to the extent not prohibited by law.

FEES AND EXPENSES

As a holder of ADSs, you will be required to pay the following service fees to the depositary:

| <u>Service</u> | <u>Fees:</u> |
|--|---|
| ● Issuance of an ADS, including as a result of a distribution of common shares or rights or other property | Up to US\$5.00 per 100 ADSs |
| ● Cancellation of an ADS, including if the deposit agreement terminates | Up to US\$5.00 per 100 ADSs |
| ● Cash payment | Up to US\$.02 per ADS |
| ● Transfer and registration of common shares on the share register of the Brazilian registrar from your name to the name of the depositary or its agent when you deposit or withdraw common shares | Registration or Transfer Fees |
| ● Conversion of <i>reais</i> to U.S. dollars | Expenses of the depositary |
| ● Cable, telex and facsimile transmission expenses | Expenses of the depositary |
| ● Servicing of common shares or deposited securities | Expenses of the depositary |
| ● Depositary services; provided that this fee will not be charged if a fee of US\$.02 was charged in the same calendar year for a cash distribution | Up to US\$.02 per ADS per calendar year |

As a holder of ADSs, you may also have to pay taxes and other governmental charges the depositary or the custodian have to pay on any ADR or common share underlying an ADR, for example, stock transfer taxes, stamp duty or withholding taxes.

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PAYMENT OF TAXES

You will be responsible for any taxes or other governmental charges payable on your ADRs or on the deposited securities underlying your ADRs. The depositary may refuse to transfer your ADRs or allow you to withdraw the deposited securities underlying your ADRs until such taxes or other charges are paid. It may apply payments owed to you or sell deposited securities underlying your ADRs to pay any taxes owed and you will remain liable for any deficiency. If it sells deposited securities, it will, if appropriate, reduce the number of ADRs to reflect the sale and pay to you any proceeds, or send to you any property, remaining after it has paid the taxes.

RECLASSIFICATIONS, RECAPITALIZATIONS AND MERGERS

If we change the nominal or par value of our common shares or reclassify, split up or consolidate any of the deposited securities, then the cash, common shares or other securities received by the depositary will become deposited securities. Each ADR will automatically represent its equal share of the new deposited securities.

If we distribute securities on the common shares that are not distributed to you or if we recapitalize, reorganize, merge, liquidate, sell all or substantially all of our assets, or take any similar action, then the depositary may, and will if we ask it to, distribute some or all of the cash, common shares or other securities it received. The depositary may also issue new ADRs or ask you to surrender your outstanding ADRs in exchange for new ADRs identifying the new deposited securities.

AMENDMENT AND TERMINATION

We may agree with the depositary to amend the deposit agreement and the ADRs without your consent for any reason. If the amendment adds or increases fees or charges, except for taxes and other governmental charges or registration fees, cable, telex or facsimile transmission costs, delivery costs or other such expenses, or prejudices an important right of ADR holders, it will only become effective 30 days after the depositary notifies you of the amendment. At the time an amendment becomes effective, you are considered, by continuing to hold your ADR, to agree to the amendment and to be bound by the ADRs and the deposit agreement as amended.

The depositary will terminate the deposit agreement if we ask it to do so. The depositary may also terminate the deposit agreement if the depositary has told us that it would like to resign and we have not appointed a new depositary within 90 days. In both cases, the depositary must notify you at least 30 days before termination.

After termination, the depositary and its agents will be required to do only the following under the deposit agreement: (1) collect distributions on the deposited securities and (2) deliver common shares and other deposited securities upon cancellation of ADRs. After 60 days after the date of termination, the depositary will, if practical, sell any remaining deposited securities by public or private sale. After that, the depositary will hold the proceeds of the sale, as well as any other cash it is holding under the deposit agreement for the *pro rata* benefit of the ADR holders that have not surrendered their ADRs. It will not invest the money and will have no liability for interest. The depositary's only obligations will be to account for the proceeds of the sale and other cash. After termination our only obligations will be with respect to indemnification and to pay certain amounts to the depositary.

LIMITATIONS ON OBLIGATIONS AND LIABILITY TO ADR HOLDERS

The deposit agreement expressly limits our obligations and the obligations of the depositary, and it limits our liability and the liability of the depositary. We and the depositary:

- are only obligated to take the actions specifically set forth in the deposit agreement without negligence or bad faith;
- are not liable if either is prevented or delayed by law or circumstances beyond their control from performing their obligations under the deposit agreement;
- are not liable if either exercises discretion permitted under the deposit agreement;
- have no obligation to become involved in a lawsuit or other proceeding related to the ADRs or the deposit agreement on your behalf or on behalf of any other party; and
- may rely upon any documents they believe in good faith to be genuine and to have been signed or presented by the proper party.

In the deposit agreement, we and the depositary agree to indemnify each other under certain circumstances.

REQUIREMENTS FOR DEPOSITARY ACTIONS

Before the depositary will issue or register transfer of an ADR, make a distribution on an ADR, or withdrawal of common shares, the depositary may require:

- payment of stock transfer or other taxes or other governmental charges and transfer or registration fees charged by third parties for the transfer of any common shares or other deposited securities;
- production of satisfactory proof of the identity and genuineness of any signature or other information it deems necessary; and
- compliance with regulations it may establish, from time to time, consistent with the deposit agreement, including presentation of transfer documents.

The depositary may refuse to deliver, transfer, or register transfers of ADRs generally when the books of the depositary or Sabesp are closed, or at any time if the depositary or Sabesp thinks it advisable to do so.

You have the right to cancel your ADRs and withdraw the underlying common shares at any time except:

- when temporary delays arise because: (1) the depositary or Sabesp has closed its transfer books; (2) the transfer of common shares is blocked to permit voting at a shareholders' meeting; or (3) we are paying a dividend on the common shares;
- when you or other ADR holders seeking to withdraw common shares owe money to pay fees, taxes and similar charges; or
- when it is necessary to prohibit withdrawals in order to comply with any laws or governmental regulations that apply to ADRs or to the withdrawal of common shares or other deposited securities.

This right of withdrawal may not be limited by any other provision of the deposit agreement.

PRE-RELEASE OF ADRS

In certain circumstances, subject to the provisions of the deposit agreement, the depositary may issue ADRs before deposit of the underlying common shares. This is called a pre-release of the ADR. The depositary may also deliver common shares upon cancellation of pre-released ADRs (even if the ADRs are cancelled

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before the pre-release transaction has been closed out). A pre-release is closed out as soon as the underlying common shares are delivered to the depositary. The depositary may receive ADRs instead of common shares to close out a pre-release. The depositary may pre-release ADRs only under the following conditions: (1) before or at the time of the pre-release, the person to whom the pre-release is being made must represent to the depositary in writing that it or its customer owns the common shares or ADRs to be deposited; (2) the pre-release must be fully collateralized with cash or other collateral that the depositary considers appropriate; and (3) the depositary must be able to close out the pre-release on not more than five business days' notice. In addition, the depositary will limit the number of ADRs that may be outstanding at any time as a result of pre-release, although the depositary may disregard the limit from time to time, if it thinks it is appropriate to do so.

Taxation

The summary contains a description of certain Brazilian and U.S. federal income tax consequences of the purchase, ownership and disposition of common shares or ADSs by a holder as of the date hereof.

The summary is based upon the tax laws of Brazil and the United States as in effect on the date of this prospectus, which are subject to change, possibly with retroactive effect, and to differing interpretations. Prospective purchasers of common shares or ADSs should consult their own tax advisors as to the Brazilian, U.S. or other tax consequences of the purchase, ownership and disposition of common shares or ADSs, including, in particular, the effect of any foreign, state or local tax laws.

Although there presently is no income tax treaty between Brazil and the United States, the tax authorities of the two countries have had discussions in the past regarding such a treaty. No assurance can be given, however, as to if or when a treaty will enter into force or how it will affect the U.S. holders of common shares or ADSs.

BRAZILIAN TAX CONSIDERATIONS

General. The following discussion summarizes the material Brazilian tax consequences of the acquisition, ownership and disposition of common shares or ADSs, as the case may be, by a holder that is not domiciled in Brazil, also called a non-Brazilian holder, for purposes of Brazilian taxation and, in the case of a holder of common shares, which has registered its investment in common shares at the Central Bank as a U.S. dollar investment.

Pursuant to Brazilian law, investors may invest in the common shares under Resolution No. 2,689, of January 26, 2000, of the National Monetary Council.

The rules of Resolution No. 2,689 allow foreign investors to invest in almost all financial assets and to engage in almost all transactions available in the Brazilian financial and capital markets, provided that some requirements are fulfilled. In accordance with Resolution No. 2,689, the definition of foreign investor includes individuals, legal entities, mutual funds and other collective investment entities, domiciled or headquartered abroad.

Pursuant to the rules, foreign investors must: (1) appoint at least one representative in Brazil with powers to perform actions relating to the foreign investment; (2) complete the appropriate foreign investor registration form; (3) register as a foreign investor with the Brazilian securities commission; and (4) register the foreign investment with the Central Bank.

Securities and other financial assets held by foreign investors pursuant to Resolution No. 2,689 must be registered or maintained in deposit accounts or under the custody of an entity duly licensed by the Central Bank or the Brazilian securities commission. In addition, securities trading is restricted to transactions carried out in the stock exchanges or organized over-the-counter markets licensed by the Brazilian securities commission.

Taxation of Dividends. Dividends, including stock dividends and other dividends paid in property, paid by us to the depositary in respect of the ADSs, or to a non-Brazilian holder in respect of the common shares, are currently not subject to withholding income tax, provided that they are paid out of profits generated as of or after January 1, 1996 (or out of reserves derived therefrom). We do have retained earnings generated prior to January 1, 1996. Dividends paid from profits generated before January 1, 1996 may be subject to taxation at varying rates, except in the case of stock dividends, which are not subject to withholding income tax in Brazil unless we redeem the common shares within five years from such distribution or the non-Brazilian holder sells the common shares in Brazil within such five year period.

Taxation of Gains. For purposes of Brazilian taxation, there are two types of non-Brazilian holders of ADSs or common shares: (1) non-Brazilian holders that are not resident or domiciled in a tax haven jurisdiction (i.e., a country that does not impose income tax or where the maximum income tax rate is lower than 20%), and that, in the case of holders of common shares, are registered before the Central Bank and the Brazilian securities commission to invest in Brazil in accordance with Resolution No. 2,689; and (2) other non-Brazilian holders, which include any and all non-residents of Brazil who invest in equity securities of Brazilian companies through any other means and all types of investors that are located in tax haven jurisdiction. The investors identified on clause (1) above are subject to favorable tax treatment in Brazil, as described below.

Gains realized outside Brazil by a non-Brazilian holder on the disposition of ADSs to another non-Brazilian holder are not subject to Brazilian tax.

The deposit of common shares in exchange for ADSs may be subject to Brazilian capital gains at the rate of 15% if the amount previously registered with the Central Bank as a foreign investment in the common shares is lower than (1) the average price per common share on a Brazilian stock exchange on which the greatest number of such shares were sold on the day of deposit; or (2) if no common shares were sold on that day, the average price on the Brazilian stock exchange on which the greatest number of common shares were sold in the 15 trading sessions immediately preceding such deposit. In such a case, the difference between the amount previously registered and the average price of the common shares calculated as above, will be considered a capital gain. Such taxation is not applicable in case of investors registered under Resolution No. 2,689 which are not located in a tax haven jurisdiction, which are tax exempt. The withdrawal of ADSs in exchange for common shares is not subject to Brazilian tax. On receipt of the underlying common shares, the non-Brazilian holder registered under Resolution No. 2,689 will be entitled to register the U.S. dollar value of such shares with the Central Bank as described below in “—Registered Capital.”

Non-Brazilian holders are not subject to tax in Brazil on gains realized on sales of common shares that occur abroad to non-Brazilian holders. Non-Brazilian holders registered under Resolution No. 2,689 which are not located in a tax haven jurisdiction are subject to income tax imposed at a rate of 15% on gains realized on sales or exchanges of the common shares that occur in Brazil or with a resident of Brazil, other than in connection with transaction on the Brazilian stock, future or commodities exchange. With reference to proceeds of a redemption or of a liquidating distribution with respect to the common shares, the difference between the amount effectively received by the shareholder and the amount of foreign currency registered with the Central Bank, translated in *reais* at the commercial market rate on the date of the redemption or liquidating distribution, will be also subject to income tax at a rate of 15% once such transactions are treated as a sale or exchange not carried out on the Brazilian stock, future and commodities exchange.

Gains realized arising from transactions on the Brazilian stock, future or commodities exchanges by an investor registered under Resolution No. 2,689 which is not located in a tax haven jurisdiction are exempt from Brazilian income tax. As of January 1, 2000, the preferential treatment under Resolution No. 2,689 is no longer applicable if the non-Brazilian holder of the ADSs or common shares is resident in a tax haven jurisdiction in accordance with Law No. 9,959 of January 27, 2000. As a consequence, gains realized on transactions performed by such holder on the Brazilian stock, future or commodities exchange are subject to income tax at a rate of 20%.

Therefore, non-Brazilian holders are subject to income tax imposed at a rate of 20% on gains realized on sales or exchanges of common shares that occur on the São Paulo Stock Exchange unless such a sale is made by a non-Brazilian holder which is not resident in a tax haven jurisdiction and (1) such sale is made within five business days of the withdrawal of such common shares in exchange for ADSs and the proceeds thereof are remitted abroad within such five-day period, or (2) such sale is made under Resolution No. 2,689 by registered non-Brazilian holders who obtain registration with the Brazilian securities commission. In these two cases, the transaction will be tax exempt. The “gain realized” is the difference between the amount in

reais realized on the sale or exchange and the acquisition cost measured in *reais*, without any correction for inflation, of the shares sold. The “gain realized” as a result of a transaction that occurs other than on the São Paulo Stock Exchange will be the positive difference between the amount realized on the sale or exchange and the acquisition cost of the common shares, both such values to be taken into account in *reais*; there are grounds, however, to hold that the “gain realized” should be calculated based on the foreign currency amount registered with the Central Bank, such foreign currency amount to be translated into *reais* at the commercial market rate on the date of such sale or exchange. There is no assurance that the current preferential treatment for holders of the ADSs and some non-Brazilian holders of the common shares under Resolution No. 2,689 will continue in the future. Any exercise of preemptive rights relating to the common shares will not be subject to Brazilian taxation. Any gain on the sale or assignment of preemptive rights relating to the common shares by the depositary on behalf of holders of the ADSs will be subject to Brazilian income taxation according to the same rules applicable to the sale or disposition of common shares, unless such sale or assignment is performed on the São Paulo Stock Exchange by an investor under Resolution No. 2,689 who is not a resident in a tax haven jurisdiction, in which case the gains are exempt from income tax.

Taxation on Interest on Shareholders’ Equity. Any payment of interest on shareholders’ equity (see “Dividends and Dividend Policy—Record of Dividend Payments and Interest Attributed to Shareholders’ Equity”) to holders of ADSs or common shares, whether or not they are Brazilian residents, is subject to Brazilian withholding income tax at the rate of 15% at the time Sabesp records such liability, whether or not the effective payment has been made at that time. In the case of non-Brazilian residents that are resident in a tax haven jurisdiction, the applicable rate for income tax is 25%.

Taxation of Foreign Exchange Transactions (“IOF/Câmbio”). Under Decree No. 2,219, of May 2, 1997, the conversion into Brazilian currency of proceeds received by a Brazilian entity from a foreign investment in the Brazilian securities market (including those in connection with an investment in common shares or the ADSs and those under Resolution No. 2, 689) and the conversion into foreign currency of proceeds received by a non-Brazilian holder is subject to a tax on exchange transactions known as IOF/Câmbio, which is currently zero on most transactions. However, according to Law No. 8,894, of June 21, 1994, the IOF/Câmbio rate may be increased at any time to a maximum of 25% by a decision of the Minister of Finance, but only in relation to future exchange transactions.

Taxation on Bonds and Securities Transactions (“IOF/Títulos”). Law No. 8,894 created the Tax on Bonds and Securities Transactions, or IOF/Títulos, which may be imposed on any transactions involving bonds and securities effected in Brazil, even if these transactions are performed on the Brazilian stock, futures or commodities exchange. As a general rule, the rate of this tax is currently zero but the executive branch may increase such rate up to 1.5% per day, but only with respect to future transactions.

Other Brazilian Taxes. There are no Brazilian inheritance, gift or succession taxes applicable to the ownership, transfer or disposition of common shares or ADSs by a non-Brazilian holder, except for gift and inheritance taxes which are levied by some states of Brazil on gifts made or inheritances bestowed by individuals or entities not resident or domiciled in Brazil within such state to individuals or entities resident or domiciled within such state in Brazil. There are no Brazilian stamp, issue, registration, or similar taxes or duties payable by holders of common shares or ADSs.

Transactions on Bank Accounts (“CPMF”). As a general rule, the *Contribuição Provisória sobre Movimentação Financeira*, the tax on transactions on bank accounts, or CPMF, is imposed on any debit to bank accounts. Therefore, transactions by the depositary or by holders of common shares which involve the transfer of Brazilian currency through Brazilian financial institutions will be subject to the CPMF tax. This includes when a non-Brazilian holder transfers the proceeds from the sale or assignment of common shares by an exchange transaction, in which case the CPMF tax shall be levied on the amount to be remitted abroad in *reais*. If we have to perform any exchange transaction in connection with ADSs or common

shares, we will also be subject to the CPMF tax. The CPMF tax is imposed generally on bank account debits, at a rate of .38%. Although the CPMF tax is set to expire on June 16, 2002, the Brazilian Congress is discussing the possibility of extending such period or converting this tax into a permanent tax. The responsibility for the collection of the CPMF tax is borne by the financial institution that carries out the relevant financial transaction.

Beneficiaries Resident or Domiciled in Tax Havens or Low Tax Jurisdictions. Law No. 9,779, dated as of January 1, 1999, states that, with the exception of limited prescribed circumstances, income derived from operations by a beneficiary, resident or domiciled in a country considered a tax haven is subject to withholding income tax at the rate of 25%. Tax havens are considered to be countries which do not impose any income tax or which impose such tax at a maximum rate of less than 20%. Accordingly, if the distribution of interest attributed to shareholders' equity is made to a beneficiary resident or domiciled in a tax haven jurisdiction, the applicable income tax rate will be 25% instead of 15%. Capital gains are not subject to this 25% tax, even if the beneficiary is resident in a tax haven jurisdiction. See “—Taxation of Gains.”

Registered Capital. The amount of an investment in common shares held by a non-Brazilian holder who obtains registration under Resolution No. 2,689, or by the depositary representing such holder, is eligible for registration with the Central Bank; such registration (the amount so registered being called registered capital) allows the remittance outside Brazil of foreign currency, converted at the commercial market rate, acquired with the proceeds of distributions on, and amounts realized with respect to dispositions of, such common shares. The registered capital for each common share purchased as part of the international offering or purchased in Brazil after the date hereof, and deposited with the depositary will be equal to its purchase price (in U.S. dollars). The registered capital for a common share that is withdrawn upon surrender of an ADS will be the U.S. dollar equivalent of:

- the average price of an common share on the Brazilian stock exchange on which the greatest number of such shares were sold on the day of withdrawal; or
- if no common shares were sold on that day, the average price on the Brazilian stock exchange on which the greatest number of common shares were sold in the 15 trading sessions immediately preceding such withdrawal.

The U.S. dollar value of the average price of common shares is determined on the basis of the average of the U.S. dollar/*real* commercial market rates quoted by the Central Bank information system on the date (or, if the average price of common shares is determined under the second option above, the average of such average quoted rates on the same 15 dates used to determine the average price of common shares).

A non-Brazilian holder of common shares may experience delays in effecting such registration, which may delay remittances abroad. Such a delay may adversely affect the amount, in U.S. dollars, received by the non-Brazilian holder. See “Risk Factors—Risks Relating to the Common Shares and the ADSs—The relative volatility and illiquidity of the Brazilian securities market may substantially limit your ability to sell the common shares underlying the ADSs at the prices and time you desire.”

UNITED STATES TAXATION

The discussion below is applicable to you only if you are a U.S. holder that is not domiciled in Brazil (or domiciled or resident in a tax haven jurisdiction) for purposes of Brazilian taxation and, in the case of a holder of common shares, that has registered its investment in common shares with the Central Bank as a U.S. dollar investment. A U.S. holder is a beneficial owner of a common share or ADS that is:

- a citizen or resident of the United States;

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- a corporation or partnership created or organized in or under the laws of the United States or any political subdivision of the United States;
- an estate the income of which is subject to United States federal income taxation regardless of its source; or
- a trust if it (1) is subject to the primary supervision of a court within the United States and one or more United States persons have the authority to control all substantial decisions of the trust or (2) has a valid election in effect under applicable United States Treasury regulations to be treated as a United States person.

Except where noted, this summary deals only with common shares or ADSs held as capital assets and does not deal with special situations, such as those of dealers in securities or currencies, traders in securities that elect to use a mark-to-market method of accounting for their securities holdings, financial institutions, tax-exempt entities, insurance companies, real estate investment trusts, regulated investment companies, persons holding common shares or ADSs as part of a hedging, integrated, conversion or constructive sale transaction or a straddle, persons owning 10% or more of our voting stock, or persons whose “functional currency” is not the U.S. dollar. Furthermore, this discussion set forth under “United States Taxation” is based upon the provisions of the Internal Revenue Code of 1986, as amended (the “Code”), and regulations, rulings and judicial decisions thereunder as of the date hereof, and such authorities may be repealed, revoked or modified so as to result in United States federal income tax consequences different from those discussed below. In addition, such summary is based, in part, upon representations made by the Depository to us and assumes that the deposit agreement, and all other related agreements, will be performed in accordance with their terms.

If a partnership holds common shares or ADSs, the tax treatment of a partner will generally depend upon the status of the partner and the activities of the partnership. If you are a partner of a partnership holding the shares or ADSs, you should consult your tax advisor.

In general for United States federal income tax purposes, U.S. holders of ADSs will be treated as the owners of the underlying common shares that are represented by such ADSs. Deposits or withdrawals of common shares by U.S. holders for ADSs will not be subject to United States federal income tax. However, the United States Treasury has expressed concerns that parties involved in transactions wherein depository shares are pre-released may be taking actions that are inconsistent with the claiming of foreign tax credits by the holders of ADSs. Accordingly, the analysis of the creditability of Brazilian taxes described herein could be affected by future actions that may be taken by the United States Treasury.

