

## Risk Factors

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

***We are controlled by the State, whose interests may be contrary to the interests of holders of our shares or ADSs.***

The State of São Paulo, which we refer to as the State, through its ownership of our common shares, has the ability to control the election of a majority of the members of our *Conselho de Administração* (“Board of Directors”), to appoint our senior management and to determine our operations and strategy. The State owned 50.3% of our outstanding common shares as of March 31, 2006 and 50.3% of our outstanding common shares as of December 31, 2005.

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

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

Newly-elected Governors of the State typically make significant changes in our Board of Directors and senior management and, historically, the Chairman of our Board of Directors has been the Secretary of the Energy, Water Resources and Sanitation Secretariat of the State. In 2002, new senior officials were appointed for the state government administration, including Mr. Mauro Guilherme Jardim Arce as the new Secretary of the Energy, Water Resources and Sanitation Secretariat of the State. Mr. Arce was also elected as Chairman of our Board of Directors. On October 2006, there will be elections for the State government. Changes in government or government policy could lead to changes in our senior management which in turn could have a material adverse effect on our business strategy, cash flows, results of operations, financial condition or prospects.

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

Historically, the State and some State entities have had substantial overdue accounts payable to us relating to (1) the provision of water and sewage services and (2) State-mandated special retirement and pension payments that we make to some of our former employees for which the State is required to reimburse us. As of December 31, 2005, the amounts owed to us by the State for the provision of water and sewage services included R\$182.7 million, which was considered overdue as of February 29, 2004. As of December 31, 2005, the State owed us an additional R\$111.5 million in accounts receivable related to the provision of water and sewage services rendered from February 2004. With respect to reimbursement for pensions paid on behalf of the State, the State owed us

R\$672.7 million as of December 31, 2005 (R\$320.6 million of which was acknowledged by the State in an agreement with us subject to a further audit which has not yet occurred, as discussed below). We expect amounts owed to us by the State for water and sewage services and reimbursements for pensions paid to increase in the future. We have not established any provisions for any amounts due to us by the State.

In September 1997, December 2001 and March 2004, we entered into agreements with the State to settle overdue amounts payable to us. Under the terms of these agreements, the amounts may be settled through the application of dividends payable by us to the State and by the transfer to us of certain reservoirs in the Alto Tietê System which we use, but which are owned by the State. However, the agreements do not require the State to apply all dividends payable by us to them to the repayment of amounts owed to us. Since the State entered into these agreements it has applied the dividend received from us to the repayment of amounts it owes to us.

Under the December 2001 agreement, we converted a substantial amount of overdue accounts receivable due from the State and some State entities into long-term accounts receivable. According to the March 2004 agreement,

which amended the December 2001 agreement, the State recognized a debt with us in the amount of R\$581.8 million regarding unpaid receivables up to February 29, 2004 and we recognized an amount owed to the State as dividends declared in the form of interest on shareholders' equity totaling R\$518.7 million.

We cannot assure you as to when or if the State will pay overdue amounts due to us by it and by some State-controlled entities. Furthermore, due to the State's history of not making timely payments to us in respect of services provided by us and of not reimbursing us in a timely manner for the State-mandated special retirement and pension payments, we 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. If the State does not pay the amounts it owes us, our cash flows, results of operations and financial condition will be adversely affected.

***We expect that a portion of long-term accounts payable by the State to us will be settled by the transfer to us of State-owned reservoirs in the Alto Tietê System, but we cannot assure you of the value to be given to these reservoirs or of the timing or legality of these transfers.***

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

In July and August 2002, a State-owned construction company, on behalf of the State, and an independent appraisal firm, on our behalf, presented their valuation reports relating to the reservoirs. The appraisals contained in these reports were in the amounts of R\$335.8 million and R\$341.2 million, respectively. Under the terms of the

December 2001 agreement, the arithmetic average of these appraisals will be deemed to be the fair value of the reservoirs. Because we had already made investments in these reservoirs by then, the arithmetic average of the appraisals submitted to our Board of Directors by August 2002, R\$300.9 million, was net of a percentage corresponding to these investments. However, a final determination as to the fair value of these reservoirs is still pending and we cannot assure you as to when the reimbursement of the pension payments will take place.