Taxation of Dividends. The gross amount of distributions paid to you (including amounts withheld by the Brazilian taxing authority, if any, and any payments of interest attributed to shareholders’ equity, as described above under “—Brazilian Tax Considerations”) will be treated as dividend income, to the extent paid out of our current or accumulated earnings and profits, as determined under United States federal income tax principles. Such income will be includable in your gross income as ordinary income when received by you, in the case of common shares, or when received by the Depository, in the case of ADSs. Such dividends will not be eligible for the dividends received deduction allowed to corporations under the Code. To the extent that the amount of any distribution exceeds our current and accumulated earnings and profits for a taxable year, the distribution will first be treated as a tax-free return of capital, causing a reduction in the adjusted basis of the common shares or ADSs (thereby increasing the amount of gain, or decreasing the amount of loss, to be recognized on a subsequent disposition of the common shares or ADSs), and the balance in excess of adjusted basis will be taxed as capital gain recognized on a sale or exchange.

The amount of any dividend paid in *reais* will equal the U.S. dollar value of the *reais* received calculated by reference to the exchange rate in effect on the date the dividend is received by you, in the case of common shares, or by the Depository, in the case of ADSs, regardless of whether the *reais* are converted into U.S.

dollars. If the *reais* received as a dividend are not converted into U.S. dollars on the date of receipt, you will have a basis in the *reais* equal to their U.S. dollar value on the date of receipt. Any gain or loss realized on a subsequent conversion or other disposition of the *reais* will be treated as ordinary income or loss.

Subject to certain limitations, Brazilian withholding taxes on dividends, if any, may be treated as foreign taxes eligible for credit against a U.S. holder's United States federal income tax liability. For purposes of calculating the foreign tax credit, dividends paid on the common shares will be treated as income from sources outside the United States and will generally constitute "passive income" or, in the case of certain U.S. holders, "financial services income." Special rules apply to certain individuals whose foreign source income during the taxable year consists entirely of "qualified passive income" and whose creditable foreign taxes paid or accrued during the taxable year do not exceed US\$300 (US\$600 in the case of a joint return). Further, a U.S. holder that (i) has held common shares or ADSs for less than a specific minimum period during which it is not protected from risk of loss or (ii) is obligated to make payments related to the dividends will not be allowed a foreign tax credit for foreign taxes imposed on dividends paid on common shares or ADSs. In addition, a U.S. holder that holds the shares in certain arrangements in which the U.S. holder's expected economic profits are insubstantial may not be allowed a foreign tax credit for such foreign taxes. The rules governing the foreign tax credit are complex. You should consult your tax advisor regarding the availability of the foreign tax credit under your particular circumstances.

Taxation of Capital Gains. For United States federal income tax purposes, you will recognize taxable gain or loss on any sale or exchange of a common share or ADS in an amount equal to the difference between the amount realized for the common share or ADS and your basis in the common share or ADS. Such gain or loss will be capital gain or loss. Capital gains of individuals derived with respect to capital assets held for more than one year are eligible for reduced rates of taxation. The deductibility of capital losses is subject to limitations. Any gain or loss recognized by you will generally be treated as United States source gain or loss. Consequently, a U.S. holder may not be able to use the foreign tax credit arising from Brazilian tax imposed, if any, on the disposition of a common share or ADS unless such credit can be applied (subject to applicable limitations) against tax due on other income treated as derived from foreign sources.

Information Reporting and Backup Withholding. In general, information reporting requirements will apply to dividends in respect of the common shares or ADSs or the proceeds received on the sale, exchange, or redemption of the ADSs paid within the United States (and in certain cases, outside of the United States) to you unless you are an exempt recipient (such as a corporation), and backup withholding may apply to such amounts if you fail to provide an accurate taxpayer identification number or to report interest and dividends required to be shown on your federal income tax returns. The amount of any backup withholding from a payment to you will be allowed as a credit against the your United States federal income tax liability.

Underwriting

Under the terms and subject to the conditions contained in an underwriting agreement, dated May 10, 2002, between Sabesp, the selling shareholder and the underwriters, each underwriter named below has severally agreed to purchase, and the selling shareholder has agreed to sell to them, the number of ADSs indicated below:

| <u>Name</u> | <u>Number of ADSs</u> |
|--|-----------------------|
| UBS Warburg LLC | 3,254,222 |
| Santander Central Hispano Investment Securities Inc. | 1,752,273 |
| Total | <u>5,006,495</u> |

UBS Warburg LLC is acting as managing underwriter and sole book-runner in connection with the international offering. UBS Warburg LLC and Santander Central Hispano Investment Securities Inc. are acting as joint global coordinators in connection with the international offering.

We and the selling shareholder have entered into a Brazilian underwriting agreement with Banco UBS Warburg S.A. and Banco Santander Brasil S.A. providing for the concurrent offer and sale of common shares in Brazil. The closings of the international offering and Brazilian offering are conditioned on each other.

The underwriters are offering the ADSs subject to their acceptance of the ADSs and subject to prior sale. The underwriting agreement provides that the obligations of the several underwriters to pay for and accept delivery of the ADSs offered by this prospectus are subject to certain other conditions. The underwriters are obligated to take and pay for all of the ADSs offered by this prospectus if any of the ADSs are taken. However, the underwriters are not required to take or pay for the ADSs covered by the underwriters' over-allotment option described below.

The selling shareholder has granted to the underwriters an option, exercisable for 30 days from the commencement of trading in the ADSs, to purchase up to an aggregate of 2,769,156 additional ADSs, at the initial public offering price listed on the cover page of this prospectus, less underwriting discounts and commissions. The underwriters may exercise this option solely for the purpose of covering over-allotments, if any, made in connection with the offering of the ADSs offered by this prospectus. To the extent the underwriters' over-allotment option is exercised, each underwriter will become obligated, subject to certain conditions, to purchase the same percentage of the additional ADSs as the number listed next to the underwriter's name in the preceding table bears to the total number of ADSs listed next to the names of all underwriters in the preceding table.

The underwriters initially propose to offer the ADSs directly to the public at the initial public offering price listed on the cover page of this prospectus and to certain dealers at such prices less a concession not in excess of US\$0.085 per ADS. Any underwriter may allow, and such dealers may reallow, a concession not in excess of US\$0.030 per ADS, to other underwriters or to certain dealers. After the initial offering of the ADSs, the offering price and other selling terms may from time to time be varied by the underwriters.

The underwriters do not intend sales to discretionary accounts to exceed five percent of the total number of ADSs offered by them.

The underwriting discounts and commissions per ADS are US\$0.145, or 1.29% of the public offering price. The total underwriting discounts and commissions, assuming that the underwriter's over-allotment option is exercised in full, will be US\$1,127,469. The underwriters have agreed to reimburse the selling shareholder for 15% Brazilian withholding tax on the underwriting discounts and commissions.

Underwriting

The major categories of expenses of the offering are estimated as follows: US\$27,600 for filing fees, US\$300,000 for printing costs, US\$1,125,000 for legal fees, US\$651,000 for accounting fees, US\$150,000 for listing fees on the New York Stock Exchange and US\$100,000 for miscellaneous expenses. Pursuant to the underwriting agreement, the underwriters have agreed to pay the registration fees, printing costs and a portion of our miscellaneous expenses.

The selling shareholder will not be paying any expenses of this offering. We have agreed to advance to the underwriters up to R\$3.0 million towards the expenses to be borne by them. The selling shareholder has agreed to reimburse Sabesp for any amounts advanced, and under the terms of the underwriting agreement, the underwriters have agreed to reimburse us and the selling shareholder for any such advance made.

We and the selling shareholder have agreed that, without the prior written consent of UBS Warburg LLC on behalf of the underwriters, we and the selling shareholder will not, during the period ending 180 days after the date of this prospectus sell, offer or agree to sell, grant any option to sell or otherwise dispose of, directly or indirectly, any common shares, ADSs or securities convertible into or exchangeable or exercisable for common shares or ADSs or warrants or other rights to purchase common shares or ADSs. These restrictions do not apply to:

- the common shares and ADSs to be sold in the international offering and in the concurrent Brazilian offering; and
- common shares issued in connection with Sabesp entering into any concession agreement with a municipality.

We and the selling shareholder have agreed to indemnify the underwriters against certain liabilities, including liabilities under the Securities Act or to contribute to payments which the underwriters may be required to make in respect of those liabilities.

Stabilization

In order to facilitate the offering of the ADSs the underwriters may engage in transactions that stabilize, maintain or otherwise affect the price of the ADSs. Specifically, the underwriters may sell more ADSs than the underwriters are obligated to purchase under the underwriting agreement, creating a short position for their own account. A short sale is “covered” if the short position is no greater than the number of common shares available for purchase by the underwriters under the underwriters’ over-allotment option. The underwriters can close out a covered short sale by exercising the underwriters’ over-allotment option or purchasing ADSs in the open market. In determining the source of ADSs to close out a covered short sale, the underwriters will consider, among other things, the open market price of ADSs compared to the price available under the underwriters’ over-allotment option. The underwriters may also sell ADSs in excess of the underwriters’ over-allotment option, creating a naked short position. The underwriters must close out any naked short position by purchasing ADSs in the open market. A naked short position is more likely to be created if the underwriters are concerned that there may be downward pressure on the price of the ADSs in the open market after pricing that could adversely affect investors who purchase in the international offering. In addition, to stabilize the price of the ADSs, the underwriters may bid for, and purchase, ADSs in the open market. Finally, the underwriting syndicate may reclaim any concession allowed to an underwriter or a dealer for distributing ADSs in the offering, if the syndicate repurchases previously distributed ADSs to cover syndicate short positions or to stabilize the price of the ADSs. Any of these activities may stabilize or maintain the market price of the ADSs above independent market levels or retard a decline in the market price of the ADSs. The underwriters are not required to engage in these activities, and may end any of these activities at any time.

Underwriting

The underwriters also may impose a penalty bid. This occurs when a particular underwriter repays to the underwriters a portion of the underwriting discount received by it because the underwriters have repurchased in stabilizing or short covering transactions ADSs sold by or for the account of such underwriter.

The ADSs have been approved for listing on the New York Stock Exchange under the symbol “SBS”, subject to official notice of issuance.

From time to time in the ordinary course of their respective businesses, one or more of the underwriters and their affiliates may engage in commercial or investment banking transactions with Sabesp and its affiliates.

Trading in Brazilian securities markets is not as highly regulated or supervised as it is in the United States and some other markets. Brazilian law prohibits market manipulation and insider trading, and it requires a company’s insiders (including directors, officers and major shareholders, as defined under Brazilian law) to disclose all their transactions in its securities. It also prohibits a company from trading in its own shares, subject to very limited exceptions. The enforcement of these legal provisions, and the supervision of trading markets, are not as well developed as they are in the United States.

SELLING RESTRICTIONS

General

Each of the underwriters has represented and agreed that no action has been or will be taken in any jurisdiction, except in the United States, that would permit a public offering of the ADSs, or the possession, circulation or distribution of this prospectus or any material relating to us or the ADSs, in any jurisdiction where action for that purpose is required. Each of the underwriters has agreed that it will comply with all applicable laws and regulations in each jurisdiction in which it acquires, offers, sells or delivers ADSs or has in its possession or distributes this prospectus or any other material relating to us or the ADSs.

United Kingdom

Each of the underwriters has represented and agreed that:

- it has not offered or sold and, prior to the expiry of a period of six months from the closing date, will not offer or sell any ADSs to persons in the United Kingdom except to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their business, or otherwise in circumstances which have not resulted and will not result in an offer to the public in the United Kingdom within the meaning of the Public Offers of Securities Regulations 1995 (as amended);
- it has only communicated and 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 Financial Services and Markets Act 2000 (“FSMA”)) received by it in connection with the issue or sale of any ADRs in circumstances in which Section 21(1) of the FSMA does not apply to Sabesp or the selling shareholder; and
- it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the ADRs in, from or otherwise involving the United Kingdom.

BRAZILIAN OFFERING

The selling shareholder is conducting a concurrent public offering in Brazil of 3,363,636,250 of our common shares pursuant to the Brazilian underwriting agreement. In the Brazilian offering, subject to certain limits of investment, Brazilian individual investors who, and certain Brazilian investment vehicles available to Brazilian individual investors that, in each case, wish to acquire our common shares will request the shares and will deposit the amount of their proposed investment with the Brazilian underwriters prior to the Brazilian offering. At settlement, each individual investor and investment vehicle will purchase the number of full shares covered by the amount they deposited. The Brazilian underwriters will return any amounts remaining in the accounts to the depositing investors. Any remaining shares will be allocated between sales to institutional investors in the Brazilian offering and sales of ADSs in this offering.

Retail Incentives. In order to encourage investment at the retail level in the Brazilian offering, the selling shareholder is offering incentives to Brazilian individual investors and their investment vehicles, including:

- preferential treatment of retail investors and their investment vehicles in allocating shares; and
- a discounted purchase price under certain circumstances.

Priority in the Allocation of Shares. In the event of an over-subscription for our shares in the Brazilian offering, Brazilian individual retail investors and their investment vehicles will have priority over potential Brazilian institutional investors and investors in the ADSs with respect to the allocation of the shares the selling shareholder is offering. The more shares Brazilian retail investors request, the fewer shares and ADSs will be available for this offering and for Brazilian institutional investors in the Brazilian offering. In the extreme case, if the Brazilian retail investors in the Brazilian offering request all of the shares being sold by the selling shareholder, there would be no ADSs available to be sold in this offering and no shares available to be sold to institutional investors in the Brazilian offering.

Discounted Purchase Price. Brazilian individual investors and investment vehicles who agree not to sell or transfer any common shares for six months after the settlement date, will be entitled to purchase the shares offered in the Brazilian offering at a discount of 5% from the offering price.

Brazilian Retail Offering to our Employees. Our employees may participate in the Brazilian offering. They will be considered retail investors for the purposes of the retail offering and will be subject to certain limits on investment. Our employees will be permitted to acquire shares individually or through an investment vehicle. Employees who purchase shares and agree not to sell or transfer the shares for a three-month period after the settlement date will be entitled to purchase the shares at a discount of 5% from the offering price.

Validity of Securities

The validity of the ADSs will be passed upon for us and the selling shareholder by Simpson Thacher & Bartlett, New York, New York, our U.S. counsel. Certain legal matters will be passed upon for the international underwriters by Cleary, Gottlieb, Steen & Hamilton, New York, New York. The validity of the common shares and other matters governed by Brazilian law will be passed upon for us by Mattos Filho, Veiga Filho, Marrey Jr. e Quiroga Advogados, our Brazilian counsel, and for the international underwriters by Souza, Cescon Avedissian, Barrieu e Flesch—Advogados.

Experts

The financial statements as of December 31, 2001 and 2000 and for each of the three years in the period ended December 31, 2001, included in this prospectus have been so included in reliance on the report of PricewaterhouseCoopers Auditores Independentes, independent accountants, given on the authority of said firm as experts in auditing and accounting.

Where You Can Find More Information About Us

We have filed with the U.S. Securities and Exchange Commission, or the Commission, a registration statement (including amendments and exhibits to the registration statement) on Form F-1 under the U.S. Securities Act of 1933, as amended, also known as the Securities Act. This prospectus does not contain all of the information set forth in the registration statement, parts of which are omitted in accordance with the rules and regulations of the Commission. For further information, we refer you to the registration statement.

As a result of the filing of the registration statement with the Commission, we will become subject to the periodic reporting and other informational requirements of the U.S. Securities Exchange Act of 1934, as amended, also known as the Exchange Act. Accordingly, we will be required to file reports and other information with the Commission. You may inspect and copy reports and other information to be filed by us at the public reference facilities maintained by the Commission at 450 Fifth Street, N.W., Washington D.C. 20549. You may obtain copies of these materials upon written request from the Public Reference Section of the Commission at 450 Fifth Street, N.W., Washington D.C. 20549, at prescribed rates. You may also inspect this material at the offices of the New York Stock Exchange, Inc., 20 Broad Street, New York, New York 10005. In addition to the public reference facilities maintained by the Commission and the New York Stock Exchange, you may obtain a copy of the registration statement, upon written request from the depository for the ADSs at its corporate trust office located at 101 Barclay Street, New York, New York 10286.

As a foreign private issuer, we are not subject to the same disclosure requirements as a domestic U.S. registrant under the Exchange Act. For example, we are not required to prepare and issue quarterly reports. However, we intend to furnish our shareholders with annual reports containing financial statements audited by our independent accountants and to make available to our shareholders quarterly reports containing unaudited financial data for the first three quarters of each fiscal year. We plan to file quarterly financial statements with the Commission within two months of the end of the first three quarters of our fiscal year, and we will file annual reports on Form 20-F within the time period required by the Commission, which is currently six months from the end of our fiscal year on December 31.

We will also furnish to the depository annual reports in English including audited annual financial statements and unaudited quarterly financial statements in English for each of the first three quarters of the fiscal year. We will also furnish to the depository English translations or summaries of all notices of shareholders' meetings and other reports and communications that are made generally available to holders of common shares. Upon receipt, if requested in writing by us, the depository will promptly mail copies of those notices, reports and communications to all holders of ADSs.

Service of Process and Enforcement of Judgments

We are a mixed capital company (*sociedade de economia mista*) organized under the laws of Brazil. All of our directors and officers and certain advisors named herein and the selling shareholder reside in Brazil. All of our assets and those of these other persons are located in Brazil. As a result, it may not be possible for investors to effect service of process upon us or these other persons within the United States or other jurisdictions outside Brazil or to enforce against us or these other persons judgments obtained in the United States or other jurisdictions outside Brazil.

We have been advised by our Brazilian counsel, Mattos Filho, Veiga Filho, Marrey Jr. e Quiroga Advogados, that subject to specific requirements described below, judgments of U.S. courts for civil liabilities based upon the U.S. federal securities laws may be enforced in Brazil. A judgment against us, the selling shareholder or the persons described above obtained outside Brazil would be enforceable in Brazil, without reconsideration of the merits, upon confirmation of that judgment by the Brazilian Federal Supreme Court. That confirmation 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 law;
- is not subject to appeal;
- is for payment of 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.

We and the selling shareholder have also been advised by our Brazilian counsel that:

- original actions based on the U.S. federal securities laws may be brought in Brazilian courts and that, subject to Brazilian public policy and national sovereignty, Brazilian courts may enforce liabilities in such actions against Sabesp, its directors, certain of its officers, the advisors named herein and the selling shareholder;
- the ability of a judgment creditor of us or the other persons named above to satisfy a judgment by attaching our assets or those of any of the selling shareholder is limited by provisions of Brazilian law. For example, under Brazilian law, none of our assets which are essential to our ability to render public services are subject to seizure or attachment and the public property of the selling shareholder is not subject to execution or attachment, either prior or after judgment; and
- the execution of a judgment against the selling shareholder may be delayed as payment of such judgment must be made pursuant to the State's budget in a subsequent fiscal year. In addition, none of the public property of the selling shareholder is subject to execution or attachment, either prior or after judgment.

A plaintiff, whether Brazilian or non-Brazilian, who resides outside Brazil during the course of litigation in Brazil must provide a bond to guarantee court costs and legal fees if the plaintiff owns no real property in Brazil. The bond must have a value sufficient to satisfy the payment of court fees and defendant's attorney fees, as determined by a Brazilian judge. This requirement does not apply to the enforcement of foreign judgments which have been duly confirmed by the Brazilian Federal Supreme Court.

Our Brazilian legal counsel, Mattos Filho, Veiga Filho, Marrey Jr. e Quiroga Advogados, located at Av. Paulista 1499, 20º andar, São Paulo, SP, 01311-928 Brazil, has consented to the inclusion of their name above and the statements attributed to them.

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Report of Independent Accountants

To the Board of Directors and Shareholders
Companhia de Saneamento Básico do
Estado de São Paulo—SABESP

- 1 We have audited the accompanying balance sheets of Companhia de Saneamento Básico do Estado de São Paulo—SABESP (the “Company”) as of December 31, 2001 and 2000, and the related statements of operations, of changes in shareholders’ equity and of changes in financial position for each of the three years in the period ended December 31, 2001. 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 auditing standards generally accepted in Brazil and in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
- 3 In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2001 and 2000, and the results of its operations and the changes in its financial position for each of the three years in the period ended December 31, 2001, in conformity with the Brazilian Corporation Law.
- 4 Accounting principles under the Brazilian Corporation Law vary in certain respects from accounting principles generally accepted in the United States of America. Application of accounting principles generally accepted in the United States of America would have affected results of operations for the years ended December 31, 2001, 2000 and 1999 and shareholders’ equity as of December 31, 2001 and 2000 to the extent summarized in Note 22 of the financial statements.

/s/ PRICEWATERHOUSECOOPERS
PricewaterhouseCoopers
Auditores Independentes

February 28, 2002
São Paulo, Brazil

Balance Sheet at December 31

In thousands of *reais*

| | <u>2001</u> | <u>2000</u> |
|--|-------------------|-------------------|
| Assets | | |
| Current assets | | |
| Cash and time deposits | 460,220 | 232,708 |
| Customer accounts receivable (Note 5) | | |
| Third parties | 1,399,305 | 1,352,383 |
| Receivable from State Government | 35,782 | 116,649 |
| Allowance for doubtful accounts | (623,351) | (472,653) |
| Reimbursement due from State Government for pensions paid (Note 6) . | 19,740 | 253,549 |
| Inventories | 21,887 | 32,776 |
| Recoverable taxes | 27,415 | 4,669 |
| Other | 30,083 | 4,437 |
| | <u>1,371,081</u> | <u>1,524,518</u> |
| Long-term assets | | |
| Customer accounts receivable | 11,017 | 7,668 |
| Receivable from State Government agreements (Note 13 (c)) | 649,057 | — |
| Judicial deposits | 16,097 | 18,309 |
| Tax incentives | 4,157 | 6,618 |
| Compensation for concession termination (Note 7(a)) | 148,794 | 148,794 |
| Deferred income tax and social contribution | 91,340 | 32,418 |
| | <u>920,462</u> | <u>213,807</u> |
| Permanent assets | | |
| Investments | 740 | 740 |
| Property, plant and equipment | 13,509,950 | 13,346,363 |
| Deferred charges | 115,651 | 106,717 |
| | <u>13,626,341</u> | <u>13,453,820</u> |
| | <u>15,917,884</u> | <u>15,192,145</u> |

Balance Sheet at December 31 (Continued)

In thousands of *reais*

| | <u>2001</u> | <u>2000</u> |
|--|-------------------|-------------------|
| Liabilities and shareholders' equity | | |
| Current liabilities | | |
| Accounts payable to suppliers and contractors | 81,023 | 56,442 |
| Loans and financings | 549,322 | 381,653 |
| Salaries and payroll charges | 953 | 23,168 |
| Provision for vacation, paid leave and related charges | 74,360 | 70,280 |
| Taxes and contributions | 80,189 | 76,203 |
| Provisions for contingencies | 166,240 | 90,420 |
| Interest attributed to shareholders' equity (Note 15) | 528,341 | 35,637 |
| Other | 38,131 | 55,699 |
| | <u>1,518,559</u> | <u>789,502</u> |
| Long-term liabilities | | |
| Loans and financings | 5,920,629 | 5,616,056 |
| Taxes and contributions | 124,093 | 164,992 |
| Provisions for contingencies | 76,625 | 35,498 |
| Deferred income tax and social contribution | 256,839 | 309,093 |
| Other | 24,449 | 8,531 |
| | <u>6,402,635</u> | <u>6,134,170</u> |
| Shareholders' equity | | |
| Paid-in capital | 3,403,688 | 3,403,688 |
| Capital reserves | 40,979 | 39,141 |
| Revaluation reserve | 2,953,806 | 3,083,658 |
| Appropriated reserve | 1,598,217 | 1,741,986 |
| | <u>7,996,690</u> | <u>8,268,473</u> |
| | <u>15,917,884</u> | <u>15,192,145</u> |

The accompanying notes are an integral part of these financial statements.