In addition, on October 29, 2003, the Public Attorney of the State (*Ministério Público do Estado de São Paulo*), on behalf of the people of the State, brought a civil public action in a Trial Court of the state of São Paulo (*12a Vara da Fazenda Pública do Estado de São Paulo*) alleging that a transfer to us of ownership of the Alto Tietê System reservoirs from the State Department of Water and Energy of the State would be illegal. In October 2004, the court ruled in favor of the Public Attorney of the State. In response, we filed an appeal, which is pending final decision and the State successfully filed an action suspending the lower court's decisions until final judgment is reached by the Court of Appeals of the state of São Paulo (*Tribunal de Justiça do Estado de São Paulo*). We are unable to predict whether we will succeed in appealing such decision and cannot assure you as to whether the transfer of these reservoirs will occur.

***The State has agreed to reimburse us for pension benefits owed to us; however, if agreement is not reached with respect to the amounts of these reimbursements or if the State delays in making these payments, our cash flows, results of operations and financial condition could be adversely affected.***

The December 2001 agreement also provided that the State's legal advisors would carry out specific analyses, which have commenced, to ensure agreement among the parties as to the methodology employed in determining the amount of reimbursement for pension benefits owed to us by the State. The commencement of reimbursement payments with respect to pension amounts owed to us by the State has been postponed until these analyses are completed, the appraisal report is approved and the credit assignments relating to the transfer of the reservoirs in the Alto Tietê System are formalized. In addition, the transfer of these reservoirs is currently being disputed and we are not certain whether such transfer will be legally allowed, as discussed above. Under the December 2001 agreement, the original first payment was to be made in July 2002. Negotiations are still ongoing between the Company and the State with a view to restatement of the debt for supplemental retirement and pension benefits, under the terms defined in the December 2001 agreement, including amounts due after November 2001. These negotiations are expected to be consolidated in a second amendment to the December 2001 agreement. We have retained *Fundação*

*Instituto de Pesquisas Contábeis, Atuárias e Financeiras (“FIPECAFI”) to validate the actual values to be reimbursed by the State, in accordance with the opinions provided by the Office of the State Attorney General. We cannot assure you as to when agreement among the parties will be reached or when the State will commence making payments in respect of these amounts. If an agreement among the parties is not reached or if the State delays or fails to make such payments, our cash flows, results of operations and financial condition could be adversely affected.*

***We may be required to acquire reservoirs that we use and that are owned by a State-controlled company, or we may be required to pay substantial fees to the owner in the form of 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 these acquisitions, our cash position and overall financial condition could be adversely affected. In addition, since we are not currently charged for the use of these reservoirs, we are uncertain as to whether 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 imposed. We may also be required to pay additional maintenance and operational costs for our use of the Billings and Guarapiranga reservoirs. If we were required to pay substantial fees to the owner or additional maintenance or operational costs for these properties, our cash flows, results of operations and financial condition could be adversely affected.

#### **Risks Relating to Our Business**

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

There is not, at the present time, any specific regulation in connection with sanitation services in Brazil. Accordingly, the Brazilian Federal Congress has, from time to time, discussed proposals for regulation, which would establish directives for basic sanitation services.

Currently, several bills are under debate at the Brazilian Federal Congress and at the Brazilian Senate. Both Houses of Representatives have agreed upon the creation of a joint committee (*comissão mista*) that will be responsible for the organization and systemization of the proposed regulation for water and sewage services in Brazil. Any proposed regulation, when and if approved, could establish a new municipal regulatory authority for our industry that may, in part, preempt the existing State regulatory authorities under which we operate in the Metropolitan Region. In this respect, there are currently two legal proceedings being reviewed by the Brazilian Supreme Court (*Supremo Tribunal Federal*) challenging the constitutionality of two state laws that provide for the creation of metropolitan regions and seeking the declaration of the state as the regulatory authority for water and sewage services within such regions. Although the results of these proceedings may not directly impact the bills currently in debate at the House of Representatives, they will set relevant precedents in connection with the establishment of the regulatory authority for metropolitan regions. In addition, a new regulation could modify the way we charge for our water and sewage services businesses, as well as our capital expenditure program. Any of these changes could have an adverse effect on our revenue, by causing us to lose concessions we currently hold, or on our operating margins, by limiting our ability to pass our cost on to our customers.

As of the date of this annual report, no proposed federal regulation for the water and sewage industry has been voted on by the Brazilian Federal Congress. We cannot anticipate if, when or in which terms any proposed federal regulation will become effective. Any of the proposed new regulations, if approved by the Brazilian Federal Congress, could have a negative effect on our operations in the São Paulo Metropolitan Region, as well as in other areas that we serve.

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

Governmental water agencies of the State and the Federal Government are authorized to collect fees from entities, including us, 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 sponsor studies, programs, projects and constructions provided for in the Water Resources Plan (*Plano de Recursos Hídricos*) and for the payment of expenses concerning the creation of the Federal System for Water Resources Managing (*Sistema Nacional de Gerenciamento de Recursos Hídricos*), as well as administrative costs regarding the bodies and entities pertaining thereto and they may be loaned or provided as grants or subsidies to governmental agencies and corporations, including us, for use in the development and maintenance of water resources. The legislature of the State and the Federal Government enacted legislation under which we must pay fees to the Federal Government, the State or an agency in respect of the use of water from specified sources. Since February 2004 we have been incurring expenses in connection with the use of water from the Paraíba do Sul River Basin and since January 2006 from the Piracicaba, Capivari and Jundiá River Basin. Given that the tariff readjustment formula currently approved by our Board of Directors takes into consideration the variation of expenses considered as “non-administrable”, which these expenses fall under, we expect to continue to be able to pass on these expenses to our customers.

However, we are uncertain as to the likely fees that may be assessed in connection with the abstraction of water or the dumping of sewage to other water resources that we use, or whether we will be able to continue to pass on the cost of all of these fees to our customers.

***We have accounts receivable due from municipalities and we cannot assure you as to when or whether these municipalities will pay us.***

As of December 31, 2005, we had accounts receivable totaling R\$727.9 million from municipalities to which we provide water on a wholesale basis. Of this amount, R\$78.9 million was 91 to 360 days overdue and R\$588.7 million was more than 360 days overdue. In some cases, the Brazilian courts have required that we continue to provide water on a wholesale basis to municipalities, even if they fail to pay our invoices. Additionally, as of December 31, 2005, we had accounts receivable in the amount of R\$377.4 million, owed to us by municipalities to which we render water and sewage services, including R\$300.6 million owed by the Municipality of the City of São Paulo.

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 regular basis. We cannot assure you as to whether or when these municipalities will resume making regular payments or pay overdue amounts owing to us. If these municipalities and government agencies do not pay amounts they owe us, our cash flows, results of operations and financial condition will be adversely affected.

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

We do not hold formal concessions in the City of São Paulo, which on December 31, 2005 accounted for 56.8% of our sales and services rendered, or in 40 other municipalities in the state of São Paulo. Because we do not hold concessions or formal contract rights to provide services in these municipalities, we may not be able to effectively enforce our right to continue to provide services or to be paid for the services we provide. In the future, our rights in respect of the City of São Paulo and these other municipalities could be modified or adversely affected by Brazilian federal, state or local governmental actions or other factors.

From time to time, mayors of the City of São Paulo have initiated or proposed discussions with the State regarding entering into a formal concession contract with us to provide water and sewage services in the City of São Paulo. The City of São Paulo legislature approved Law 13,670 of November 25, 2003 through which it intended to establish the authority to regulate its public water supply and sewage services. Following the enactment of Law No. 13,670, the Governor of the State filed a legal action alleging that the law is unconstitutional, as a result of which the enforcement of Law No. 13,670 has been suspended. On April 20, 2005, the court ruled in favour of the Governor of the State, by a majority of votes. The City of São Paulo appealed the decision and a trial judgement was still pending as of the date of this annual report. We cannot assure you when or if the suspension of Law 13,670 will end, and we cannot anticipate the effect of its renewed application which could result in the creation of different conditions as compared to those under which our services are currently provided in the City of São Paulo.

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

We provide water and sewage services in 325 municipalities pursuant to concessions granted by the municipalities. Substantially all of these concessions have 30-year terms. As of December 2005, 17 of our concessions had expired; 256 are due to expire between 2006 and 2010, of which 127 are scheduled to expire during 2006 and 30 in 2007. All other concessions will expire between 2011 and 2034.