Statement of Operations Years Ended December 31

In thousands of *reais*

| | <u>2001</u> | <u>2000</u> | <u>1999</u> |
|--|--------------------|--------------------|--------------------|
| Sales and services rendered | 3,543,508 | 3,457,953 | 3,334,267 |
| Taxes on sales and services—COFINS and PASEP | (108,741) | (102,202) | (98,546) |
| Net operating revenue | 3,434,767 | 3,355,751 | 3,235,721 |
| Cost of services rendered (Note 19) | (1,590,435) | (1,474,068) | (1,364,162) |
| Gross profit | <u>1,844,332</u> | <u>1,881,683</u> | <u>1,871,559</u> |
| Operating expenses (Note 19) | | | |
| Selling expenses | (332,597) | (332,738) | (278,653) |
| General and administrative expenses | (203,135) | (137,349) | (153,767) |
| Financial expenses, net | (1,105,152) | (737,711) | (1,529,931) |
| | <u>(1,640,884)</u> | <u>(1,207,798)</u> | <u>(1,962,351)</u> |
| Operating profit (loss) | <u>203,448</u> | <u>673,885</u> | <u>(90,792)</u> |
| Non-operating income (expenses), net | | | |
| Loss on property, plant and equipment, net (Note 8(b)) . . . | (84,948) | (118,722) | (116,854) |
| Other | 8,028 | 36,422 | (7,626) |
| | <u>(76,920)</u> | <u>(82,300)</u> | <u>(124,480)</u> |
| Income (loss) before taxes on income | 126,528 | 591,585 | (215,272) |
| Income tax | 61,894 | (47,884) | (17,390) |
| Social contribution | 27,805 | (22,266) | (2,786) |
| Net income (loss) | <u>216,227</u> | <u>521,435</u> | <u>(235,448)</u> |
| Net income (loss) per thousand shares at balance sheet date—R\$ | <u>7.59</u> | <u>18.31</u> | <u>(8.28)</u> |

The accompanying notes are an integral part of these financial statements.

Statement of Changes in Shareholders' Equity

In thousands of *reais*

| | Capital | Capital reserves | Revaluation reserve | Appropriated reserves | | Unappropriated reserve | Total |
|--|-----------|------------------|---------------------|-----------------------|---------------------|------------------------|-----------|
| | | | | Legal reserve | Investments reserve | Retained earnings | |
| At December 31, 1998 | 3,314,930 | 30,322 | 3,456,140 | 67,791 | — | 1,555,340 | 8,424,523 |
| Capital increase—stock exchanged | | | | | | | |
| for assets | 81,971 | — | — | — | — | — | 81,971 |
| Donations (Note 15(f)) | — | 497 | — | — | — | — | 497 |
| Realization of revaluation reserve . . | — | — | (212,926) | — | — | 212,926 | — |
| Loss for the year | — | — | — | — | — | (235,448) | (235,448) |
| At December 31, 1999 | 3,396,901 | 30,819 | 3,243,214 | 67,791 | — | 1,532,818 | 8,271,543 |
| Capital increase—stock exchanged | | | | | | | |
| for assets | 6,787 | — | — | — | — | — | 6,787 |
| Donations (Note 15(f)) | — | 8,322 | — | — | — | — | 8,322 |
| Realization of revaluation reserve . . | — | — | (159,556) | — | — | 159,556 | — |
| Net income for the year | — | — | — | — | — | 521,435 | 521,435 |
| Appropriation and distribution of income | | | | | | | |
| Legal reserve | — | — | — | 26,072 | — | (26,072) | — |
| Interest attributed to shareholders' equity paid and payable | — | — | — | — | — | (539,614) | (539,614) |
| Transfer to investments reserve (Note 15(h)) | — | — | — | — | 1,648,123 | (1,648,123) | — |
| At December 31, 2000 | 3,403,688 | 39,141 | 3,083,658 | 93,863 | 1,648,123 | — | 8,268,473 |
| Donations (Note 15(f)) | — | 1,838 | — | — | — | — | 1,838 |
| Realization of revaluation reserve . . | — | — | (129,852) | — | — | 129,852 | — |
| Net income for the year | — | — | — | — | — | 216,227 | 216,227 |
| Appropriation and distribution of income | | | | | | | |
| Legal reserve | — | — | — | 10,811 | — | (10,811) | — |
| Interest attributed to shareholders' equity paid and payable | — | — | — | — | — | (489,848) | (489,848) |
| Transfer to investments reserve (Note 15(h)) | — | — | — | — | (154,580) | 154,580 | — |
| At December 31, 2001 | 3,403,688 | 40,979 | 2,953,806 | 104,674 | 1,493,543 | — | 7,996,690 |

The accompanying notes are an integral part of these financial statements.

Statement of Changes in Financial Position Years Ended December 31

In thousands of *reais*

| | 2001 | 2000 | 1999 |
|--|------------------|------------------|------------------|
| Financial resources were provided by | | | |
| Operations | | | |
| Net income (loss) for the year | 216,227 | 521,435 | (235,448) |
| Expenses (income) not affecting working capital | | | |
| Depreciation and amortization | 477,329 | 457,036 | 434,068 |
| Net book value of investments and property, plant and equipment written off | 85,513 | 120,241 | 202,790 |
| Interest and indexation charges on long-term assets and liabilities | 437,341 | 217,205 | 741,929 |
| Fiscal incentive investments—realization allowance | — | — | 11,998 |
| Deferred income tax and social contribution | | | |
| Long-term assets | (58,922) | (11,450) | (20,968) |
| Long-term liabilities | (52,254) | (46,539) | 12,001 |
| | <u>1,105,234</u> | <u>1,257,928</u> | <u>1,146,370</u> |
| Shareholders | | | |
| Capital subscription | — | 6,787 | 81,971 |
| | <u>—</u> | <u>6,787</u> | <u>81,971</u> |
| Third parties | | | |
| Long-term assets | — | 724 | — |
| Long-term loans and financings | 327,907 | 685,149 | 483,414 |
| Long-term liabilities | 57,055 | 13,776 | — |
| Donations—contributions of assets | 1,838 | 8,322 | 497 |
| | <u>386,800</u> | <u>707,971</u> | <u>483,911</u> |
| Total funds provided | <u>1,492,034</u> | <u>1,972,686</u> | <u>1,712,252</u> |
| Financial resources were used for | | | |
| Increase in long-term receivables | 647,335 | — | 133,248 |
| Permanent assets | | | |
| Investments | — | — | 230 |
| Property, plant and equipment | 719,027 | 617,713 | 725,448 |
| Deferred charges | 16,336 | 14,884 | 11,188 |
| Decrease in long-term liabilities | — | — | 7,174 |
| Transfer of long-term liabilities to current | | | |
| Loans and financings | 447,161 | 291,039 | 229,384 |
| Taxes and contributions | 54,821 | 21,988 | 103,834 |
| Interest attributed to shareholders' equity paid and payable | 489,848 | 539,614 | — |
| | <u>2,374,528</u> | <u>1,485,238</u> | <u>1,210,506</u> |
| Total funds used | <u>2,374,528</u> | <u>1,485,238</u> | <u>1,210,506</u> |
| Increase (decrease) in working capital | <u>(882,494)</u> | <u>487,448</u> | <u>501,746</u> |
| Changes in working capital | | | |
| Current assets | | | |
| At the end of the year | 1,371,081 | 1,524,518 | 1,515,607 |
| At the beginning of the year | 1,524,518 | 1,515,607 | 1,257,968 |
| | <u>(153,437)</u> | <u>8,911</u> | <u>257,639</u> |
| Current liabilities | | | |
| At the end of the year | 1,518,559 | 789,502 | 1,268,039 |
| At the beginning of the year | 789,502 | 1,268,039 | 1,512,146 |
| | <u>729,057</u> | <u>(478,537)</u> | <u>(244,107)</u> |
| Increase (decrease) in working capital | <u>(882,494)</u> | <u>487,448</u> | <u>501,746</u> |

The accompanying notes are an integral part of these financial statements.

Notes to the Financial Statements at December 31

In thousands of *reais*

1. Our Company and its Operations

Companhia de Saneamento Básico do Estado de São Paulo—SABESP (the “Company”, “Sabesp” or “we”) operates 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 governmental customers. We also supply water on a bulk basis to certain municipalities in the São Paulo Metropolitan Region in which we do not operate water systems.

The Company was formed in 1973 as a result of the merger of a number of State of São Paulo Government (“State Government”) agencies and state-owned companies involved in water supply and sewage collection and treatment operations in the State of São Paulo. The State Government is required by law to own at least two-thirds of our voting (common) shares. At December 31, 2001, the State Government holds, directly and indirectly, approximately 88.33% of our voting shares.

We do not hold a formal concession to provide water and sewage services in the City of São Paulo, which accounts for a substantial majority of our sales and services rendered, or in 43 other municipalities in the State of São Paulo. None of these other municipalities has a significant population, other than Santos. We believe that we have a vested right to provide water and sewage services based upon, among other things, our ownership of the water and sewage systems serving the City of São Paulo and these other municipalities and certain succession rights resulting from the merger which formed Sabesp.

The Company provides water and sewage services in 322 municipalities in the State of São Paulo pursuant to concessions granted by the municipalities. Substantially all of these concessions have 30-year terms, one of which expires in 2004 and the rest expire between 2005 and 2029. Each of these concessions is automatically renewable for a period equal to its initial term, unless the municipality or Sabesp exercises the right to terminate the concession at least six months prior to the expiration date of the concession.

2. Financial Statement Presentation

Our statutory financial statements, which are used as the basis for determining income taxes and dividends calculation, have been prepared in accordance with the Brazilian Corporation Law (the “Corporation Law”) (Law No. 6,404/76, as amended) and the rules and regulations of the *Comissão de Valores Mobiliários* (the Brazilian Securities Commission, or “CVM”). Financial statements prepared in accordance with the Corporation Law have not been indexed for inflation after 1995.

(a) Inflation accounting under the Corporation Law method

The Corporation Law method provided a simplified methodology for accounting for the effects of inflation through 1995. This method consists 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*”).

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

3. Summary of Significant Accounting Policies

Our accounting policies, which are based on the accrual concept, comply with the Corporation Law but differ in certain significant respects from accounting principles generally accepted in the United States of America (“U.S. GAAP”). Also, 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. See Note 22 for further discussion of the differences between the Corporation Law and U.S. GAAP and the reconciliation of shareholders’ equity and net income (loss) from the Corporation Law to U.S. GAAP.

(a) Gross revenue from sales and services

Revenues for water services are recognized when the water is consumed. Revenues from sewage services are based on water consumed. We record water supply and sewage services rendered but not billed by the balance sheet date on an estimated basis during the month in which the service is provided in order to match the costs incurred.

(b) Concentration of credit risk

Financial instruments which potentially subject Sabesp to concentrations of credit risk include cash and cash equivalents, time deposits, accounts receivable, including receivables from the State Government (both for water and sewage services rendered and for reimbursements for pensions paid) and compensation for concession terminations. We limit credit risk associated with cash and cash equivalents by placing investments, as required by law, with government financial institutions in short-term securities. The law requires that we invest cash equivalents and securities at government-owned financial institutions. With respect to accounts receivable, our credit risk is mitigated by selling to a reasonably geographically dispersed customer base, including sales to municipal authorities, and by performing ongoing credit evaluations. In 2001, 2000 and 1999, 7% of the Company’s gross sales were to the State Government.

(c) Marketing costs

Marketing costs are reported in selling expenses and include costs of advertising and other marketing activities. Advertising expenses were R\$ 21,640, R\$ 17,793 and R\$ 7,718 for the years ended December 31, 2001, 2000 and 1999, respectively. No deferred advertising assets are recognized at the balance sheet dates presented.

(d) Financial income and expenses

These comprise mainly interest, indexation charges and income accruals and exchange losses arising from financial investments, receivables under agreements and loans and financings.

(e) Employee profit sharing

We make provisions, when appropriate, for granting employees the right to a share of profits determined on a performance-based plan.

(f) Income tax and social contribution

Tax liabilities are recognized, to the extent practicable, based on the amount expected to be paid. Income tax and social contribution (a Federally mandated tax based on income) are accrued on taxable results at the applicable tax rates. Deferred taxes are calculated based on results which will be taxable or deductible in the

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

future. The deferred tax benefit of tax loss carryforwards is generally recognized to the extent that realization is believed to be probable.

Following CVM Instruction No. 273, which approved the Institute of Independent Auditors of Brazil (*Instituto dos Auditores Independentes do Brasil—IBRACON*) standard on accounting for income taxes and social contribution, we started to record deferred income taxes for Corporation Law purposes as from 1999 onwards. Since such procedure was optional through that date, except for the deferral of tax on indexing gains (Note 11(b)), no amounts had been recorded in the past. Upon adoption of this new accounting standard, a deferred tax charge of R\$ 21,658 was recognized directly in income in 1999 relating to prior period deferred taxes.

As permitted by the CVM, the Company opted not to recognize the income tax and social contribution deferred tax liability (non-cash) on the revaluation reserve of property, plant and equipment recorded up to 1991.

(g) Earnings per share

Earnings per share are calculated based on the number of shares outstanding at each balance sheet date. Earnings and dividends per share are disclosed in amounts per thousand shares, as a one thousand share lot is the minimum number of shares of the Company that can be traded on the São Paulo Stock Exchange.

(h) Cash and time deposits

Cash and cash equivalents are carried at cost plus accrued interest. Time deposits denominated in *reais* have a ready market and an original maturity of 90 days or less. These comprise mainly Bank Deposit Certificates (CDBs) and are recorded at cost plus accrued income. Foreign currency deposits are translated at balance sheet exchange rates. We are obliged by law to invest our excess cash with financial institutions controlled by the Brazilian Government.

(i) Customers accounts receivable and amounts to be billed

Our accounts receivable from our customers do not generally accrue interest or indexation charges or penalties, except for refinanced agreements (Note 5). Amounts to be billed include services provided to our customers up to the balance sheet date but not yet invoiced. Management is confident that an arrangement exists with our customers at a fixed price and collection is reasonably assured.

The allowance for doubtful accounts is recorded in an amount we consider sufficient to cover any probable losses on realization of our accounts receivable from our customers and is adjusted through charges or credits to selling expenses. For accounts receivable balances under five thousand *reais* and overdue more than 180 days, the probable losses are written-off through a direct charge to selling expenses; for these balances recovered amounts are recorded as a reduction of selling expenses.

(j) Inventories

Inventories of materials used in operations and in the maintenance of the water and sewages systems are stated at average purchase cost and are recorded in current assets. Inventories of spare parts are recorded in property, plant and equipment, and are stated at the lower of the average cost of purchase, inflation adjusted from date of purchase until 1995, and replacement or realizable values.

(k) Property, plant and equipment

Property, plant and equipment are substantially stated at amounts established by independent technical appraisals, plus price-level restatements from the date of the appraisals to 1995. Revaluation increments

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

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 or upon disposal. The price-level restatement adjustments were based on official inflation indices published by the Federal government. We believe that the distortion caused by indices which understated the independently measured inflation rate have been mitigated by recording revaluation increments.

Up to 1995, the Corporation Law did not require the capitalization of interest cost 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 1989. No interest was capitalized from 1990 to 1995; interest was again capitalized as from 1996. As from 1999 capitalized interest includes foreign exchange losses and indexation charges.

In addition, 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. Interest capitalized is depreciated 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. Following changes in the CVM requirements in 1996, under the Corporation Law method, we capitalized interest during the construction period and included the charge in property, plant and equipment. We capitalize interest incurred on borrowings to the extent that borrowings do not exceed construction-in-progress, as a reduction of interest expense. In addition, in 2001, 2000 and 1999, Sabesp capitalized indexation charges associated with the indexation charges on the *real*-denominated borrowings and the foreign exchange losses on foreign currency borrowings.

We capitalize improvements to existing property and charge maintenance and repair costs to expense as incurred. Materials allocated to specific projects are added to construction-in-progress.

As of January 1, 1998, 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. Concession assets 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 to avoid backloading the charge in later years by estimating future disbursement commitments to meet our concession obligations.

Depreciation of other assets is provided using the straight-line method based on the estimated useful lives of the underlying assets. The principal depreciation rates are detailed in Note 8.

We review long-lived assets, primarily buildings and water and sewage systems 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. We assess impairment on the basis of the projected recovery of depreciation charges through results of operations. Impairment losses recorded in the periods are detailed in Note 8. Write-down of the carrying value of assets or groups of assets is made if and when appropriate.

Contributions of property, plant and equipment by third parties (such as property owners) to allow us to supply water and sewage services are recorded in income. Occasionally, we issue stock at market prices for

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

the purchase of assets, principally from municipal authorities, at fair value, which is recorded as a capital increase. Contributions of assets from our principal shareholder (the State Government) are recorded as a capital reserve.

Construction-in-progress projects are recorded at cost and are primarily construction projects under contract with third parties. For long-term projects, we capitalize these projects once our engineering department approves that the project milestones have been achieved and we take delivery of the assets.

(l) Deferred charges

Deferred charges consist of feasibility study costs and project expenses and are shown net of accumulated amortization, which is computed on the straight-line method over a period of five years.

(m) Accounts payable

Accounts payable to suppliers are presented at their actual amounts.

(n) Loans and financings

Loans and financings are adjusted by indexation charges and foreign exchange variations and include the respective interest charge accruals. Foreign currency-denominated debt is translated to *reais* using the exchange rate at the balance sheet date. Foreign exchange rate differences are recognized as they occur in financial expenses, net.

(o) Salaries and payroll charges

The provision for vacation pay, including supplementary payments negotiated in collective bargaining agreements, paid leave of absence benefits and related social charges are accrued as earned.

(p) Pension contributions

We provide postretirement benefits to certain employees through a defined-benefit pension fund (Note 12) for which contributions are recorded on a monthly accrual basis. Additionally, we pay certain benefits to retirees on behalf of the State Government for which we are later reimbursed at cost. We do not account for the actuarial pension obligation as a liability on our balance sheet (Note (u) below). We have, however, recognized a contractual obligation for past service costs which is payable in installments (Note 12).

(q) Provisions for contingencies

Provisions for contingencies are recorded to cover losses related to labor, tax, civil, commercial and other lawsuits, when the loss is considered by us and our legal counsel to be reasonably estimable and probable.

(r) Environmental expenditures

Expenditures relating to ongoing environmental programs are charged against earnings as incurred. Ongoing programs are designed to minimize the environmental impact of our operations and to manage the environmental risks inherent to our activities. Provisions with respect to such costs are recorded at the time they are considered to be probable and reasonably estimable. Management believes that, at present, there are no significant environmental contingencies which require further provisions.

(s) Interest attributed to shareholders' equity

Brazilian corporations are permitted to deduct for tax purposes interest attributed to shareholders' equity, which is a distribution similar to a dividend. For financial reporting purposes, interest attributed to shareholders' equity is recorded as a deduction directly from unappropriated retained earnings. As from

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

1997, the withholding tax with respect to payment of interest attributed shareholders' equity is paid by us on behalf of our shareholders (Note 15(e)).

(t) Use of estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses for the periods presented. Actual results in the future could differ from those estimates.

(u) Accounting standard recently issued by the IBRACON

In December 2000, IBRACON issued an accounting standard regarding pension plan and other post-employment benefits for employees, which establishes the period, method and disclosure requirements for the recognition of costs associated with benefits granted to employees and non-employees. The standard was also approved by the CVM. The standard is effective for 2002 and requires companies to disclose the impact on their financial statements at December 31, 2001. We have the option to account for the impact at December 31, 2001 either against retained earnings or prospectively as a charge against earnings over five years. This standard will require comprehensive recording and disclosure of pension expenses and obligations on an actuarial basis instead of, as is currently required, based on the required contributions for the year.

We have elected to recognize the liability on a straight line basis through earnings over the five years ending December 31, 2006. The annual charge to earnings for each of the five years to recognize the actuarial liability on our pension plan, Plan G1, is estimated at R\$ 80,000 (Note 12(b)).

In addition, Amendment No. 20, dated December 15, 1998, to the Federal Constitution and subsequent regulations established thereunder provide that contributions made by state-owned companies to pension plans cannot exceed amounts contributed by beneficiaries under these pension plans. However, these regulations do provide for an exception to this rule when a contribution is made by the state-owned company to encourage beneficiaries to change from a defined benefit plan to a defined contribution plan. In this case, the state-owned company is permitted to assume the existing deficit on behalf of the beneficiary. As legal precedents and interpretation of these regulations are not settled, no amendments have been made to Sabesp's estimated pension obligations.

Consistent with current accounting practice under the Corporation Law, we have not recognized our actuarial obligation for pension liabilities in the financial statements. Pension expenses are recognized as they fall due.

4. Cash and Time Deposits

| | 2001 | 2000 |
|-------------------------------------|----------------|----------------|
| Cash and cash equivalents | 48,861 | 37,633 |
| Debentures in treasury | 47,432 | 3,850 |
| Time deposits | 281,746 | 118,014 |
| Foreign currency deposits | 82,181 | 73,211 |
| | <u>460,220</u> | <u>232,708</u> |

Foreign currency deposits are composed of US\$ 26,576 thousand and Sw.Fr. 14,790 thousand, which were acquired in order to repay certain loans and financings coming due. The obligation with respect to such loans and financings had not, however, been extinguished (Note 9).

Notes to the Financial Statement at December 31 (Continued)

In thousands of *reais*

5. Customer Accounts Receivable

Amounts receivable from customers (except under agreements to refinance overdue accounts receivable) do not include interest, fines or any other charges on overdue bills.

| | <u>2001</u> | <u>2000</u> |
|---|------------------|------------------|
| General customers— | | |
| Consumers | 393,850 | 413,392 |
| Special consumers | 61,028 | 55,902 |
| Agreements | 46,579 | 59,511 |
| | <u>501,457</u> | <u>528,805</u> |
| Bulk sale customers— | | |
| Municipal authorities | | |
| Guarulhos | 143,956 | 126,080 |
| Santo André | 126,325 | 103,861 |
| São Bernardo do Campo | 118,931 | 100,126 |
| Mauá | 36,453 | 28,171 |
| Diadema | 30,416 | 23,267 |
| São Caetano do Sul | 1,890 | 1,708 |
| Mogi das Cruzes | 2,612 | 1,376 |
| | <u>460,583</u> | <u>384,589</u> |
| Municipal authorities (excluding bulk sale customers) | 226,761 | 259,056 |
| Federal government | 9,582 | 6,364 |
| Amounts to be billed | 200,922 | 173,569 |
| Total third parties | <u>1,399,305</u> | <u>1,352,383</u> |
| Government-controlled entities— | | |
| State Government | 35,782 | 246,220 |
| Undistributed dividends to be paid and reimbursed | — | (129,571) |
| | <u>35,782</u> | <u>116,649</u> |
| Allowance for doubtful accounts | <u>(623,351)</u> | <u>(472,653)</u> |
| Total current receivables | <u>811,736</u> | <u>996,379</u> |
| Sundry customers, principally agreements | <u>11,017</u> | <u>7,668</u> |
| Total long-term receivables | <u>11,017</u> | <u>7,668</u> |

(a) General customers

Balances receivable from general customers comprise:

- (i) consumers—household and small and medium-sized companies;
- (ii) special consumers—large consumers, companies, industries, condominiums and special billing consumers (industrial waste, wells, etc.); and

Notes to the Financial Statement at December 31 (Continued)

In thousands of *reais*

(iii) agreements with customers relating to renegotiation of overdue accounts receivable (non-government controlled companies). Contractual indexation and interest income on renegotiated installments recognized in income were R\$ 12,506 in 2001, R\$ 28,248 in 2000 and R\$ 43,551 in 1999.

(b) State Government receivables

Undistributed dividends to be paid and reimbursed, relate to the offsetting of interest attributed to shareholders' equity due to the State Government against accounts receivable from water and sewage services provided. These dividends are withheld by Sabesp pending settlement of accounts receivable from the State Government for services provided. The presentation of the receivable net of the amount payable is consistent with the protocol of understanding signed in September 1997 (Note 13).

At December 31, 2001, as a result of the agreement signed with the State Government on December 11, 2001 (Note 13(c)), the interest attributed to shareholders' equity payable to the State was classified as a liability.

Water and sewage services provided to the State Government and amounts settled in each year, are as follows:

| | <u>2001</u> | <u>2000</u> |
|---|------------------|------------------|
| At beginning of year | 246,220 | 258,089 |
| Services provided | 242,074 | 229,770 |
| Amounts under agreements with the State Government—reclassified to non-current in 2001 (Note 13(c)) | (358,207) | — |
| Amounts under agreements with the State Government—current portion | 15,711 | — |
| Amounts received by Sabesp | <u>(110,016)</u> | <u>(241,639)</u> |
| At end of year | <u>35,782</u> | <u>246,220</u> |

On December 11, 2001, we entered into an agreement with the State Government, under which the State acknowledged and agreed to pay to Sabesp amounts it owes Sabesp in respect of, among other things, water and sewage services provided by Sabesp to governmental agencies, state-owned autonomous entities and foundations totaling R\$ 358,207. Based on such agreement, part of this amount has been reclassified as non-current receivables from the State Government (Note 13(c)).

Interest attributed to shareholders' equity payable and paid to the State Government in each year are as follows:

| | <u>2001</u> | <u>2000</u> |
|---|----------------|------------------|
| At beginning of year | (129,571) | (61,614) |
| Accruals | (417,856) | (460,735) |
| Payments by Sabesp | 120,000 | 392,778 |
| Interest attributed to shareholders' equity payable reclassified to liability in 2001 | <u>427,427</u> | — |
| At end of year | <u>—</u> | <u>(129,571)</u> |

For purposes of presentation in the statement of cash flows (Note 23), we present the payments to the State Government of interest attributed to shareholders' equity as a financing activity and amounts received from

Notes to the Financial Statement at December 31 (Continued)

In thousands of *reais*

the State Government, in settlement of accounts receivable from water and sewage services rendered, as an operating activity. This presentation reflects the movement of cash on these transactions.

(c) Bulk sale customers

Customer accounts receivable from bulk sale customers refer to treated water supplied to certain municipal authorities, which are themselves responsible for water distribution, billing and collection. Water services provided to bulk sale customers and amounts settled in each year, are as follows:

| | <u>2001</u> | <u>2000</u> |
|--|----------------|----------------|
| At beginning of year | 384,589 | 304,016 |
| Services provided | 201,043 | 184,476 |
| Settlements for: | | |
| Current year services rendered | (123,514) | (84,023) |
| Prior years services rendered | (1,535) | (19,522) |
| Other | — | (358) |
| At end of year | <u>460,583</u> | <u>384,589</u> |

A number of bulk sale customers have been contesting certain tariff increases since mid-1998 and are not paying the amounts disputed. At December 14, 2001, a preliminary court decision determined that the tariff increases disputed by the municipality of Mauá are due and must be paid by such municipality, since these increases were based on the contract signed between the parties.

The municipalities of São Bernardo do Campo and Mauá made deposits in court in 2001, totaling R\$ 23,961 and R\$ 9,677, respectively. An aggregate of R\$ 32,726 from these court deposits was released to Sabesp during 2001.

(d) Amounts to be billed

Amounts to be billed refer to water and sewage services provided but not yet billed, which are estimated from the last measurement date to month-end based on the prior month's billings. Revenue is recognized during the month in which service is provided to assure matching of costs on the accrual basis of accounting.

(e) Allowance for doubtful accounts

| | <u>2001</u> | <u>2000</u> | <u>1999</u> |
|--------------------------------|------------------|------------------|------------------|
| At beginning of year | (472,653) | (344,707) | (285,631) |
| Provisions | (178,320) | (135,652) | (125,178) |
| Recoveries | 27,622 | 7,706 | 66,102 |
| At end of year | <u>(623,351)</u> | <u>(472,653)</u> | <u>(344,707)</u> |
| Relating to— | | | |
| Bulk sale customers | (367,782) | (268,241) | (180,001) |
| Other customers | (255,569) | (204,412) | (164,706) |
| At end of year | <u>(623,351)</u> | <u>(472,653)</u> | <u>(344,707)</u> |

Notes to the Financial Statement at December 31 (Continued)

In thousands of *reais*

(f) Doubtful accounts expenses

| | <u>2001</u> | <u>2000</u> | <u>1999</u> |
|--|------------------|------------------|------------------|
| Provisions | (178,320) | (135,652) | (125,178) |
| Recoveries | 27,622 | 7,706 | 66,102 |
| Direct write-off (less than five thousand <i>reais</i>) | (107,335) | (143,256) | (151,891) |
| Amounts recovered (less than five thousand <i>reais</i>) | <u>104,253</u> | <u>80,888</u> | <u>48,077</u> |
| Doubtful accounts expense included in selling expenses (Note 19) . . | <u>(153,780)</u> | <u>(190,314)</u> | <u>(162,890)</u> |

(g) Customer accounts receivable aging

The aging of current receivables (including the State Government) is presented below:

| | <u>2001</u> | <u>2000</u> |
|--|------------------|------------------|
| Amounts currently due | 374,885 | 351,014 |
| Overdue up to 30 days | 94,174 | 93,254 |
| Overdue up to 60 days | 34,868 | 40,659 |
| Overdue up to 90 days | 24,142 | 30,329 |
| Overdue up to 120 days | 13,964 | 27,632 |
| Overdue up to 180 days | 57,297 | 67,471 |
| Overdue up to 360 days | 149,331 | 193,870 |
| Overdue for more than 360 days | <u>686,426</u> | <u>664,803</u> |
| | <u>1,435,087</u> | <u>1,469,032</u> |

Under Federal Law No. 9,430, Sabesp is not permitted to write off or record an allowance for doubtful accounts against any amounts owing to it from the State Government or entities controlled by the State Government. The accounting policy adopted by the Company, for establishing the allowance for doubtful accounts reserve is summarized as follows:

- (i) accounts receivable balances (excluding accounts receivable from the State Government) more than five thousand *reais* and less than thirty thousand *reais* overdue more than 360 days are included in the allowance for doubtful accounts;
- (ii) accounts receivable balances (excluding accounts receivable from the State Government) more than thirty thousand *reais* overdue more than 360 days, for which legal action has been taken, are included in the allowance for doubtful accounts; and
- (iii) accounts receivable balances (excluding accounts receivable from the State Government) less than five thousand *reais* overdue more than 180 days are written-off through a direct charge to selling expenses.

6. Reimbursement due from State Government for Pensions Paid

Reimbursement due from State Government for pensions paid represent supplementary pensions and leave benefits that we pay, on behalf of the State Government, to former employees of the State Government-owned companies which merged to form Sabesp. These amounts are reimbursed to us by the State Government, being the primary obligor. The resources to pay these benefits are included in the State Government annual budget approved by the State of São Paulo Legislature. During 2001 and 2000, 2,873

Notes to the Financial Statement at December 31 (Continued)

In thousands of *reais*

and 2,869 retirees respectively, received supplementary pensions. At December 31, 2001, there were 303 active employees who will be entitled to these benefits once they retire.

The reimbursement balance due from the State Government does not accrue interest charges.

| | <u>2001</u> | <u>2000</u> |
|--|---------------|----------------|
| At beginning of year | 253,549 | 184,239 |
| Disbursements | 72,752 | 69,310 |
| Amounts under agreements with the State Government—reclassified to non-current assets in 2001 (Note 13(c)) | (320,623) | — |
| Amounts under agreements with the State Government—current portion | <u>14,062</u> | <u>—</u> |
| At end of year | <u>19,740</u> | <u>253,549</u> |

On December 11, 2001, we entered into an agreement with the State Government, under which the State acknowledged and agreed to pay to Sabesp amounts it owes Sabesp in respect of, among other things, supplemental retirement and pension benefits paid by Sabesp on behalf of the State Government totaling R\$ 320,623. Based on such agreement, in 2001 part of this amount is presented as non-current receivables from the State Government (Note 13(c)).

Pursuant to a protocol of understanding and the December 11, 2001 agreement, the State may, under certain circumstances, authorize Sabesp to use dividends, including interest attributed to shareholders' equity, declared by Sabesp and otherwise payable to the State Government to offset accounts receivable in connection with the provision to the State Government, or its controlled entities, of water and sewage services.

7. Long-term Assets

(a) Compensation for concession termination

Compensation for concession terminations represents amounts receivable from the municipalities of Diadema and Mauá (Note 21(b)) as indemnification for the unilateral withdrawal by those authorities of our water and sewage service concessions in 1995.

(i) The Diadema concession

In 1996, we recorded a loss on disposal of these assets of R\$ 12,355 representing the difference between the book value of the concession assets (R\$ 75,231) and the compensation for concession termination (R\$ 62,876).

The amount receivable from the municipality of Diadema at December 31, 2001 of R\$ 62,876 was determined by an agreement signed between us and the municipality in December 1996, before a court of law, to be received over 180 months. The agreement, which stipulated a market remuneration rate on the balance due, also determined that, in the event of non-payment, the State Government would withhold transfer of the State value-added tax resources to the municipality. Following a change in its elected municipal officers, the municipality of Diadema failed to pay the first installments under the agreement in early 1997 and filed an action against us contesting the validity of the agreement. A final judicial decision is pending. The municipality of Diadema has not paid any of the installments under the agreement nor has the State Government withheld

Notes to the Financial Statement at December 31 (Continued)

In thousands of *reais*

transfers of tax revenues. No interest income has been recognized by Sabesp on the unpaid balance.

(ii) The Mauá concession

The amount receivable from the municipality of Mauá at December 31, 2001 of R\$10,617 relates to the compensation for the fair value of assets expropriated by the municipality of Mauá in 1995, based on the latest appraisal report. We filed a legal action in 1996 to recover the value of our concession assets and loss of earnings, at which time the arbitration court appointed an appraisal expert. The appraisal expert's valuation report has yet to be filed in court and a definitive ruling issued. In 1999, when the appraisal report was first made available to us, we recorded a loss of R\$ 17,845 on disposal of these assets, which were carried at revalued cost of R\$ 103,763, net of the amount recoverable of R\$ 85,918. Prior to 1999, we were unable to estimate the probable loss expected to be realized from the concession termination and the compensation amount (Note 21(b)).

Although there can be no assurance that we will prevail in realizing the above-mentioned amounts, our management, on advice of our outside legal counsel, believes that we are entitled to these amounts and that non-recovery is considered not to be probable. The Company expects to receive a new decision from the court by 2003, for which amounts are not expected to be materially different from the valuation report.

(b) Judicial deposits

Judicial deposits represent escrow deposits made under court instructions relating to labor, tax and civil lawsuits to which we are a party. These deposits, although restricted pending the final court decision with respect to the corresponding lawsuit, are our assets held by the court until such time as a final court ruling is issued. Full provisions have been established to cover the probable loss of these deposits.

(c) Tax incentives

Tax incentives comprise investments made under tax incentives programs, primarily the Amazon Investment Fund (FINAM) and to the Northeast Region Investment Fund (FINOR) in lieu of payment of income tax. Amounts are recorded net of provisions for probable losses.

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

8. Property, Plant and Equipment

| | 2001 | | | 2000 | |
|---|-----------------------------|-------------------|--------------------------|-------------------|-------------------|
| | Annual depreciation rates-% | Revalued cost | Accumulated depreciation | Net | Net |
| Water systems | | | | | |
| Land | | 916,088 | — | 916,088 | 913,424 |
| Buildings | 4 | 2,452,852 | (884,485) | 1,568,367 | 1,631,878 |
| Ducts | 5 | 702,271 | (209,350) | 492,921 | 503,257 |
| Water meters | 10 | 221,987 | (93,004) | 128,983 | 119,020 |
| Networks | 2 | 2,800,745 | (618,406) | 2,182,339 | 2,216,305 |
| Equipment | 10 | 126,029 | (77,402) | 48,627 | 38,798 |
| Other | 2 to 20 | 338,977 | (136,740) | 202,237 | 215,030 |
| | | <u>7,558,949</u> | <u>(2,019,387)</u> | <u>5,539,562</u> | <u>5,637,712</u> |
| Sewage systems | | | | | |
| Land | | 339,494 | — | 339,494 | 303,944 |
| Buildings | 4 | 1,163,321 | (283,980) | 879,341 | 922,563 |
| Ducts | 5 | 717,216 | (203,793) | 513,423 | 511,493 |
| Networks | 2 | 3,705,535 | (683,041) | 3,022,494 | 3,077,939 |
| Equipment | 10 | 350,946 | (149,749) | 201,197 | 212,685 |
| Other | 2 to 20 | 19,360 | (6,838) | 12,522 | 39,114 |
| | | <u>6,295,872</u> | <u>(1,327,401)</u> | <u>4,968,471</u> | <u>5,067,738</u> |
| Concession assets acquired | 3.3 | <u>300,402</u> | <u>(21,803)</u> | <u>278,599</u> | <u>280,106</u> |
| Common use (water and sewage) assets | | | | | |
| Land | | 102,527 | — | 102,527 | 102,699 |
| Buildings | 4 | 110,647 | (45,593) | 65,054 | 68,500 |
| Transportation equipment | 20 | 123,612 | (96,406) | 27,206 | 19,661 |
| Furniture, fixtures and equipment | 10 | 199,426 | (105,581) | 93,845 | 69,024 |
| | | <u>536,212</u> | <u>(247,580)</u> | <u>288,632</u> | <u>259,884</u> |
| Total in use | | <u>14,691,435</u> | <u>(3,616,171)</u> | <u>11,075,264</u> | <u>11,245,440</u> |
| Non-operational assets | | | | | |
| Other | | 33,335 | (2,471) | 30,864 | 30,985 |
| | | <u>33,335</u> | <u>(2,471)</u> | <u>30,864</u> | <u>30,985</u> |
| Construction-in-progress | | | | | |
| Water systems | | 861,173 | — | 861,173 | 790,908 |
| Sewage systems | | 1,521,035 | — | 1,521,035 | 1,260,006 |
| Other | | 21,614 | — | 21,614 | 19,024 |
| | | <u>2,403,822</u> | <u>—</u> | <u>2,403,822</u> | <u>2,069,938</u> |
| Total | | <u>17,128,592</u> | <u>(3,618,642)</u> | <u>13,509,950</u> | <u>13,346,363</u> |

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

(a) Revaluation

All property, plant and equipment in use was revalued to market values in 1990 and in 1991 and has been further price-level adjusted for the effects of inflation through 1995. Assets are depreciated at rates which take into consideration the new estimated remaining economic useful lives of the assets as determined in the respective valuation reports over periods which, generally, do not exceed the original depreciable lives.

(b) Loss on property, plant and equipment, net

In 2001, we recorded losses on disposals and write-offs of property, plant and equipment of R\$ 84,948, comprising (i) R\$ 74,453 relating to losses on disposals and obsolescence write-offs and (ii) R\$ 10,495 relating to construction-in-progress projects which were deemed in the year not to be economically feasible.

In 2000, we recorded losses on disposals and write-offs of property, plant and equipment of R\$ 118,722, comprising (i) R\$ 83,588 relating to losses on disposals and obsolescence write-offs and (ii) R\$ 35,134 relating to construction-in-progress projects which were deemed in the year not to be economically feasible.

Studies supporting the write-offs for obsolescence and construction-in-progress were concluded by our engineering department in the accounting period of the write-off 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 adjust the net book value to assure future projected operating revenues are sufficient to recover the carrying value of the assets. When possible, depreciation rates are adjusted to take account of changes in estimated prospective depreciable lives as assets are replaced.

(c) Capitalization of interest and financial charges

We capitalized financial charges of R\$ 18,885 in 2001, R\$ 23,743 in 2000 and R\$ 73,829 in 1999 in property, plant and equipment during the period in which the assets were under construction.

(d) Concessions acquired

Beginning in 1998, we purchased the right to operate in a number of municipalities; in all cases the concession lives are 30 years as from the date we assumed the rights. The concession rights are usually purchased with corresponding rights to operate concession assets for which we do not have title. The principal purchases, which are made at fair values as determined by appraisal reports on the basis of projected cash flows, and the remaining concession periods at the date of acquisition, are as follows:

| <u>Municipality</u> | <u>2001</u> | <u>2000</u> |
|------------------------------------|-----------------|-----------------|
| Osasco (Note 21(a)) | 242,019 | 234,120 |
| Paraguaçu Paulista | 13,802 | 13,792 |
| Várzea Paulista | 11,044 | 10,972 |
| Campo Limpo Paulista | 10,697 | 10,634 |
| Agudos | 5,785 | 5,786 |
| Itararé | 5,018 | 4,914 |
| Miguelópolis | 3,849 | 3,845 |
| Estância de Serra Negra | 3,646 | 3,566 |
| Conchas | 2,111 | 2,111 |
| Duartina | 933 | 915 |
| Santa Maria da Serra | 820 | 820 |
| Marabá Paulista | 327 | 324 |
| Sandovalina | 184 | 169 |
| Paulistânia | 107 | — |
| Bom Sucesso do Itararé | 60 | — |
| | <u>300,402</u> | <u>291,968</u> |
| Accumulated depreciation | <u>(21,803)</u> | <u>(11,862)</u> |
| | <u>278,599</u> | <u>280,106</u> |

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

(e) **Construction-in-progress**

Construction-in-progress at December 31, 2001 and 2000 relates primarily to upgrades and operational improvements in:

| | <u>2001</u> | <u>2000</u> |
|--|-------------------------|-------------------------|
| Water systems | | |
| Network | 243,488 | 187,215 |
| Water production and reserves | 152,620 | 141,884 |
| Ducts | 142,931 | 134,318 |
| Sub-ducts | 144,945 | 138,876 |
| Water treatment processes | 138,669 | 166,629 |
| Other water systems | 38,520 | 21,986 |
| Total water system | <u>861,173</u> | <u>790,908</u> |
| Sewage systems | | |
| Waste collection | 1,139,705 | 943,977 |
| Sewage treatment processes | 286,546 | 257,741 |
| Other sewage systems | 94,784 | 58,288 |
| Total sewage system | <u>1,521,035</u> | <u>1,260,006</u> |
| Other | <u>21,614</u> | <u>19,024</u> |
| Total construction-in-progress | <u><u>2,403,822</u></u> | <u><u>2,069,938</u></u> |

(f) **Non-operational assets**

At December 31, 2001 and 2000, we had R\$ 30,864 and R\$ 30,985, respectively of other non-operational assets, net of depreciation, comprising primarily land surrounding reservoirs.

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

9. Loans and Financings

| Financial institution | 2001 | | 2000 | | Annual interest |
|--|----------------|------------------|----------------|------------------|---------------------------------------|
| | Current | Long-term | Current | Long-term | |
| In reais—denominated | | | | | |
| Federal Government | 122,864 | 2,410,937 | 110,360 | 2,477,192 | UPR + 8.5% |
| Debentures | — | 713,094 | — | 413,094 | 1.2% to 1.5% over CDI rate |
| Caixa Econômica Federal | 24,948 | 495,256 | 16,373 | 499,210 | UPR + 5.0% to 9.5% |
| Others, including interest and charges | 23,792 | 25,630 | 22,120 | 21,930 | UPR + 12.0%, CDI rate, TJLP + 6.0% |
| | <u>171,604</u> | <u>3,644,917</u> | <u>148,853</u> | <u>3,411,426</u> | |
| In foreign currency | | | | | |
| Long-term Notes— | | | | | |
| 2001—US\$475,000 thousand | | | | | |
| 2000—US\$475,000 thousand . . | — | 1,102,190 | — | 928,815 | 10% to 12% |
| Inter-American Development Bank— | | | | | |
| 2001—US\$424,041 thousand | | | | | Variation in the basket of currencies |
| 2000—US\$468,580 thousand . . | 76,677 | 907,267 | 68,167 | 848,095 | + US\$+ 3.0% to 7.7% |
| International Bank for Reconstruction and Development (“World Bank”) | | | | | |
| 2001—US\$76,684 thousand | | | | | Variation in the basket of currencies |
| 2000—US\$113,875 thousand . . | 62,706 | 119,872 | 56,719 | 165,951 | + US\$+ 5.01% |
| Deutsche Bank Luxembourg— | | | | | |
| 2001—US\$80,000 thousand | | | | | |
| 2000—US\$100,000 thousand . . | 46,408 | 139,224 | 39,108 | 156,432 | 11.125% |
| Westdeutsche Landesbank Girozentrale— | | | | | |
| 2001—US\$50,000 thousand | | | | | |
| 2000—US\$50,000 thousand . . | 116,020 | — | — | 97,770 | 9.75% |
| Société Générale— | | | | | |
| 2001—EUR 4,109 thousand— | | | | | |
| 2000—FF 30,647 thousand . . . | 1,320 | 7,159 | 1,038 | 7,567 | 5.9% |
| Interest and charges | 74,587 | — | 67,768 | — | |
| | <u>377,718</u> | <u>2,275,712</u> | <u>232,800</u> | <u>2,204,630</u> | |
| | <u>549,322</u> | <u>5,920,629</u> | <u>381,653</u> | <u>5,616,056</u> | |

Benchmark interest rates at December 31, 2001 and 2000: *Unidade Padrão de Referência*—UPR (Standard Reference Unit) is equal to the *Taxa Referencial*—TR (Government interest rate)—December: 0.2% and 0.1% per month; *Certificado de Depósitos Interbancários*—CDI (Interbank rate) 19% and 16% per annum; *Taxa de Juros a Longo Prazo*—TJLP (Long-term interest rate fixed by the Federal government on a quarterly basis): 10.00% and 9.75% per annum.