Some of the expired concession agreements have been extended for a short term while we negotiate the terms and conditions of a final agreement with each relevant municipality. The new agreements may be executed under a new regime provided for by a newly enacted law which establishes principles to be observed when public consortiums contract with the municipalities, with the objective of allowing the provision of public services to be jointly managed. Despite the expiration of the agreements, we continue to provide water and sewage services to all 17 municipalities. If certain municipalities choose not to renew their concessions, it could adversely affect our results of operations and financial condition. Even if they choose to renew these concessions, we cannot assure you that we will obtain the same terms that we currently have.

***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 and applicable law. 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. The Constitution of the State establishes that the municipalities in which we operate as water and sewage service providers may, in the course of granting authority over these services, create their own autonomous entities to render such services in their territories instead of continuing to use our services, with the obligation to indemnify us for the termination of the concession with us over a term of up to 25 years rather than at the time the concession is terminated. The State obtained an injunction in a legal action alleging the 25-year term to be unconstitutional. As a result, the maximum term for payment of the indemnification has been suspended. In the event that this injunction is stayed and/or the outcome of the legal action is not favorable to us, the indemnification over a term of 25 years may adversely affect our operational results and financial condition. In 1997, the Municipality of Santos enacted a law expropriating our water and sewage systems in Santos. In response, we filed an action seeking an injunction against this expropriation which was denied by the lower court. This decision was later reversed by the Court of Appeals of the State, which ordered the action to be carried forward and issued a preliminary order suspending that law. On August 2, 2002, a decision on this matter was rendered in our favor by a lower court. The municipality and the house of representatives of Santos have filed an appeal, and we cannot assure you that the ultimate determination will be favorable to us. Despite the pending lawsuit, we continue to provide water and sewage services to Santos.

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 cash flows, results of operations and financial condition.

***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 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.

In the event we are obligated to participate in public bidding processes in order to renew our existing concessions or to obtain new ones, our failure to outbid our competitors for our existing concessions may adversely impact our cash flows, results of operations and financial condition.

***We may be unable to increase customer tariffs in line with increases in inflation and operating expenses, including taxes.***

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. From mid-1999 until mid-2001 we did not raise our tariffs, due to a State policy of not increasing tariffs for public services. In June 2001, we increased our average tariffs by approximately 13.1% which was broadly in line with the prevailing inflation rates in Brazil since mid-1999, and in August 2002 we raised our tariffs by approximately 8.2% . A new readjustment formula was approved by our Board of Directors and has been applied to the tariff adjustment since August 2003. Using this new formula, in August 2003 we raised our tariffs for water and sewage services by approximately 18.9%, and in August 2004 we raised our tariffs for water and sewage services by approximately 6.8% . The application of the formula in 2005 would result in a tariff increase of 11.12% . Because that increase was much higher than the accumulated inflation levels for the corresponding period, we decided to adjust the tariff by 9.0%, effective August 31, 2005. The remaining percentage (1.94%) was deferred to the 2006 tariff adjustment. Tariffs with respect to the residential social (which includes residences of low-income families that live in sub-standard conditions, residences of persons unemployed for up to 12 months and collective living residences) and *favela* (shantytown) categories, are not always increased at the same rate as other tariffs. For example, in August 2003, these tariffs were increased by only 9.0% and were not set using the new formula. However, in August 2004 and August 2005, the tariffs with respect to the residential social categories were increased by the same percentage as the other categories, 6.8% and 9.0% respectively. We will continue to rely upon tariff revenue to provide funds for our capital expenditure program in addition to our financing activities and to meet our debt service requirements. We are currently conducting studies with a view to implementation of a new tariff policy. Such studies have been delivered to our executive committee and board of directors and the recommendations resulting thereof are currently being detailed for implementation. However, we cannot assure you when and if a new tariff policy will be implemented or if such implementation will meet our expectations. Any failure to establish or maintain tariffs commensurate with these and our other needs could have an adverse effect on our cash flows, results of operations and financial condition.

***Our capital expenditure program requires substantial liquidity and capital resource, and any failure to obtain new financing may have a material adverse effect on the operation and development of our business.***

Our capital expenditure program calls for expenditures of approximately R\$4.8 billion in the period from 2006 through 2010, including approximately R\$960.0 million in 2006 and R\$960.0 million in 2007. We spent R\$678.2 million on our capital expenditure program in 2005.