(a) Federal Government

In March 1994, we refinanced loan agreements with the Caixa Econômica Federal, for which Banco do Brasil acts as an agent, and the related loan rights were transferred to the Federal government. The loan falls due monthly with final maturity in 2014. The Federal government has liens on certain bank accounts of the Company, into which certain customers make payments for water and sewage services. These liens secure

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

amounts owed under these loan agreements. Additionally, the State Government has provided guarantees for a portion of amounts owing to the Federal government under these loan agreements.

(b) Debentures

In March 1999, we made a public placement of 413,094 non-convertible debentures, aggregating R\$ 413,094, which mature in November 2002. These debentures had an effective interest cost to the Company of 104.5% of the CDI rate. In March and September 2000, Sabesp and the holders of these debentures agreed to refinance the debentures at an interest rate equivalent to 103% to 104% of the CDI rate.

In March and September 2000, we disbursed R\$ 3,853 to repurchase 1,235 debentures and 2,608 debentures, respectively, from the debentureholders who had not elected to endorse the refinancing, which were placed in treasury.

On April 1, 2001, we made a public placement of 30,000 non-convertible debentures in an aggregate amount of R\$ 300,000, which debentures mature in December 2006. These debentures had an effective interest cost to the Company equal to the Interfinancial Deposits (“DI”) rate plus interest of 1.2% per annum. The placement of these debentures in the local market occurred through an auction held on June 8, 2001.

On September 24, 2001, we and holders of our non-convertible debentures, issued in March 1999, agreed to amend certain terms of these debentures. Under this agreement, the interest rate on the debentures was changed to the equivalent of the CDI rate plus 1.5% per annum and the maturity date was changed from November 2002 to September 2004. In September 2001, we disbursed R\$ 37,655 to redeem 37,655 debentures held by the holders who did not elect to endorse such amendments. These debentures were placed in treasury. In 2001 and 2000, we accrued quarterly interest charges on the debentures of R\$ 111,144 and R\$ 70,266, respectively.

(c) Caixa Econômica Federal

Several loan agreements were signed in 1996 through 1998 under the Federal Government Pro-Sanitation Program. Caixa Econômica Federal has liens on certain bank accounts of the Company, into which certain customers make payments for water and sewage services. These liens secure amounts owed under these loan agreements. The amortization period provided for the loan agreements varies from 120 to 180 months from the date of borrowing. As of December 31, 2001, R\$5,079 was available to be drawn down under these loan agreements.

(d) Long-term Notes

- 10% Notes Due 2005

In July 1997, we issued and sold US\$ 275 million 10% Notes due 2005.

- 12% Notes Due 2003

In June 2000, we issued and sold US\$ 200 million 12% Notes due 2003.

We are subject to covenants under agreements evidencing or governing our outstanding indebtedness, including those set forth in a loan agreement with the Inter-American Development Bank, the indentures relating to the 10% Notes Due 2005 and the 12% Notes Due 2003 and the loan agreements relating to the syndicated loans discussed in (g) below. Each of these agreements contains, among other provisions, limitations on our ability to incur debt. The indentures relating to the 10% Notes Due 2005 and the 12% Notes Due 2003 are the most stringent of these debt agreements. Both of these indentures prohibit, subject to some exceptions, the incurrence of additional debt in the event that (1) the ratio of Indebtedness to Adjusted Capitalization (as defined therein) is greater than 0.42x or (2) the Debt Service Coverage Ratio (as

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

defined therein) 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 Corporation Law method and that incorporates inflation accounting no longer commonly used in Brazil).

(e) Inter-American Development Bank

In June 1987, we signed a loan agreement with the Inter-American Development Bank for US\$ 163 million to finance improvements and expansion of the sewage systems in the São Paulo Metropolitan Region. The period of semiannual amortization started in January 1994, with final maturity in July 2007. This loan bears interest at 7.7% per annum.

In December 1992, we signed a loan agreement with the Inter-American Development Bank, for US\$ 400 million to finance the first stage of the clean-up of the Tietê River. The period of semiannual amortization started in June 1999, with final maturity in December 2017. This loan bears interest at a variable rate based on the cost of funding to the Inter-American Development Bank. At the same time, we signed a loan agreement for a further US\$ 50 million with the Inter-American Development Bank to finance the first stage of the clean-up of the Tietê River. The period of semiannual amortization started in June 1999, with final maturity in December 2016. This loan bears interest at 3.0% per annum.

In July 2000, we signed a loan agreement with the Inter-American Development Bank for US\$ 200 million to finance the second stage of the clean-up of the Tietê River. The estimated total cost of the second stage of the clean-up project is R\$ 782,000, of which 50% will be financed by the Inter-American Development Bank and the balance will be financed by the Company. As of December 31, 2001 and 2000, Sabesp had drawn down R\$ 12,680 and R\$ 238, respectively, under these loan agreements relating to clean-up costs incurred. The loan will be repaid in semiannual installments through July 2025. Interest accrues semiannually, based on the Inter-American Development Bank's cost of funding of each prior six-month period.

The Federal government provides guarantees of the loans to the Inter-American Development Bank.

(f) World Bank

In February 1990, we signed a loan agreement with the World Bank for US\$ 280 million to finance improvements in the Company's operating efficiency. The period of amortization began in September 1994 and the loan bears interest at 0.5% per annum above the World Bank's cost of funding in the prior six-month period, with final maturity in March 2004. At December 31, 2001, the amount outstanding on this loan was R\$ 135,252 (US\$ 58,288 thousand).

In March 1993, we signed a loan agreement with the State Government in which we received funds raised by the State Government from the World Bank arising from a loan obtained by the State Government in December 1992. The proceeds from this loan were designated to finance the environmental clean-up of the Guarapiranga Basin. At December 31, 2001, the amount outstanding on this loan was R\$ 47,326 (US\$ 20,396 thousand). The period of semiannual amortization started in October 1997, with final maturity due in April 2007. This loan bears interest at 0.5% per annum above the World Bank's cost of funding.

The Federal government provides guarantees of the loans to the World Bank.

Notes to the Financial Statements at December 31

In thousands of *reais*

(g) Syndicated loans

- Deutsche Bank Luxembourg

In October 2000, we entered into a U.S. dollar-denominated loan agreement for US\$ 100 million which bears interest of 11.13% per annum which will be repaid in ten semiannual installments through October 2005.

- Westdeutsche Landesbank Girozentrale

In February 2000, we entered into a U.S. dollar-denominated loan agreement for US\$ 50 million which bears annual interest of 9.75% per annum and matures in February 2002.

(h) Maturities

The long-term portion of loans and financings at December 31, 2001 fall due as follows:

| | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 onwards | Total |
|---------------------|----------------|----------------|------------------|----------------|----------------|------------------|------------------|
| <i>Real-</i> | | | | | | | |
| denominated | 164,813 | 692,144 | 294,541 | 311,391 | 229,640 | 1,952,388 | 3,644,917 |
| Foreign currency- | | | | | | | |
| denominated | 651,362 | 160,997 | 772,261 | 87,962 | 81,556 | 521,574 | 2,275,712 |
| | <u>816,175</u> | <u>853,141</u> | <u>1,066,802</u> | <u>399,353</u> | <u>311,196</u> | <u>2,473,962</u> | <u>5,920,629</u> |

(i) Short-term debt

At December 31, 2001, and 2000 there was no short-term debt outstanding, other than the current portion of long-term debt.

10. Taxes and Contributions

| | Current | | Long-term | |
|---|---------------|---------------|----------------|----------------|
| | 2001 | 2000 | 2001 | 2000 |
| Tax Recovery Program (REFIS) | 57,274 | 52,103 | 124,093 | 164,992 |
| National Institute of Social Security (INSS) | 10,121 | 9,810 | — | — |
| Social Contribution on Revenues (COFINS) and Public Service Employee Savings Program (PASEP) | 5,898 | 6,200 | — | — |
| Income tax and social contribution | — | 3,677 | — | — |
| Other | 6,896 | 4,413 | — | — |
| Total | <u>80,189</u> | <u>76,203</u> | <u>124,093</u> | <u>164,992</u> |

In 2000, taxes and contributions payable in installments were included in the alternative payment plan of the REFIS. Amounts settled under the REFIS program in 2001, totaled R\$ 96,648 (including financial charges of R\$ 39,236). In 2000, this amount totaled R\$ 41,827 (including financial charges of R\$ 20,143). Taxes subject to refinancing include income taxes, social contribution, COFINS and PASEP. The tax charges

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

were recorded in income in the periods to which the charges related. Part of our land, with a book value of R\$ 249,034, secures amounts owed under the REFIS program.

11. Income Tax and Social Contribution

(a) Taxes on income

(i) Tax rates

The statutory rates applicable in each year are as follows:

| | <u>2001</u> | <u>2000</u> | <u>1999</u> |
|-------------------------------------|-------------|-------------------|-------------------|
| Federal income tax | 25% | 25% | 25% |
| Social contribution | 9% | 9% to 12% | 8% to 12% |
| Composite income tax rate | <u>34%</u> | <u>34% to 37%</u> | <u>33% to 37%</u> |

The basic social contribution rate is 8%. A provisional measure increased the rate to 12% from May 1999 to January 2000 and 9% from February 2000 to December 2002. The provisional measure, was not officially enacted into definitive law until September 2001.

(ii) Income tax reconciliation

The amount reported as income tax expense in these financial statements is reconciled to the statutory composite rates as follows:

| | <u>2001</u> | <u>2000</u> | <u>1999</u> |
|--|---------------|-----------------|-----------------|
| Income (loss) before taxes on income | 126,528 | 591,585 | (215,272) |
| Tax (expense) benefit at statutory composite rate (2001: 34%; 2000: 34%; 1999: 37%) | (43,020) | (201,139) | 79,651 |
| Adjustments to derive effective rate: | | | |
| Tax benefit on deductibility of interest attributed to shareholders' equity | 166,549 | 183,469 | — |
| Non-deductible realization of revaluation increments (revaluation not tax-effected) | (44,150) | (54,249) | (78,783) |
| Timing differences not tax-effected prior to 1999 (Note 3(f)) | — | — | (21,658) |
| Deferred social contribution on prior year disputed tax provisions (previously treated as permanent differences (*)) | 5,706 | — | — |
| Other permanent differences | 4,614 | 1,769 | 614 |
| Tax expense as reported in the statement of operations | <u>89,699</u> | <u>(70,150)</u> | <u>(20,176)</u> |

(*) Based on recent positions taken by the tax authorities relating to the deductibility of social contribution on disputed taxes (PASEP and COFINS—Note 14(a)), we recognized the related tax benefit in the results of our operations during the year ended December 31, 2001.

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

(iii) Analysis of tax balances

| | <u>2001</u> | <u>2000</u> |
|---|----------------|----------------|
| Long-term deferred tax assets | | |
| Provisions for contingencies | 73,473 | 25,314 |
| Net operating loss carryforwards | 14,275 | 5,390 |
| Other temporary differences | 3,592 | 1,714 |
| | <u>91,340</u> | <u>32,418</u> |
| Long-term deferred tax liabilities | | |
| Deferral of tax on indexing gains | 189,171 | 236,452 |
| Deferred taxes on revenues from governmental entities | 55,141 | 60,115 |
| Other temporary differences | 12,527 | 12,526 |
| | <u>256,839</u> | <u>309,093</u> |
| Net long-term deferred tax liabilities | <u>165,499</u> | <u>276,675</u> |

(b) Deferral of tax on indexing gains (inflationary profit)

This balance arises from the inflation accounting system in use prior to 1996 through which time certain adjustments for inflation were taxable or tax deductible. The deferral of the date of payment of income tax arising through that period was generally over the life of the underlying non-monetary assets but not exceeding ten years. At December 31, 2001, the balance is expected to become payable through 2005.

12. Pension and Health Benefit Plans

(a) Funded defined-benefit pension fund

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

SABESPREV was formed in August 1990, to manage our employees’ retirement and pension plans and health benefit program, which supplement benefits that the Brazilian Federal government social security system provides. SABESPREV’s assets are held independently of Sabesp although we nominate the majority of the directors to SABESPREV.

SABESPREV also provides medical and dental assistance to sponsoring employees and their dependents (approximately 59,000 and 58,800 beneficiaries, including dependents, at December 31, 2001 and 2000, respectively) through to the age of retirement. In-patient health care services are normally fully covered by SABESPREV. SABESPREV also offers medical assistance to approximately 2,000 former employees and their 3,200 dependents (all post-retirement medical assistance is funded by the beneficiaries themselves). SABESPREV primarily administers its medical and dental assistance through independent health providers.

Our monthly contributions to the benefits and pension plans correspond at a minimum to the difference between the total cost determined by an independent actuary and the percentage of contribution of the participating employees and transfers from SABESPREV’s investment program. The contributions have been: (i) Sabesp’s contributions: 2.10% of the payroll; (ii) employee contributions: 2.10% in 2001 and 2000 of average base salaries, which on an individual basis vary between 1% to 8.5% of salaries; and

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

(iii) transfers from the investment program: 1.49% in 2000 of the payroll. There were no transfers from the investment program in 2001.

In addition, we assumed an obligation for pensions for service prior to the formation of SABESPREV, payable monthly through 2011. The prior service liability at December 31, 2001 of R\$ 9,237 (2000- R\$ 9,462) is recorded on the balance sheet.

The health care benefit program is also funded by our contributions and participating employee contributions. These contributions during the year were as follows: (i) Sabesp's contributions: 6.21% in 2001 and 2000, based on the average payroll; and (ii) participating employees' contributions: 3.21% in 2001 and 2000, plus adjustments, based on the average payroll.

(b) Actuarial obligation

In December 2000, IBRACON issued an accounting pronouncement regarding the recording of pension plan and other post-employment benefits for employees, which establishes the period, method and disclosure requirements for the recognition of costs associated with benefits granted to employees and non-employees.

We have elected to recognize the liability on a straight line basis through income over the five years ending December 31, 2006. The annual charge to income for each of the five years to recognize the actuarial liability for Plan G1 is estimated at R\$ 80,000.

Based on an independent actuarial report as at December 31, 2001, the actuarial obligation totals R\$ 266,074, which represents the difference between the present value of pension benefit obligations and the fair value of the plan assets as detailed below:

| | |
|---|------------------|
| ● Actuarial obligation | |
| Projected value of benefit obligation | 591,998 |
| Fair value of plan assets | <u>(325,924)</u> |
| Non-accrued pension liability | <u>266,074</u> |
| ● Estimated net periodic pension cost for 2002 | |
| Service cost | 10,711 |
| Interest cost | 61,438 |
| Expected return on assets | (34,639) |
| Amortization of transition obligation | 53,214 |
| Employee contribution | <u>(11,336)</u> |
| Total net periodic cost | <u>79,388</u> |
| Weighted-average assumptions | |
| Discount rate | 10.5% |
| Expected return on plan assets | 10.5% |
| Rate of compensation increase | 4.75% |

The weighted-average assumptions used in the actuarial calculations were determined together with the State Government and are consistent with assumptions used by other State-owned companies.

Notes to the Financial Statements at December 31 (Continued)

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We are currently evaluating the possible introduction of a defined contribution plan for new employees and providing existing employees a migration option from the Plan G1 defined benefit plan.

(c) Amendment No. 20 to the Federal Constitution

Constitutional Amendment No. 20, dated December 15, 1998, and subsequent regulations, established that contributions made by state-owned companies to pension plans cannot exceed amounts contributed by beneficiaries under these same plans. However, these regulations do provide for an exception when a contribution is made by the state-owned sponsor to encourage beneficiaries to change from a defined benefit plan to a defined contribution plan. In this case, the state-owned company is permitted to assume the existing deficit on behalf of the beneficiary. As legal precedents and interpretation of these regulations are not settled, no amendments have been made to Sabesp's estimated pension obligations.

13. Related Party Transactions

| | <u>2001</u> | <u>2000</u> |
|--|-------------|-------------|
| Current assets | | |
| Cash and time deposits with financial institutions controlled by the State Government (Note 4) | 319,734 | 138,424 |
| Accounts receivable (*) | | |
| State Government receivable for water and sewage services (Note 5) | 35,782 | 116,649 |
| Reimbursement due from State Government for pensions paid (Note 6) | 19,740 | 253,549 |
| Long-term assets | | |
| Receivable from State Government agreement | 649,057 | — |
| Gross operating revenue from sales and services rendered | | |
| Sale of water and sewage services | 242,074 | 229,770 |
| Financial income | | |
| Time deposits (Note 19) | 60,309 | 53,312 |
| Financial expenses | | |
| SABESPREV loan | — | 49 |

(*) These refer to sales to State Government agencies carried out under the same terms and conditions as sales to third parties. Pursuant to a protocol of understanding consummated with the State Government in September 1997, the State Government confirmed the amounts owed to Sabesp. In addition, the State Government declared its commitment to apply its best efforts to settle amounts due through that date, and from then on, on a timely basis. At December 31, 2000, the amount of R\$ 129,571 relating to undistributed interest attributed to shareholders' equity is presented as an offset to accounts receivable from the State Government (Note 5).

The State government and the Federal government, in some cases, provide guarantees of, or security for loans and financings of Sabesp.

(a) Agreements to use certain reservoirs

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 of São Paulo. We currently

Notes to the Financial Statements at December 31 (Continued)

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do not pay any fees with respect to the use of these reservoirs. We are, however, responsible for maintaining and meeting the operating costs of these reservoirs.

The arrangement not to pay any fees to the State of São Paulo 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. We are responsible for maintaining and meeting the operating costs of these reservoirs, and the State of São Paulo does not incur such costs on our behalf. In the event these facilities had not been made available to the Company, we would have had to obtain water from more distant sources which would have been more costly.

As part of the arrangement, we agreed to fund 100% of the estimated costs of the 1992 agreement equal to R\$ 27,795 and 75% of the 1997 agreement equal to R\$ 63,420 which has already been disbursed. The Government of the State of São Paulo, through its subsidiary *Departamento de Água e Energia Elétrica do Estado de São Paulo*—DAEE, agreed to fund approximately 25% of the estimated costs of the 1997 agreement equal to R\$ 21,100. The agreement is to construct ducts, tunnels and other facilities to interconnect the Tietê River with the Biritiba and Jundiá reservoirs and other bodies of water in exchange for the Company's use of the reservoirs during a 30-year period. The amendments to the 1997 agreement increased our obligations under such agreement by R\$ 5,900, which has yet to be disbursed.

We have a right to draw water from and release emissions into the reservoirs during a 30-year period beginning in 1997. We capitalize our expenditures on the facilities constructed. The project subject to the 1992 agreement was concluded and the assets entered operations in 1994. The project subject to the 1997 agreement is still under construction and once operational will be depreciated over a 30-year period.

(b) Agreements for tariff reduction

We have entered into agreements with approximately 5,000 State-owned entities under which we provide these entities with a 25% 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% in water consumption.

(c) Agreement signed with the State Government

On December 11, 2001, we entered into an agreement with the State Government and the *Departamento de Água e Energia Elétrica do Estado de São Paulo*—DAEE (State Department of Water and Energy). Pursuant to this agreement, the State acknowledged and agreed to pay to Sabesp amounts it owes Sabesp in respect of:

- (i) water and sewage services provided by Sabesp to governmental agencies, state-owned autonomous entities and foundations up to December 1, 2001; and
- (ii) supplemental retirement and pension benefits paid by Sabesp from March 1986 to November 2001 on behalf of the State to former employees of the State Government-owned companies which merged to form Sabesp.

The agreement provides that the DAEE will transfer to Sabesp ownership of the Taiapuê, Jundiá, Biritiba, Paraitinga and Ponte Nova reservoirs, which make up the Alto Tietê System and that the fair value of these assets will reduce the amounts owed to Sabesp by the State.

A State-owned construction company, *Companhia Paulista de Obras e Serviços*, and an independent appraisal firm to be selected by Sabesp will appraise the fair value of the reservoirs. An arithmetic average of these appraisals will determine the fair value of these reservoirs. In the event there is a difference between these two appraisals of more than 10%, a third arbitrator will define the fair value.

Notes to the Financial Statements at December 31 (Continued)

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Under the terms of the agreement, for amounts due in excess of the fair value of the reservoirs, the State will make payments in 114 consecutive monthly installments, the first payment to be made upon the later of 210 days after the date of the agreement and the agreement by the parties on the fair value of the reservoirs and conclusion of the audit, by a State-appointed auditor, of amounts owed. The nominal amount the State owes will not be indexed to inflation or earn interest if there is a delay in concluding the appraisal of fair value. The installments will be indexed on a monthly basis by the IGP-M, plus an interest rate of 6% per year, starting on the date the first installment becomes due. Pursuant to a protocol of understanding and the December 11, 2001 agreement, the State may, under certain circumstances, authorize Sabesp to use dividends, including interest attributed to shareholders' equity, declared by Sabesp and otherwise payable to the State Government to offset accounts receivable in connection with the provision to the State Government, or its controlled entities, of water and sewage services.

Based on the December 11, 2001 agreement, accounts receivable and reimbursements due from the State Government balances under such negotiation are presented as follows:

| | <u>At December 31, 2001</u> |
|--|-----------------------------|
| Current assets | |
| Receivable from State Government (Note 5) | 15,711 |
| Reimbursement due from State Government for pensions paid (Note 6) | <u>14,062</u> |
| Total current assets | <u>29,773</u> |
| Non-current assets | |
| Receivable from State Government—Agreements | |
| Amounts, net of current portion reclassified from: | |
| State Government receivable for water and sewage services (Note 5) | 342,496 |
| Reimbursement due from State Government for pensions paid (Note 6) | <u>306,561</u> |
| Total non-current assets | <u>649,057</u> |

There was no impact in the results of our operations in connection with the agreement signed with the State Government in 2001.

14. Commitments and Contingencies

We are party to certain legal proceedings arising in the normal course of business including tax, labor, and other proceedings. We have provided for the amounts to cover the probable estimated losses due to adverse legal judgments. In the opinion of management, such actions, if not decided in favor of Sabesp, would not have a material adverse effect on our financial condition.

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

Contingency provisions were as follows:

| | 2001 | 2000 |
|---|----------------|----------------|
| Disputed taxes | | |
| COFINS and PASEP | 111,035 | 63,420 |
| FINSOCIAL | 51,753 | 7,882 |
| Other | 4,874 | — |
| Labor claims | 15,267 | 26,783 |
| Claims from contractors | 53,418 | 27,000 |
| Environmental, civil and clients claims | 6,518 | 833 |
| Total | <u>242,865</u> | <u>125,918</u> |
| Current | <u>166,240</u> | <u>90,420</u> |
| Long-term | <u>76,625</u> | <u>35,498</u> |

(a) Disputed taxes

We filed a lawsuit challenging a law enacted in 1998 which expanded the definition of income subject to the PASEP taxes, as well as increasing the COFINS rate. Although we obtained a preliminary injunction providing protection against fines as we prosecute the claim without paying over the tax, we have recognized the legally enacted nature of the obligation by making a provision of R\$ 111,035 and R\$ 63,420 at December 31, 2001 and 2000, respectively.

The PASEP provision was first booked in 1998 and is being increased as our contested tax obligation accrues. Although we are contesting our obligation to pay this revenue-based tax, we have fully provided for this liability.

We filed a lawsuit in 1991 challenging the increase in the FINSOCIAL rate (a tax on sales revenue). The timing of these increases was successfully challenged in the lower courts by a number of Brazilian companies and a Federal Supreme Court ruling decreeing the unconstitutionality of the rate increases. Subsequent legislation allowed taxpayers to offset the overpaid tax against other taxes due to the same taxing authority.

In 1992, in the case of commercial/industrial companies, the Supreme Court held that the rate increase was unconstitutional and Sabesp reversed the excess provision to income. However, in 1997, the Federal Supreme Court complemented its earlier decision and ruled that the FINSOCIAL tax rate increases were applicable to service companies. Sabesp challenged this ruling in the courts between 1998 and 2000 and filed a number of appeals without success. Although a final petition is still pending consideration, legal counsel concluded in 2001, that our claim was unlikely to prevail and payment of the tax would be probable. Accordingly during 2001, we revised the existing provision regarding FINSOCIAL taxes, charging general and administrative expenses (principal amount) and financial expenses (interest and other charges amounts) totaling R\$ 43,871 and increasing the provision to R\$ 51,753.

(b) Labor claims

In October 1989, the São Paulo Water, Sewage and Environment Service Workers Union—SINTAEMA filed a class action lawsuit, on behalf of Sabesp's employees, alleging that we had violated Brazilian labor laws and collective bargaining contracts when we ceased making certain payments to employees in 1989. Those payments related to previously mandated inflation adjustments to such employees' wages and salaries, which, due to a change in applicable law, we had discontinued. In November 1995, SINTAEMA obtained a

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

favorable ruling, although the damages were not specified. We unsuccessfully appealed the decision in April 1997 and again appealed to the *Tribunal Superior do Trabalho*—TST (Superior Labor Court). In 2000, based on the advice of our legal counsel and after a definitive judicial ruling from the Superior Labor Court, we reversed to general and administrative expenses the amount previously accrued totaling R\$ 47,798.

Based on advice from our legal counsel and human resource department and analyses carried out by our outside legal counsel, we recorded a provision which management considers sufficient to cover probable unfavorable outcomes arising from other labor lawsuits. In the years ended December 31, 2001 and 2000, we recorded on the balance sheet a provision of R\$ 15,267 and R\$ 26,783 respectively relating to these other labor lawsuits.

(c) Claims from construction service contractors

Certain construction service contractors are judicially challenging the inflation indexation basis for installments paid by us regarding services provided by these contractors. Following an unfavorable court decision in November 2000, we recorded a provision of R\$ 27,000 in the year ended December 31, 2000. Based on advice from our legal counsel, we increased the provision to R\$ 53,418 in 2001, to meet probable losses arising from unfavorable decisions in this respect. The amounts accrued in 2000 were settled in December 2001.

(d) Other proceedings

Sabesp is party to a substantial number of other legal proceedings in the normal course of its business involving possible risk of loss, in addition to the lawsuits and administrative proceedings discussed above.

Management does not believe that such legal proceedings will, individually or in the aggregate, have a material adverse effect on our business, results of operations or financial condition, and therefore, no provisions have been recorded based on management’s assessment of the probability of loss.

These unprovided possible losses, at December 31, are as follows:

| | <u>2001</u> | <u>2000</u> |
|---|---------------|---------------|
| Tax related issues | — | 38,000 |
| Claims from contractors | 54,000 | 43,000 |
| Other proceedings (substantially labor related) | <u>7,000</u> | <u>17,000</u> |
| Total | <u>61,000</u> | <u>98,000</u> |

(e) Commitments

Commitments for construction under contract at December 31, 2001 are estimated at R\$ 731,000.

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

(f) **Operating lease**

The operating lease of administrative and operating facilities and equipment requires the following operating lease minimum payments:

| | December 31, 2001 |
|-------------------------------|----------------------|
| 2002 | 10,465 |
| 2003 | 6,522 |
| 2004 | 1,829 |
| 2005 and thereafter | 142 |
| | <u>18,958</u> |

The rental expenses for the years ended December 31, 2001, 2000 and 1999 were R\$ 14,449, R\$ 20,325 and R\$ 19,218, respectively.

15. Shareholders' Equity

(a) **Authorized capital**

We are authorized to increase our share capital up to a maximum of R\$ 4,100,000, corresponding to 40,000,000,000 shares with no par value.

Since January 1, 1998, we have 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**

At December 31, our capital comprised of voting common shares, without par value, was held, of record, as follows:

| Shareholders | 2001 | | 2000 | |
|---|-----------------------|---------------|-----------------------|---------------|
| | Number of shares | % | Number of shares | % |
| São Paulo State Finance Secretariat | 24,293,934,175 | 85.30 | 24,293,934,175 | 85.30 |
| Departamento de Águas e Energia Elétrica do Estado de São Paulo—DAEE | 862,999,886 | 3.03 | 862,999,886 | 3.03 |
| Shares held by custodian for trading on the São Paulo Stock Exchange | 3,280,070,786 | 11.52 | 3,281,390,752 | 11.52 |
| Others | 42,572,984 | 0.15 | 41,253,014 | 0.15 |
| | <u>28,479,577,827</u> | <u>100.00</u> | <u>28,479,577,827</u> | <u>100.00</u> |

(c) **Revaluation reserve**

As permitted by the CVM, we opted not to recognize the income tax and social contribution deferred tax liability (non-cash) on the revaluation reserve of property, plant and equipment recorded up to 1991. These unrecorded deferred tax balances would have amounted to R\$ 605,115 and R\$ 653,573 at December 31, 2001 and 2000, respectively. The revaluation reserve is charged against retained earnings in proportion to the depreciation and disposal of the respective assets.

Notes to the Financial Statements at December 31

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(d) Distributable earnings

We are required by the Corporation Law to propose dividends at year-end to meet the mandatory minimum dividend of 25% of adjusted annual net income. This requirement can be met through payments made in the form of dividends and interest attributed to shareholders' equity (net of withholding tax) to the extent amounts are available for distribution. Dividend distributions are limited to our retained earnings as determined in accordance with the Corporation Law. At December 31, 2001, as required by the CVM, we have designated the retained earnings balance to a discretionary investments reserve ((h) below).

For purposes of the Corporation Law, and in accordance with our by-laws, adjusted annual net income is an amount equal to our annual net income adjusted to reflect allocations to or from (i) the statutory legal reserve, (ii) an equity contingency reserve for anticipated losses, if any, and (iii) an unrealized revenue reserve, if any.

(e) Interest attributed to shareholders' equity

Our by-laws also provide for distribution of interest attributed to shareholders' equity as an alternative form of payment to shareholders. The interest is limited to the average TJLP (Note 9) during the applicable period and 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 is a tax-deductible expense, for both income tax and social contribution purposes. The amount paid to shareholders as interest attributed to shareholders' equity, net of any withholding tax, is taken into account in determining the mandatory dividend.

The charge is initially classified as financial expenses (for tax purposes) then reversed and treated as a deduction from shareholders' equity (Note 19). Interest attributed to shareholders' equity in 2001 totaled R\$ 489,848, including withholding income taxes in the amount of R\$ 6,648 relating to those shareholders which are subject to such taxation (State Government, municipalities and pension funds, among others, are exempt from withholding income taxes).

(f) Capital reserves

These comprise principally the tax incentive, donations and self-financed capitalized interest reserves.

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 fair value of assets received from parties under the common control of the State Government principally enabling us to provide service access to properties. No shares are issued in exchange nor other remuneration provided. These donations are recorded as a direct benefit to shareholders' equity.

(g) Legal (statutory) reserve

Under the Corporation Law, we are required to record a legal reserve to which we must allocate 5% of our 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.

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

(h) Investments reserve

The balance of retained earnings not distributed to shareholders is transferred to a discretionary reserve (investments reserve) in accordance with our capital expenditure budget.

16. Insurance Coverage

Insurance policies held by us provide the following coverage and take into account the risks and nature of the assets:

| <u>Type of insurance</u> | <u>2001 Insured amount</u> |
|--|--------------------------------|
| Engineering risk | 416,516 |
| Fire | 238,331 |
| Comprehensive general liability—construction-in-progress | 7,212 |
| Sundry risks | 3,991 |
| Comprehensive general liability—in operation | 1,500 |

17. Financial Instruments

(a) Market value of financial instruments

The market values of our main financial instruments are equal to their book values, as shown below:

| | <u>2001</u> | | <u>2000</u> | |
|--------------------------------|-------------------|---------------------|-------------------|---------------------|
| | <u>Book value</u> | <u>Market value</u> | <u>Book value</u> | <u>Market value</u> |
| Time deposits | 281,746 | 281,746 | 118,014 | 118,014 |
| Loans and financings | 6,469,951 | 6,469,951 | 5,997,709 | 5,997,709 |

Market values were determined as the present value of these financial instruments, based on market interest rates for instruments with similar risks and terms.

(b) Foreign currency

Transactions in foreign currency consist of borrowings for the improvement and expansion of the Company’s water and sewage services. We also hold certain foreign currency deposits.

We do not use derivative financial instruments to mitigate foreign currency exposure.

18. Expropriations

Development of major water and sewage systems frequently require expropriations of or the establishment of rights-of-way through third-party properties. Property owners are compensated through negotiation or by judicial arbitration, in accordance with applicable law.

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, sewage lines and facilities. Under Brazilian law, the State Government 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 Sabesp. 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

Notes to the Financial Statements at December 31 (Continued)

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of negotiated settlements, many property owners bring lawsuits against Sabesp seeking higher condemnation awards.

We estimate that we will be required to make payments with respect to certain condemnation matters. At December 31, 2001, future disbursements for pending cases are estimated at R\$ 185,000. The assets acquired are recorded in property, plant and equipment when the expropriation is complete and title has passed to us; accordingly no liability has been recorded.

We do not believe that the pending condemnation proceedings will, individually or in the aggregate, have a material adverse effect on our business, results of operations, financial condition or prospects. Disbursements for expropriations amounted to R\$ 8,597 and R\$ 5,944 in 2001 and 2000, respectively.

Notes to the Financial Statements at December 31 (Continued)

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19. Operating Costs and Expenses

| | 2001 | 2000 | 1999 |
|--|--------------------|------------------|--------------------|
| Cost of services rendered | | | |
| Salaries and payroll charges | 578,179 | 551,274 | 575,861 |
| Electric power | 196,869 | 180,194 | 130,917 |
| Third-party services | 198,938 | 172,333 | 136,131 |
| Supplies | 59,047 | 51,471 | 43,279 |
| Supplies for water treatment | 58,750 | 45,532 | 37,032 |
| General expenses | 33,997 | 29,612 | 25,963 |
| Depreciation and amortization | 464,655 | 443,652 | 414,979 |
| | <u>1,590,435</u> | <u>1,474,068</u> | <u>1,364,162</u> |
| Selling expenses | | | |
| Salaries and payroll charges | 80,751 | 68,437 | 66,087 |
| Third-party services | 68,165 | 49,593 | 29,840 |
| Supplies and other | 4,150 | 3,452 | 2,927 |
| General expenses | 24,137 | 19,842 | 16,007 |
| Depreciation | 1,614 | 1,100 | 902 |
| Allowance for doubtful accounts expense, net of recoveries . . | 153,780 | 190,314 | 162,890 |
| | <u>332,597</u> | <u>332,738</u> | <u>278,653</u> |
| General and administrative expenses | | | |
| Salaries and payroll charges | 81,812 | 31,271 | 74,145 |
| Third-party services | 58,432 | 59,698 | 37,454 |
| Tax expenses | 20,749 | 20,540 | 14,663 |
| Supplies and other | 5,030 | 4,069 | 2,141 |
| General expenses | 26,052 | 9,487 | 7,177 |
| Depreciation and amortization | 11,060 | 12,284 | 18,187 |
| | <u>203,135</u> | <u>137,349</u> | <u>153,767</u> |
| | <u>2001</u> | <u>2000</u> | <u>1999</u> |
| Financial expenses | | | |
| Interest and other charges | | | |
| Real - denominated loans and financings | (375,662) | (328,746) | (337,996) |
| Foreign currency - denominated loans and financings | (239,486) | (205,340) | (222,888) |
| Foreign exchange losses on loans and financings | (387,009) | (158,509) | (852,026) |
| Indexation charges on loans and financings | (68,192) | (60,948) | (151,012) |
| Interest attributed to shareholders' equity | (489,848) | (539,614) | — |
| Interest attributed to shareholders' equity-reversal | 489,848 | 539,614 | — |
| Indexation charges—Contractors | (72,808) | (27,000) | — |
| Other | (61,933) | (58,701) | (76,283) |
| | <u>(1,205,090)</u> | <u>(839,244)</u> | <u>(1,640,205)</u> |
| Financial income | | | |
| Financial investment income | 60,309 | 57,976 | 23,584 |
| Indexation accruals and interest | 43,369 | 47,158 | 89,913 |
| COFINS and PASEP taxes on financial income | (3,795) | (3,838) | (4,033) |
| Other | 55 | 237 | 810 |
| | <u>99,938</u> | <u>101,533</u> | <u>110,274</u> |
| Financial expenses, net | <u>(1,105,152)</u> | <u>(737,711)</u> | <u>(1,529,931)</u> |

Notes to the Financial Statements at December 31 (Continued)

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20. Employee Profit-sharing Program

At December 31, 2001, we accrued as salaries and payroll charges the amount of R\$ 15,886 (R\$ 30,254 for 2000) relating to employees profit sharing, in accordance with the labor legislation and agreements with trade unions. In June 2000, we made an advance payment to employees for 2000 profit sharing of R\$ 14,212.

The employees' profit-sharing amounts are measured in accordance with annual agreements with the trade unions. Such agreements define certain targets to be met by each department and also limits for distribution per employee based on monthly salaries. Payments are subject to the availability of our cash resources. The distribution of the executive officers' bonus is determined based on individual performance and efficiency metrics as approved by our Board of Directors.

The year-end provision is an estimate made by our management as the final determination of the amount payable is not available at the date of preparation of the financial statements. Amounts paid with respect to the program may differ from the liability accrued.

21. Concessions

(a) Municipality of Osasco

On November 12, 1999 we assumed responsibility for the basic sanitation services of the municipality of Osasco, which is located within the São Paulo Metropolitan Region. The transfer of the services from the municipality was approved by the City Council of Osasco on April 20, 1999. The amount payable by Sabesp, totaling R\$ 231,181, was based on the fair value of the water and sewage systems of Osasco, determined based on an independent appraisal, and was partially settled by offsetting R\$ 168,933 in receivables due from Osasco (including interest and indexation accruals totaling R\$ 43,603, recognized in income upon consummation of the agreement in 1999) arising from the sale of bulk water. The remaining balance of R\$ 62,248 was settled through an issuance of shares by Sabesp to the municipality of Osasco, totaling R\$ 28,218, based on fair values, and a cash payment of R\$ 34,030.

(b) Compensation for concession termination

The municipalities of Diadema and Mauá unilaterally withdrew our concessions for water and sewage services in 1995. In December 1996, we filed indemnification claims to seek compensation for investments made during the terms of the concession agreements (Note 7(a)). Even though we have not yet been compensated for these investments, we still supply water on a bulk basis to these municipalities, which currently operate their own water distribution and sewage collection systems.

Both claims are pending final court decisions (Note 7(a)). Outside legal counsel responsible for conducting the legal actions expects that we will achieve a favorable outcome.

In addition, in 1997, the municipality of Santos enacted a law expropriating our water and sewage systems in that municipality. In response, we filed an action seeking an injunction against this expropriation, which was denied by the lower court. This decision was later reversed by the Court of Appeals of the State of São Paulo, which issued a preliminary order suspending that law. A final decision on this matter has not yet been rendered by the Court of Appeals, and we cannot assure you that the final decision will be favorable to us. We continue to provide water and sewage services to Santos.

Notes to the Financial Statements at December 31 (Continued)

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22. Summary and Reconciliation of the Differences between the Corporation Law and U.S. GAAP

In common with other Brazilian companies that have registered securities with the SEC, the Company has presented its primary financial statements, for purposes of filing a registration statement with the SEC, on the basis of accounting principles established under the Corporation Law with a reconciliation to U.S. GAAP. Such presentation of primary financial statements is consistent with a position paper prepared by the U.S. AICPA International Practice Task Force, to which the SEC staff informally indicated that it would not object. Previously, primary financial statements were required to be prepared and presented in accordance with the constant currency methodology.

I Description of the GAAP differences

Our accounting policies comply with the Corporation Law, which differ significantly from U.S. 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 the Corporation Law; and the other known as the constant currency method. The primary difference between the Corporation Law and constant currency methodologies relates to accounting for the effects of inflation. Under the Corporation Law inflation accounting was discontinued effective January 1, 1996. Prior to that date, the Corporation Law required inflationary indexation of property, plant and equipment, investments, deferred charges and shareholders' equity, the net effect of which were reported in the statement of operations as a single line item. The constant currency methodology 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 U.S. 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 methodology and prohibited by the Corporation Law.

Financial statements prepared in accordance with the Corporation Law 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.

(a.i) Additional inflation restatement in 1996 and 1997 for U.S. GAAP

In the reconciliation from the Corporation Law to U.S. GAAP, consistent with the position paper prepared by the U.S. AICPA International Practice Task Force, an adjustment for inflation accounting has been included with relation to the period from January 1, 1996 to December 31, 1997. During this period, inflation accounting was prohibited by the Corporation Law but still required by APS 3 under U.S. GAAP.

Shareholders' equity under U.S. GAAP was increased by R\$ 1,520,782 and R\$ 1,589,526, respectively, at December 31, 2001 and 2000 due to the additional inflation restatement adjustments.

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

(a.ii) Supplementary inflation restatement replaces revaluation of property, plant and equipment for U.S. GAAP

The price-level restatement methodology under the Corporation Law 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 indices 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 recorded in the statutory Corporation Law accounting books but would have no effect for tax purposes. Sabesp anticipated the effects of this measure by having contracted an independent firm of experts to perform an appraisal to market value of its property, plant and equipment and had booked the revaluation increment in its statutory Corporation Law accounting books, also 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 Sabesp did not apply the incremental indexation.

Under U.S. GAAP, revaluations of assets to market value are not permitted (g(i) below) and the effects of the revaluation have been reversed in the reconciliation to U.S. GAAP. However, in order to preserve the integrity of the historical cost of its assets based on the price-level restatement convention adopted by the Corporation Law, Sabesp 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 U.S. GAAP. We have presented the balances of shareholders' equity and net income (loss) under Corporation Law accounting principles, 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 U.S. GAAP (Notes II and III below). The subtotal also includes the effects of having included an additional two years' inflation accounting adjustments through to 1997 for purposes of U.S. GAAP.

Shareholders' equity under U.S. GAAP was increased by R\$ 3,415,145 and R\$ 3,565,281, respectively, at December 31, 2001 and 2000 due to the supplementary inflation restatement adjustments and reduced by R\$ 2,953,806 and R\$ 3,083,658, respectively, at December 31, 2001 and 2000 due to the reversal of the revaluations, before tax effects.

(a.iii) Inflation indices

The indexation of the financial statements through 1995, except for the year 1990, under the Corporation Law 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 U.S. 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 ((a.i) and (a.ii) above).

(b) Income taxes

Under the Corporation Law, beginning in 1999, we accrue for deferred income taxes on substantially all temporary differences between our tax and accounting records. The deferred tax asset represents the

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

probable estimated amount to be recovered. In addition, deferred income taxes are shown gross rather than being netted.

Under U.S. GAAP, deferred taxes are accrued on all temporary tax differences. For purposes of deferred tax accounting, the U.S. GAAP adjustments relating to inflation restatement of land and the push-down expenses from the Plan G0 pension fund (h (ii) below) and sabbatical paid leave benefits are treated as permanent tax differences. Valuation allowances are established when it is not more likely than not that tax losses will 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. Deferred income tax assets and liabilities are netted rather than presented gross.

Taxes on income in Brazil consist of two types of taxes: income tax and social contribution (Note 11(a)(i)). 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 the Corporation Law, when calculating deferred income taxes, the provisional measures are usually taken into account.

Under U.S. 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. Deferred income tax adjustments on income arising from different enacted tax rates amounted to R\$ (3,078), R\$ 463 and R\$ 296 during 2001, 2000 and 1999, respectively.

No valuation allowance adjustments were required to be included in the reconciliation from the Brazilian Corporation Law to U.S. GAAP.

Shareholders’ equity under U.S. GAAP decreased by R\$ 1,440,070 and R\$ 1,526,160, respectively, at December 31, 2001 and 2000 due to deferred tax adjustments on U.S. GAAP differences other than revaluations.

(c) Financial instruments and concentration of credit risk

Under the Corporation Law, 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 U.S. GAAP, the applicable accounting practice for financial instruments depends on management’s intention for their disposition and may require 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 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 establishes accounting and reporting standards for derivative instruments and for hedging activities. It requires that an entity recognize

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

all derivatives as either assets or liabilities and measure those instruments at fair value. This statement was effective from January 1, 2001 and did not have a significant impact on our financial statements.

No adjustments have been included in the reconciliation from the Corporation Law to U.S. GAAP.

(d) Right of offset

The Corporation Law permits offsetting amounts due or payable among parties, for purposes of presenting balances in the financial statements based on management's expectation of being able to offset the amounts.

Under U.S. GAAP, the conditions to be met for offsetting amounts among parties are more restrictive as they require the parties to agree to the offset and the legal right of offset to exist.

Accordingly, the offsetting of Sabesp's liability for interest attributed to shareholders' equity payable to the State Government which is still subject to its distribution by Sabesp upon the payment to be made by the State Government of accounts receivable for services provided, in the amount of R\$ 129,571 at December 31, 2000 would not be offset under U.S. GAAP. At December 2001, no amount was offset in this respect. For purposes of U.S. GAAP certain debentures held in treasury and classified as cash equivalents were offset against the debenture obligation.

No adjustments have been included in the reconciliation from the Corporation Law to U.S. GAAP; the reclassifications were taken into consideration in the condensed U.S. GAAP balance sheet (V(c) below).

(e) Cash and cash equivalents

Under the Corporation Law, cash equivalents are not defined.

Under U.S. 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 the Corporation Law to U.S. GAAP.

(f) Investments in debt and equity securities

Under the Corporation Law, 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 the U.S. 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; and
- (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.

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

In the case of Sabesp, for purposes of U.S. GAAP, certain unrealized gains and losses from available-for-sale securities are recorded directly in shareholders' equity, net of tax effects, until realized, increasing shareholders' equity under U.S. GAAP by R\$ 18 and R\$ 63 at December 31, 2001 and 2000, respectively.

(g) Fixed assets

(g.i) Revaluations of property, plant and equipment

The Corporation Law 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 revaluation reserve in shareholders' equity and transferred to retained earnings as the related assets are depreciated or upon disposal.

For U.S. GAAP reconciliation purposes, net revaluation of property, plant and equipment in the amounts of R\$ 2,953,806 and R\$ 3,083,658 at December 31, 2001 and 2000, 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\$ 129,852, R\$ 159,556 and R\$ 212,926 for the years ended December 31, 2001, 2000 and 1999, respectively, has also been eliminated for U.S. GAAP purposes.

Under the Corporation Law, no deferred tax liability had been recorded on the revaluation increment. Under U.S. 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 expense will reverse through income in the future, and, as such, are recorded for purposes of determining the deferred tax liability.

(g.ii) Different criteria for capitalizing and depreciating capitalized interest

Under the Corporation Law, 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 the Corporation Law as applied to companies in the utilities industry, during the period from 1980 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. In addition, in 2001 and 2000, Sabesp capitalized indexation charges associated with the indexation charges on the *real*-denominated borrowings and the foreign exchange losses on foreign currency borrowings.

Under U.S. 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. The credit is a reduction of interest expense. Under U.S. GAAP, the amount of interest capitalized excludes the indexation charges associated with the borrowings and the foreign exchange gains and losses on foreign currency borrowings.

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

The effects of these different criteria for capitalizing and amortizing interest are presented below:

| | <u>2001</u> | <u>2000</u> |
|--|----------------|--------------------------------|
| Interest capitalized under U.S. GAAP in the period from 1990 to 1995 | 208,826 | 208,826 |
| Amortization thereof | (67,721) | (60,412) |
| Capitalized interest credited to income under the Corporation Law (12% per annum, applied monthly to the balance of construction-in-progress) in excess of actual interest | (32,983) | (32,983) |
| Amortization thereof | 23,148 | 21,994 |
| Indexation charges and foreign exchange losses capitalized in 2000 and 1999 under the Corporation Law, net | (38,161) | (36,176) |
| U.S. GAAP difference on shareholders' equity (Note III below) | <u>93,109</u> | <u>101,249</u> |
| U.S. GAAP difference on pre-tax income (Note II below) | <u>(8,140)</u> | <u>(9,035)</u> <u>(39,451)</u> |

(g.iii) Valuation of long-lived assets

Under the Corporation Law, 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. In the event that such operating income is insufficient, within the context of the fixed asset group, to recover the depreciation due to permanent impairment of assets, the assets, or groups of assets, are written-down to recoverable values, preferably, based on the projected discounted cash flows of future operations.

Under U.S. GAAP, SFAS No. 121, "Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to Be Disposed Of", requires companies to periodically evaluate the carrying value of long-lived assets to be held and used, when events and circumstances warrant such a review. The carrying value of long-lived assets is considered impaired when the anticipated undiscounted cash flow from such asset groups are separately identifiable and is less than their carrying value. In that event, a loss is recognized based on the amount by which the carrying value exceeds the fair market value of the assets or discounted cash flows generated by the assets.

No adjustment has been included in the reconciliation from the Corporation Law to U.S. 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. Loss on 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.

(g.iv) Deferred charges

Under the Corporation Law deferral of feasibility study costs and of 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 U.S. GAAP, such amounts do not meet the conditions established for deferral and accordingly are charged to income.

The balance of feasibility study costs outstanding, amounted to R\$ 44,841 and R\$ 41,633 at December 31, 2001 and 2000, respectively, and was written-off for U.S. GAAP purposes. The net effects on income from

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

amortization and deferrals in the statement of operations at December 31, 2001, 2000 and 1999 were R\$ (3,208), R\$ 711 and R\$ 796, respectively.

Certain other amounts included as deferred charges under the Corporation Law, primarily laying of ducts on third party property totaling R\$ 70,810 and R\$ 65,084 at December 31, 2001 and 2000, respectively, have been reclassified to property, plant and equipment for purposes of U.S. GAAP.

(h) Pension benefits

Under the Corporation Law, amounts due to the pension plan are treated on an accrual basis as the obligations fall due. As described in Note 12, an obligation for past employee contributions assumed by us in 1989 was recognized as a liability.

Under U.S. GAAP, we have adopted the provisions of SFAS No. 87, “Employers’ Accounting for Pensions” and have recognized the actuarial liability.

(h.i) Pension plan (Plan G1)

Sabesp is a sponsor to a defined-benefits plan (Plan G1) and consequently is required to disclose its annual contributions and the funded status of the plan. The funded status and the supplemental disclosures under U.S. GAAP are presented in Note VI below. The provisions of SFAS No. 87 for the purposes of calculating the funded status were applied with effect from January 1, 1992, because it was not feasible to apply them from the effective date specified in the standard. 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. Such amounts should be recorded against equity. Additional disclosure required by SFAS No. 132, “Employers’ Disclosures About Pensions and Other Post-Retirement Benefits”, about pension and other post-retirement benefit plans is provided.

Accrued pension cost adjustments under Plan G1 at December 31, 1999 included a deduction for short-term debt owed to SABESPREV (Notes 9 and 13) which was considered as a negative contribution for SFAS No. 87 calculation purposes. In addition, the Plan G1 amount accrued under the Corporation Law for prior services (Note 12) is excluded for U.S. GAAP purposes.

The changes introduced by Amendment No. 20 to the Federal Constitution (Note 3(u)) have not been treated as amendments or curtailments for SFAS No. 87 purposes.

(h.ii) Supplementary pension plan (Plan G0)

Pursuant to a law enacted by the State Government, certain employees who provided service to Sabesp between 1972 and 1974 acquired a legal right to receive supplemental pension payments (which rights are referred to as “Plan G0”); these amounts are paid by us and are claimed as a reimbursement from the State Government (Note 6).

Consistent with the guidance in SEC Staff Accounting Bulletin Topic 5-T (“SAB No. 5-T”), we recognized as an expense the costs incurred by the State Government on our behalf in respect of the provision of pension costs payments made to these employees in recognition of the services rendered to Sabesp for which such payments are the remuneration therefor.

We accounted for this actuarial liability on a push-down basis consistent with guidance in SAB No. 5-T, as an adjustment for purposes of U.S. GAAP by reducing retained earnings for the first year (1998) presented and subsequently charging to income the balance denominated “Reimbursement due from the State Government for pensions paid”, as this amount relates to a charge for past services rendered by our former employees. Amounts reimbursed to us by the State Government, our controlling shareholder, 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) was charged off as a deduction to shareholders’ equity.

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

The liability for the future Plan G0 obligations have been determined under the actuarial criteria stipulated in SFAS No. 87.

(h.iii) Sabbatical paid leave

We also pay amounts equivalent to three months of vacation for each five years' of service as a form of sabbatical paid leave to certain of our employees for which we also claim reimbursement from the State Government (Note 6). Consistent with the guidance in SAB Topic 5-T, we recorded as an expense the costs incurred by the State Government on our behalf in respect of the sabbatical leave payments made to these employees in recognition of the services rendered to Sabesp for which such payments are the remuneration therefor.

We accounted for this sabbatical expense on a push-down basis consistent with guidance in SAB No. 5-T, as an adjustment for purposes of U.S. GAAP by relieving directly against retained earnings for the first year presented and subsequently we 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 our former/current employees. Amounts reimbursed by the State Government were accounted for as additional paid-in capital.

During the year ended December 31, 2000, in the financial statements prepared in accordance with the Corporation Law, 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 we do not consider this to be an expense under the Corporation Law. During 2001, total amounts not accrued in this respect were R\$ 1,921. Such amounts, consistent with the U.S. GAAP difference mentioned above, were pushed down as expenses in the reconciliation to U.S. GAAP.

(h.iv) Summary of pension benefits adjustments

The effects included in the shareholders' equity reconciliation (Note III below) arising from these different criteria for pension and benefit accounting are presented below:

| | <u>2001</u> | <u>2000</u> |
|---|------------------|------------------|
| (h.i)—Plan G1 | | |
| Accrued pension cost (Note VI(a) below) | (479,853) | (411,427) |
| Pension cost accrued under the Corporation Law (Note 12) | 9,237 | 9,462 |
| Accrued pension cost (Plan G1) | <u>(470,616)</u> | <u>(401,965)</u> |
| (h.ii)—Plan G0 (Note VI (b) below) | | |
| Accrued pension cost (Plan G0) | <u>(868,791)</u> | <u>(791,925)</u> |
| Adjustment to recognize minimum pension liability | (9,595) | (215,349) |
| Intangible asset | 9,595 | 185,050 |
| Minimum pension liability in excess of unrecognized net transition obligation | <u>—</u> | <u>(30,299)</u> |

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

| | <u>2001</u> | <u>2000</u> |
|--|------------------|------------------|
| (h.iii)—Sabbatical paid leave | | |
| Recognition of reversed expense | <u>(25,668)</u> | <u>(23,747)</u> |
| (h.ii)/(h.iii)—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>(441,271)</u> | <u>(368,519)</u> |
| Additional paid-in capital—Plan G0 and sabbatical paid leave reimbursed by the State Government | <u>114,970</u> | <u>114,970</u> |

The effects included in the reconciliation of net income (loss) reconciliation (Note II below) arising from these different criteria for pension and benefit accounting are presented below:

| | <u>2001</u> | <u>2000</u> | <u>1999</u> |
|--|-----------------|-----------------|-----------------|
| (h.i)—Plan G1 | | | |
| Accrued pension cost (Plan G1) | <u>(68,651)</u> | <u>(63,528)</u> | <u>(74,407)</u> |
| (h.ii)—Plan G0 (Note VI (b) below) | | | |
| Accrued pension cost (Plan G0) | <u>(76,866)</u> | <u>(77,396)</u> | <u>(79,146)</u> |
| (h.iii)—Sabbatical paid leave | | | |
| Recognition of reversed expense | <u>(1,921)</u> | <u>(23,747)</u> | <u>—</u> |
| (h.ii)/(h.iii)—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>(72,752)</u> | <u>(69,310)</u> | <u>(67,040)</u> |

(i) Segment reporting

Under the Corporation Law, no separate segment reporting is required.

Under U.S. 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.

Sabesp operates in two segments: water services and sewage services (Note 24).

(j) Comprehensive income

Under U.S. GAAP, we adopted SFAS No. 130, “Reporting Comprehensive Income” (V below). A foreign (i.e., non-U.S.) registrant may present the statement of comprehensive income in any format permitted by SFAS No. 130.

(k) Provision for dividends and interest attributable to shareholders’ equity

Under the Corporation Law, 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 the Corporation Law, 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

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

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. We present the financial expense net of the reversal in our financial statements (Note 19).

Under U.S. GAAP, since proposed dividends must be ratified or modified at the annual shareholders' meeting, such dividends would not be considered as declared at the balance sheet date and, as such, would not be accrued. However, because the State Government is our controlling shareholder, the minimum dividend proposal when made by management at year end is maintained as a provision, and therefore, no adjustments have been included in the reconciliation from the Corporation Law to U.S. GAAP. Interim dividends paid or interest credited to shareholders as interest attributable to shareholders' equity under the Corporation Law would be considered as declared for U.S. GAAP purposes. Under U.S. GAAP, no similar interest distribution concept exists.

Distributions per share data (in the form of dividends or interest attributable to shareholders' equity) is not required to be disclosed under the Corporation Law.

Interest attributable to shareholders' equity per thousand common shares were as follows:

| | <u>reais</u> |
|------------|--------------|
| 2001 | 17.20 |
| 2000 | 18.97 |
| 1999 | — |

(l) Related parties

Under the Corporation Law, related parties are generally defined in a more limited manner and require fewer disclosures than U.S. GAAP. We have expanded our disclosure for purposes of the Corporation Law.

No adjustments have been included in the reconciliation from the Corporation Law to U.S. GAAP.

(m) Accounting changes

Under the Corporation Law, the cumulative effect of changes in accounting principles is generally applied as an adjustment to the current year's opening equity balance, but can also be recorded in earnings in the year of the change.

Under U.S. GAAP, the cumulative effect of changes in accounting principles is generally disclosed as an adjustment to earnings in the year of the change, along with pro forma disclosure of the effects of such change on prior years' financial statements. The effects of changes in accounting estimates are generally reflected prospectively. Under Accounting Principles Board ("APB") Opinion No. 20,—“Accounting Changes”, accounting policy changes may be applied retroactively when a company initially produces publicly available U.S. GAAP financial statements.

The deferred tax charges introduced under the Corporation Law in 1999 were incorporated as from the first year presented under U.S. GAAP (Note 3(f)).

Deferred income tax adjustments recorded in the reconciliation for the year ended December 31, 1999 were R\$ 21,658.

(n) Items posted directly to shareholders' equity accounts

Under the Corporation Law, 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

Notes to the Financial Statements at December 31 (Continued)

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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 U.S. 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 U.S. 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 U.S. GAAP (Note (g.ii) above).

(o) Discounting

Under the Corporation Law, discounting of trade receivables and payables to present value is not permitted.

Under U.S. GAAP, APB No. 21 "Interest on Receivables and Payables", such discounting, in certain cases, is required to eliminate 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.

No adjustments have been included in the reconciliation from the Corporation Law to U.S. GAAP.

(p) Classification of statement of operations line items

Under the Corporation Law, as noted above, the classification of certain income and expense items is presented differently from U.S. GAAP. We have recast our statement of operations under the Corporation Law to present a condensed statement of operations in accordance with U.S. GAAP (Note V below). 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 the Corporation Law. Such amounts have been reclassified to non-operating income and expenses in the condensed statement of operations in accordance with U.S. GAAP.
- (ii) Under the Corporation Law, gains and losses on the disposal or impairment of permanent assets are classified as non-operating income (expense). Under U.S. GAAP, gains and losses on the disposal or impairment of property, plant and equipment are classified as an adjustment to operating income.
- (iii) The net income (loss) differences between the Corporation Law and U.S. GAAP—as detailed in the reconciliation in Note II below, were incorporated in the statement of operations in accordance with U.S. GAAP.

(q) Earnings per share

Under the Corporation Law, 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 São Paulo Stock Exchange.

Under U.S. 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

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

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 2001 was 28,479,577,827, for 2000 was 28,448,607,067 and for 1999 was 28,159,720,588. Sabesp has no transactions that might cause a dilutive effect on its earnings per share.

(r) Disputed sales tax obligation (FINSOCIAL)

During 2001, Sabesp recorded a provision in respect of an anticipated adverse decision in a FINSOCIAL-related lawsuit (Note 14(a)), in which Sabesp had disputed a FINSOCIAL tax obligation.

This amount had already been accrued for purposes of U.S. GAAP as at December 31, 2000 as a contingent liability and, accordingly, resulted in a reconciling item of R\$ 38,000 between the Corporation Law and under U.S. GAAP with respect to net income for the year ended December 31, 2001, as well as between shareholders' equity presented under the Corporation Law method and under U.S. GAAP at December 31, 2000.

(s) Financial statement note disclosures

The Corporation Law requires, in general, less information to be disclosed in the notes to the financial statements than U.S. GAAP. The additional disclosures required by U.S. GAAP which are relevant to these financial statements are included in this Note 22 and Notes 23 and 24.

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

II Net income (loss) reconciliation of the differences between the Corporation Law and U.S. GAAP

| | Note 22-I | Years ended December 31 | | |
|---|-----------|-------------------------|----------------|----------------|
| | | 2001 | 2000 | 1999 |
| Net income (loss) as reported under the Corporation Law | | 216,227 | 521,435 | (235,448) |
| Depreciation of additional inflation restatement in 1996 and 1997 | (a.i) | (68,743) | (81,928) | (92,243) |
| Reversal of depreciation of revaluation increments | (g.i) | 129,852 | 159,556 | 212,926 |
| Depreciation of supplementary restatement prior to 1991 | (a.ii) | (150,136) | (184,477) | (246,181) |
| Deferred tax effects on above (excluding revaluation) | (b) | 72,230 | 87,914 | 111,680 |
| Net income (loss) as reported under the Corporation Law, adjusted for inflation restatements and revaluations | | 199,430 | 502,500 | (249,266) |
| Accrued supplementary pension cost (Plan G0) | (h.iv) | (76,866) | (77,396) | (79,146) |
| Accrued pension cost (Plan G1) | (h.iv) | (68,651) | (63,528) | (74,407) |
| Sabbatical paid leave of absence benefits . . | (h.iv) | (1,921) | (23,747) | — |
| Actuarial liability (Plan G0) and sabbatical expense push-down recognition | (h.iv) | (72,752) | (69,310) | (67,040) |
| Disputed sales tax obligation— | | | | |
| FINSOCIAL | (r) | 38,000 | — | — |
| Capitalized interest | (g.ii) | (8,140) | (9,035) | (39,451) |
| Deferred charges expensed, net of (amortization) | (g.iv) | (3,208) | 711 | 796 |
| | | 5,892 | 260,195 | (508,514) |
| Deferred income taxes effects: | | | | |
| Deferred income tax changes due to enacted tax rate difference (34%-33%) . | (b) | (3,078) | 463 | 296 |
| Deferred tax on temporary differences not recorded prior to 1999 under the Corporation Law (Note 3 (f)) | (b) | — | — | 21,658 |
| Other GAAP differences above, excluding reversal of revaluation increments | (b) | 13,859 | 23,711 | 37,310 |
| Net income (loss) under U.S. GAAP | | 16,673 | 284,369 | (449,250) |
| Earnings/(loss) per thousand common shares | | | | |
| Basic and diluted (in <i>reais</i>) | | 0.59 | 10.00 | (15.95) |
| Weighted average number of common shares outstanding | | 28,479,577,827 | 28,448,607,067 | 28,159,720,588 |

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

III Shareholders' equity reconciliation of the differences between the Corporation Law and U.S. GAAP

| | Note 22-I | 2001 | 2000 |
|--|-----------|--------------------|--------------------|
| Shareholders' equity, as reported under the Corporation Law | | 7,996,690 | 8,268,473 |
| Add (deduct) | | | |
| Additional inflation restatement in 1996 and 1997, net | (a.i) | 1,520,782 | 1,589,526 |
| Reversal of revaluation increments, net | (g.i) | (2,953,806) | (3,083,658) |
| Supplementary restatement prior to 1991, net | (a.ii) | 3,415,145 | 3,565,281 |
| Deferred tax effects on above (excluding revaluation) | | <u>(1,579,445)</u> | <u>(1,651,675)</u> |
| Shareholders' equity, as reported under the Corporation Law, adjusted for inflation restatements and revaluations | | <u>8,399,366</u> | <u>8,687,947</u> |
| Accrued supplementary pension cost (Plan G0) | (h.iv) | (868,791) | (791,925) |
| Minimum pension liability in excess of unrecognized net transition obligation (Plan G0) | (h.iv) | — | (30,299) |
| Accrued pension cost (Plan G1) | (h.iv) | (470,616) | (401,965) |
| Actuarial liability (Plan G0) and sabbatical expense push-down recognition | (h.iv) | (441,271) | (368,519) |
| Additional paid-in capital—Plan G0 and sabbatical expense reimbursed by the State Government | (h.iv) | 114,970 | 114,970 |
| Sabbatical paid leave of absence benefits | (h.iv) | (25,668) | (23,747) |
| Capitalized interest | (g.iv) | 93,109 | 101,249 |
| Deferred charges expensed, net | (g.iv) | (44,841) | (41,633) |
| Disputed sales tax obligation (FINSOCIAL) | (r) | — | (38,000) |
| Other GAAP differences | | 18 | 63 |
| Deferred income taxes effects: | | | |
| Enacted tax rate reduction | (b) | (2,319) | 759 |
| Other deferred tax effects on GAAP differences above, excluding adjustments for available-for-sale securities, inflation restatements and revaluation increments | (b) | <u>139,375</u> | <u>125,515</u> |
| Shareholders' equity under U.S. GAAP | | <u>6,893,332</u> | <u>7,334,415</u> |
| Supplementary information in U.S. GAAP | | | |
| Property, plant and equipment | | 19,640,963 | 18,996,657 |
| Accumulated depreciation | | <u>(3,984,973)</u> | <u>(3,412,812)</u> |
| Net property, plant and equipment | | <u>15,655,990</u> | <u>15,583,845</u> |
| Total assets | | <u>17,581,833</u> | <u>17,380,954</u> |

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

The deferred tax effects from the U.S. GAAP adjustments noted above would be classified mainly as a long-term liability on the balance sheet.

IV Statement of changes in shareholders' equity in accordance with U.S. GAAP

| | Years ended December 31 | | |
|---|-------------------------|------------------|------------------|
| | 2001 | 2000 | 1999 |
| At beginning of the year | 7,334,415 | 7,609,973 | 7,908,767 |
| Shares exchanged for assets | — | 6,787 | 81,971 |
| Donations (Note 15(f)) | 1,838 | 8,322 | 497 |
| Change in available-for-sale securities, net of deferred taxes . . | (45) | (5,915) | 3,380 |
| Change in minimum pension liability, in excess of unrecognized net transition obligation | 30,299 | (29,507) | (792) |
| Additional paid-in capital | — | — | 65,400 |
| Net income (loss) for the year | 16,673 | 284,369 | (449,250) |
| Interest attributed to shareholders' equity | (489,848) | (539,614) | — |
| At end of the year | <u>6,893,332</u> | <u>7,334,415</u> | <u>7,609,973</u> |

V Condensed financial information prepared in accordance with U.S. GAAP (Note I (p) above)

(a) U.S. GAAP condensed statements of operations—Year ended December 31

| | 2001 | 2000 | 1999 |
|--|-------------------|-------------------|-------------------|
| Sales and services rendered | 3,543,508 | 3,457,953 | 3,334,267 |
| Taxes on sales and services | (108,741) | (102,202) | (98,546) |
| Net operating revenue | 3,434,767 | 3,355,751 | 3,235,721 |
| Cost of services rendered | (1,820,995) | (1,687,170) | (1,544,423) |
| Gross profit | 1,613,772 | 1,668,581 | 1,691,298 |
| Operating (expenses) | | | |
| Selling | (349,910) | (349,608) | (295,897) |
| General and administrative | (214,797) | (184,057) | (198,488) |
| Other (expenses) income | (97,965) | (151,894) | (233,704) |
| Operating profit | 951,100 | 983,022 | 963,209 |
| Financial expenses, net | (1,107,137) | (740,591) | (1,563,227) |
| Income (loss) before taxes on income | (156,037) | 242,431 | (600,018) |
| Income tax and social contribution | 172,710 | 41,938 | 150,768 |
| Net income (loss) for the year | <u>16,673</u> | <u>284,369</u> | <u>(449,250)</u> |
| Net income (loss) per thousand shares | | | |
| Basic and diluted (in <i>reais</i>) | 0.59 | 10.00 | (15.95) |
| Weighted average number of common shares outstanding— thousands | <u>28,479,578</u> | <u>28,448,607</u> | <u>28,159,721</u> |

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

(b) U.S. GAAP comprehensive income (loss) (under SFAS No. 130)

| | <u>2001</u> | <u>2000</u> | <u>1999</u> |
|---|---------------|----------------|------------------|
| Net income (loss) for the year | 16,673 | 284,370 | (449,250) |
| Minimum pension liability in excess of unrecognized transition obligation | 30,299 | (29,507) | (792) |
| Gains (losses) on available-for-sale securities | (45) | (5,915) | 3,380 |
| Comprehensive net income (loss) | <u>46,927</u> | <u>248,948</u> | <u>(446,662)</u> |

(c) U.S. GAAP condensed balance sheets as at December 31

| | <u>2001</u> | <u>2000</u> |
|---|-------------------|-------------------|
| Assets | | |
| Current assets | | |
| Cash and time deposits | 412,788 | 228,858 |
| Customer accounts receivable, net | 858,891 | 1,125,950 |
| Inventories | 21,887 | 32,776 |
| Other | 30,083 | 9,106 |
| | <u>1,323,649</u> | <u>1,396,690</u> |
| Investments | 767 | 834 |
| Property, plant and equipment | 15,655,990 | 15,583,845 |
| Intangible assets | 9,594 | 185,050 |
| Customer accounts receivable | 333,773 | 7,668 |
| Judicial deposits and tax incentives | 20,254 | 24,927 |
| Compensation for concession termination | 148,794 | 148,794 |
| Deferred income tax and social contribution | 89,012 | 33,146 |
| | <u>591,833</u> | <u>214,535</u> |
| | <u>17,581,833</u> | <u>17,380,954</u> |

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

| | 2001 | 2000 |
|---|-------------------|-------------------|
| Liabilities and shareholders' equity | | |
| Current liabilities | | |
| Accounts payable to suppliers and contractors | 81,023 | 56,442 |
| Loans and financings—current portion of long-term | 549,322 | 381,653 |
| Salaries and payroll charges | 953 | 23,168 |
| Provision for vacation, paid leave and related charges | 74,360 | 70,280 |
| Taxes and contributions | 80,189 | 76,203 |
| Provisions for contingencies | 166,240 | 90,420 |
| Interest attributed to shareholders' equity | 528,341 | 165,208 |
| Other | 38,131 | 55,699 |
| | <u>1,518,559</u> | <u>919,073</u> |
| Long-term liabilities | | |
| Loans and financings | 5,873,197 | 5,612,206 |
| Accrued pension liabilities | | |
| Plan G0 | 878,385 | 1,007,274 |
| Plan G1 | 479,853 | 411,427 |
| Provisions for contingencies | 76,625 | 73,498 |
| Deferred income tax and social contribution | 1,696,909 | 1,835,253 |
| Taxes, contributions and other | 164,973 | 187,808 |
| | <u>9,169,942</u> | <u>9,127,466</u> |
| Commitments and contingencies (Note 14) | | |
| Shareholders' equity | | |
| Paid-in capital | 3,403,688 | 3,403,688 |
| Capital reserves | 40,979 | 39,141 |
| Additional paid-in capital | 114,970 | 114,970 |
| Supplementary and additional inflation restatement reserves | 4,935,927 | 5,154,807 |
| Accumulated other comprehensive deficit | | |
| Appropriated reserve | 104,674 | 93,863 |
| Accumulated deficit | (1,706,906) | (1,472,054) |
| | <u>6,893,332</u> | <u>7,334,415</u> |
| | <u>17,581,833</u> | <u>17,380,954</u> |

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

VI Pension and post-retirement benefits

(a) Pension plan (Plan G1)

We sponsor 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 in accordance with U.S. GAAP are as follows:

| | <u>2001</u> | <u>2000</u> | |
|--|------------------|------------------|----------------|
| Accumulated benefit obligation | | | |
| Vested | (200,632) | (212,960) | |
| Non-vested | (200,713) | (267,435) | |
| Total | <u>(401,345)</u> | <u>(480,395)</u> | |
| Projected benefit obligation | (591,998) | (768,618) | |
| Fair value of plan assets | 325,924 | 267,345 | |
| Funded position | <u>(266,074)</u> | <u>(501,273)</u> | |
| Unrecognized net transition obligation | 145,410 | 174,493 | |
| Unrecognized net (gain) loss | (359,189) | (84,647) | |
| Accrued pension liability | <u>(479,853)</u> | <u>(411,427)</u> | |
| | <u>2001</u> | <u>2000</u> | <u>1999</u> |
| Weighted-average assumptions | | | |
| Discount rate | 10.5% | 8.5% | 8.5% |
| Expected return on plan assets | 10.5% | 8.5% | 8.5% |
| Rate of compensation increase | 4.75% | 4.75% | 4.75% |
| Net periodic pension cost | | | |
| Service cost | 16,356 | 18,846 | 21,734 |
| Interest cost | 64,896 | 58,972 | 56,454 |
| Expected return on assets | (22,870) | (19,140) | (13,835) |
| Amortization of transition obligation | 29,082 | 29,082 | 29,082 |
| Actuarial gain | (461) | (700) | — |
| Employee contribution | <u>(7,615)</u> | <u>(9,353)</u> | <u>(9,482)</u> |
| Total net periodic pension cost | <u>79,388</u> | <u>77,707</u> | <u>83,953</u> |

The amortization of the unrecognized liability at transition is over 16 years commencing on January 1, 1990.

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

Information with respect to the Company's pension plan, in the form required by SFAS No. 132—“Employers Disclosure about Pensions and Other Postretirement Benefits”, for the years ended December 31, 2001, 2000 and 1999 is as follows:

| | <u>2001</u> | <u>2000</u> | <u>1999</u> |
|--|------------------|------------------|------------------|
| Change in net benefit obligation | | | |
| At beginning of year | 768,618 | 699,871 | 668,763 |
| Service cost | 16,356 | 18,846 | 21,734 |
| Interest cost | 64,844 | 58,972 | 56,454 |
| Actuarial (gain) loss | (242,978) | 4,616 | (37,703) |
| Gross benefits paid | (14,841) | (13,687) | (9,377) |
| At end of year | <u>591,999</u> | <u>768,618</u> | <u>699,871</u> |
| Change in fair value of plan assets | | | |
| At beginning of year | 267,345 | 204,550 | 157,914 |
| Actual return on plan assets | 51,173 | 26,903 | 61,821 |
| Employer contributions | 10,911 | 39,915 | (15,290) |
| Employee contributions | 11,336 | 9,664 | 9,482 |
| Gross benefits paid | (14,841) | (13,687) | (9,377) |
| At end of year | <u>325,924</u> | <u>267,345</u> | <u>204,550</u> |
| Funded status | (266,075) | (501,273) | (495,321) |
| Unrecognized actuarial (gain) loss | (359,189) | (84,647) | (81,889) |
| Unrecognized net transition obligation | 145,411 | 174,493 | 203,575 |
| Net amount recognized | <u>(479,853)</u> | <u>(411,427)</u> | <u>(373,635)</u> |

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

(b) Supplementary pension plan (Plan G0)

We are co-obligors to a supplementary defined benefit pension plan (“Plan G0”) (Note 6). We accounted for this actuarial liability on a push-down basis (I (h.ii) above).

The status of the supplementary pension benefit plan and the related actuarial assumptions in accordance with U.S. GAAP are as follows:

| | <u>2001</u> | <u>2000</u> | |
|---|------------------|--------------------|----------------|
| Accumulated benefit obligation | | | |
| Vested | (824,328) | (939,946) | |
| Non-vested | (54,058) | (67,328) | |
| Total | <u>(878,386)</u> | <u>(1,007,274)</u> | |
| Projected benefit obligation | (892,387) | (1,026,972) | |
| Funded position | <u>(892,387)</u> | <u>(1,026,972)</u> | |
| Unrecognized net transition obligation | 123,367 | 185,050 | |
| Unrecognized net losses | (99,771) | 49,997 | |
| Accrued pension liability | (868,791) | (791,925) | |
| Adjustment to recognize minimum liability | (9,595) | (215,349) | |
| Intangible assets | 9,595 | 185,050 | |
| Balance to equity | — | 30,299 | |
| | <u>2001</u> | <u>2000</u> | <u>1999</u> |
| Weighted-average assumptions | | | |
| Discount rate | 10.5% | 8.5% | 8.5% |
| Rate of compensation increase | 4.75% | 4.75% | 4.75% |
| Net periodic pension cost | | | |
| Service cost | 3,275 | 3,060 | 4,039 |
| Interest cost | 84,356 | 80,756 | 78,545 |
| Amortization of transition obligation | 61,683 | 61,683 | 61,683 |
| Total net periodic pension cost | <u>149,314</u> | <u>145,499</u> | <u>144,267</u> |

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

Information with respect to the Company's supplementary pension plan, in the form required by SFAS No. 132, for the years ended December 31, 2001, 2000 and 1999 is as follows:

| | 2001 | 2000 | 1999 |
|--|------------------|------------------|------------------|
| Change in net benefit obligation | | | |
| At beginning of year | 1,026,972 | 982,036 | 955,955 |
| Service cost | 3,275 | 3,060 | 4,039 |
| Interest cost | 84,356 | 80,756 | 78,545 |
| Actuarial (gain) loss | (149,768) | 29,223 | 8,619 |
| Gross benefits paid | (72,448) | (68,103) | (65,122) |
| At end of year | <u>892,387</u> | <u>1,026,972</u> | <u>982,036</u> |
| Funded status | (892,387) | (1,026,972) | (982,036) |
| Unrecognized actuarial loss | (99,771) | 49,997 | 20,774 |
| Unrecognized net transition obligation | 123,367 | 185,050 | 246,733 |
| Net amount recognized | <u>(868,791)</u> | <u>(791,925)</u> | <u>(714,529)</u> |
| Amounts recognized on balance sheet: | | | |
| Accrued benefit liability | (868,791) | (791,925) | (714,529) |
| Additional minimum liability | (9,595) | (215,349) | (247,525) |
| Intangible asset | 9,595 | 185,050 | 246,733 |
| Accumulated other comprehensive income | — | 30,299 | 792 |
| Net amount recognized | <u>(868,791)</u> | <u>(791,925)</u> | <u>(714,529)</u> |

The amortization of the unrecognized liability at transition is over 15 years commencing on January 1, 1988.

The funded status of the pension and post retirement plans under the Corporation Law and U.S. GAAP differ primarily as a consequence of the timing of first adoption of pension accounting.

(c) Actuarial assumptions

Several statistical and other factors which attempt to anticipate 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 rate of future compensation increases as determined by Sabesp, within certain guidelines. In addition Sabesp's actuarial consultants also use subjective factors such as withdrawal, turnover and mortality rates to estimate these factors. The actuarial assumptions used by Sabesp 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 withdrawal rates or longer or shorter life spans of participants. These differences may result in a significant impact to the amount of pension expense recorded by Sabesp.

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

23. Cash flow statement

The statement of cash flows reflects the Company’s operating, investing and financing activities derived from the Corporation Law accounting records and has been presented in accordance with International Accounting Standards (“IAS”) No. 7—“Cash Flow Statements”.

| | 2001 | 2000 | 1999 |
|--|------------------|------------------|------------------|
| Cash flow from operating activities | | | |
| Net income (loss) for the year | 216,227 | 521,435 | (235,448) |
| Adjustments to reconcile net income (loss) to cash from operating activities | | | |
| Deferred income tax and social contribution | (111,176) | (57,989) | (8,967) |
| Write-off of permanent assets | 84,948 | 118,722 | 202,772 |
| Property, plant and equipment received as donation | (3,705) | (6,319) | (1,027) |
| Gain on the sale of property, plant and equipment | (836) | (1,096) | — |
| Gain on the sale of investments | — | (10,123) | (384) |
| Depreciation | 459,987 | 440,479 | 425,501 |
| Amortization | 17,342 | 16,557 | 8,567 |
| Interest on loans and financings | 635,022 | 553,162 | 591,164 |
| Foreign exchange and indexation charges on loans and financings | 455,201 | 222,336 | 1,036,334 |
| Allowance for doubtful accounts | 153,780 | 190,314 | 162,890 |
| Other accruals | 49,009 | (399) | 1,085 |
| Decrease (increase) in assets | | | |
| Customer accounts receivable, gross | (185,410) | (175,358) | (139,336) |
| Inventories | 10,889 | 29,016 | 6,082 |
| Reimbursement due from State Government | (72,752) | (69,310) | (50,040) |
| Other receivables | (17,773) | (2,989) | 67,420 |
| Tax incentives and others | (3,200) | (674) | 10,554 |
| Increase (decrease) in liabilities | | | |
| Accounts payable to suppliers and contractors | 24,580 | 14,053 | (105,533) |
| Salaries and payroll charges and provisions | (18,135) | 2,037 | (22,254) |
| Taxes and contributions | (59,659) | (66,973) | (51,635) |
| Other accounts payable | 66,288 | 27,247 | (23,565) |
| Net cash provided by operating activities | 1,700,627 | 1,744,128 | 1,874,180 |

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

| | 2001 | 2000 | 1999 |
|---|------------------|--------------------|------------------|
| Cash flow from investing activities | | | |
| Purchases of property, plant and equipment | (694,599) | (596,285) | (790,749) |
| Sales of property, plant and equipment | 1,401 | 1,964 | — |
| Acquisition of investments | — | — | (230) |
| Sale of investments | — | 10,774 | 402 |
| Deferred charges expenditure | (16,336) | (14,884) | (11,187) |
| Net cash used in investing activities | (709,535) | (598,431) | (801,764) |
| Cash flows from financing activities | | | |
| Financings—short-term debt | | | |
| Issuances | — | 327,060 | 686,718 |
| Repayments | — | (946,213) | (1,160,207) |
| Financings—long term debt | | | |
| Issuances | 327,907 | 685,746 | 484,145 |
| Repayments | (964,772) | (709,581) | (680,457) |
| Payment of interest attributed to shareholders' equity | (126,716) | (455,262) | (273,555) |
| Net cash used in financing activities | (763,581) | (1,098,250) | (943,356) |
| Net increase (decrease) in cash and time deposits | 227,512 | 47,447 | 129,060 |
| Cash and time deposits at the beginning of the year | 232,708 | 185,261 | 56,201 |
| Cash and time deposits at the end of the year | 460,220 | 232,708 | 185,261 |
| Supplementary information | | | |
| Interest paid on loans and financings | 638,061 | 540,796 | 531,811 |
| Income tax and social contribution paid | 33,239 | 127,589 | — |
| Non-cash transactions | | | |
| Property, plant and equipment received as donations and/or paid for with shares (Capital subscription) | 1,838 | 15,109 | 82,468 |
| Receivables from Osasco offset upon acquisition of concession (Note 21(a)) | — | — | 168,933 |
| Interest attributed to shareholders' equity paid with debentures | — | — | 11,985 |

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

24. Business Segments

SFAS No. 131, “Disclosures about Segments of an Enterprise and Related Information”, adopts the management approach designating the internal organization that is used by management for making operating decisions and assessing performance as the source of the company’s reportable segments. Management uses data derived under the Corporation Law to make decisions in relation to the segments. SFAS No. 131 also requires disclosure about products and services, geographical areas, and major customers. SFAS No. 131 requires reported segment information to conform to the information reported to management even if that information is not prepared under U.S. GAAP.

We have two identifiable reportable segments: (i) water systems; and (ii) sewage systems.

| | 2001 | | |
|--|--------------|---------------|--------------|
| | Water system | Sewage system | Consolidated |
| Direct sales and services rendered | 2,018,631 | 1,397,421 | 3,416,052 |
| Other sales and services rendered (*) | 88,290 | 39,166 | 127,456 |
| Sales and services rendered | 2,106,921 | 1,436,587 | 3,543,508 |
| Taxes on sales and services | (64,656) | (44,085) | (108,741) |
| Net operating revenue | 2,042,265 | 1,392,502 | 3,434,767 |
| Cost of services rendered and operating expenses | (1,436,322) | (689,845) | (2,126,167) |
| Operating profit before net financial expense | 605,943 | 702,657 | 1,308,600 |
| Financial expenses, net | | | (1,105,152) |
| Non-operating income, net | | | (76,920) |
| Taxes on income | | | 89,699 |
| Net income under the Corporation Law | | | 216,227 |

| | Water system | Sewage system | Common assets and concession assets acquired | Consolidated |
|--|--------------|---------------|--|--------------|
| | | | | |
| Depreciation and amortization charges | | | | |
| Corporation Law | (268,482) | (208,847) | | (477,329) |
| U.S. GAAP | (311,403) | (242,235) | | (553,638) |
| Additions to property, plant and equipment | | | | |
| Corporation Law | 269,507 | 387,221 | 62,299 | 719,027 |
| U.S. GAAP | 275,503 | 387,221 | 62,299 | 725,023 |

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

| | 2000 | | |
|--|------------------|-------------------|--------------|
| | Water systems | Sewage systems | Consolidated |
| Direct sales and services rendered | 1,967,839 | 1,364,803 | 3,332,642 |
| Other sales and services rendered (*) | 87,910 | 37,401 | 125,311 |
| Sales and services rendered | 2,055,749 | 1,402,204 | 3,457,953 |
| Taxes on sales and services | (60,759) | (41,443) | (102,202) |
| Net operating revenue | 1,994,990 | 1,360,761 | 3,355,751 |
| Cost of services rendered and operating expenses | (1,306,214) | (637,941) | (1,944,155) |
| Operating profit before net financial expense | 688,776 | 722,820 | 1,411,596 |
| Financial expenses, net | | | (737,711) |
| Non-operating expenses, net | | | (82,300) |
| Taxes on income | | | (70,150) |
| Net income under the Corporation Law | | | 521,435 |

| | Water systems | Sewage systems | Common assets and concession assets acquired | Consolidated |
|--|------------------|-------------------|--|--------------|
| | | | | |
| Depreciation and amortization charges | | | | |
| Corporation Law | (258,652) | (198,384) | | (457,036) |
| U.S. GAAP | (286,468) | (219,718) | | (506,186) |
| Additions to property, plant and equipment | | | | |
| Corporation Law | 258,312 | 315,460 | 43,941 | 617,713 |
| U.S. GAAP | 266,939 | 315,460 | 43,941 | 626,340 |

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

| | 1999 | | |
|--|-----------------|------------------|------------------|
| | Water system | Sewage system | Consolidated |
| Direct sales and services rendered | 1,893,464 | 1,290,877 | 3,184,341 |
| Other sales and services rendered (*) | 100,697 | 49,229 | 149,926 |
| Sales and services rendered | 1,994,161 | 1,340,106 | 3,334,267 |
| Taxes on sales and services | (58,938) | (39,608) | (98,546) |
| Net operating revenue | 1,935,223 | 1,300,498 | 3,235,721 |
| Cost of services rendered and operating expenses | (1,171,743) | (624,839) | (1,796,582) |
| Operating profit before net financial expense | <u>763,480</u> | <u>675,659</u> | 1,439,139 |
| Financial expenses, net | | | (1,529,931) |
| Non-operating expense, net | | | (124,480) |
| Income taxes | | | (20,176) |
| Loss for the year under the Corporation Law | | | <u>(235,448)</u> |

| | Water system | Sewage system | Common assets and concession assets acquired | Consolidated |
|--|-----------------|------------------|--|--------------|
| | | | | |
| Depreciation and amortization charges | | | | |
| Corporation Law | (247,289) | (186,778) | | (434,067) |
| U.S. GAAP | (256,481) | (193,720) | | (450,201) |
| Additions to property, plant and equipment | | | | |
| Corporation Law | 191,939 | 257,394 | 276,115 | 725,448 |
| U.S. GAAP | 197,627 | 257,394 | 276,115 | 731,136 |

Notes to the Financial Statements at December 31 (Continued)

In thousands of *reais*

| | <u>2001</u> | <u>2000</u> |
|---|--------------------|--------------------|
| Water systems | 6,400,735 | 6,428,620 |
| Sewage systems | 6,489,506 | 6,327,744 |
| Total segment assets | <u>12,890,241</u> | <u>12,756,364</u> |
| General corporate and other | 3,027,643 | 2,435,781 |
| Total assets | <u>15,917,884</u> | <u>15,192,145</u> |
| Water systems | (2,019,387) | (1,806,710) |
| Sewage systems | (1,327,401) | (1,149,105) |
| Others | (271,854) | (244,224) |
| Total accumulated depreciation and amortization | <u>(3,618,642)</u> | <u>(3,200,039)</u> |

(*) Other sales and services rendered comprise other services which are related to water and sewage services (mainly, charges for duct connections into the water and sewage systems, change in water measurement equipment, and sewage duct clearing services.)

Information on sales and services rendered by geographic region:

| | <u>2001</u> | <u>2000</u> | <u>1999</u> |
|---|------------------|------------------|------------------|
| São Paulo Metropolitan Region | 2,682,017 | 2,633,898 | 2,564,087 |
| Interior Region | 565,686 | 542,747 | 502,688 |
| Coastal Region | 295,805 | 281,308 | 267,492 |
| Total sales | <u>3,543,508</u> | <u>3,457,953</u> | <u>3,334,267</u> |

No single customer represented more than 10% of our sales and services rendered.

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

5,006,495 American Depositary Shares

Sole Bookrunner and Joint Global Coordinator

UBS Warburg

Joint Global Coordinator

Santander Central Hispano

Until June 4, 2002 (25 days after the date of this prospectus), all dealers that effect transactions in the ADSs, whether or not participating in this offering, may be required to deliver a prospectus. This delivery requirement is in addition to the dealer's obligation to deliver a prospectus when acting as an underwriter and with respect to unsold allotments or subscriptions.