We have funded in the past, and we plan to continue to fund, these expenditures out of funds generated by operations and domestic and foreign currency borrowings on acceptable terms. In this way, a significant portion of our financing needs has been funded by financing provided by lenders controlled by the Federal Government. For example, we are currently negotiating with the Brazilian Economic and Social Development Bank (*Banco Nacional de Desenvolvimento Econômico e Social*, or “BNDES”), and Caixa Econômica Federal (a bank owned by the Brazilian government) for additional loans to finance portions of our capital expenditure program. We also benefit from long-term financing from domestic and international multilateral agencies and development banks at attractive interest rates. Changes in the policies of the Federal Government regarding the financing of water and sewage services, or our failure to continue to benefit from long-term financing from domestic and international multilateral agencies and development banks at attractive interest rates may impair our ability to finance our capital expenditure program.

We cannot assure you that we will be able to obtain sufficient funds to complete our capital expenditure program . 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.

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

Because we are controlled by the State we are subject to special credit rules for the public sector published by the Brazilian monetary authorities. As a general rule, financial institutions and other institutions authorized to provide credit by the Central Bank may only provide loans to public sector entities, such as us, up to a certain percentage of such entities' net equity. Because of these limitations on our ability to obtain credit from domestic financial institutions, our options for raising funds, other than the cash generated by our operations, consist principally of borrowing from international financial institutions or development agencies and issuing bonds in both the domestic and international capital markets and other publicly traded obligations. These limitations on obtaining credit could adversely affect the development of our business, our ability to meet our obligations or continue our capital expenditure program, and our cash flows, results of operations and financial condition.

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\$1,650.5 million as of December 31, 2005. If, however, these and other limitations prevent us from completing our capital expenditure program or executing our business plans generally, we may be unable to satisfy all of our liquidity and capital resources requirements, which could have a material adverse effect on our cash flows, results of operations and financial condition.

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

We experience decreases in our water supply from time to time due to droughts. In the event of prolonged drought, the volume of water provided by us may be reduced, although the impact that droughts have may vary across our different water supply systems. Throughout 2003, rain levels were below average resulting in a weak replenishment of our reservoirs, particularly in the Cantareira System, the largest system in the São Paulo Metropolitan Region. The effects of this drought continued to impact our systems through 2004. In order to minimize the effects of this drought, in March 2004 we approved a water consumption reduction incentive program based on a bonus system, pursuant to which customers that achieved their consumption reduction goal would be entitled to a 20.0% discount on their water bill. This incentive program ended on September 15, 2004 and encompassed most of the customers in the São Paulo Metropolitan Region, resulting in a reduction of our revenue from water and sewage services provided to the São Paulo Metropolitan Region by R\$74.1 million. We cannot assure you that any drought in the future will not materially adversely affect our water supply and, accordingly, our cash flows, results of operations and financial condition.

***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 health and the environment. We have made, and will continue to make, substantial expenditures to comply with these provisions. In addition, because environmental laws and their enforcement are becoming more stringent, our capital expenditures and expenses for environmental compliance may increase substantially in the future. The amount of investments that we make in any given year is subject to limitations imposed by the State. Expenditures required for compliance with environmental regulation may result in reductions in other strategic investments that we have planned, which could negatively affect our profitability. We could also be exposed to criminal and administrative penalties, in addition to indemnification obligations, for possible damage for non-compliance with environmental laws and regulations. Currently, we are party to a number of environmental lawsuits and administrative proceedings, including civil public actions and criminal proceedings. Any material unforeseen environmental costs and liabilities may have a material adverse effect on our future financial performance.

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

We are a party to a number of legal proceedings involving significant monetary claims. These legal proceedings include, among others, tax, labor, condemnation and other proceedings. A substantial monetary judgment against us in one or more of these legal proceedings may have a material adverse effect on our business or financial condition. Based on advice we received from our lawyers, we have provisioned a total aggregate amount of R\$612.4 million as of December 31, 2005 to cover probable losses related to legal proceedings. This provision does not cover, however, all legal proceedings involving monetary claims filed against us. Any unfavorable judgment in relation to these proceedings may have an adverse effect on our cash flows, results of operations and financial condition.

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

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

#### **Risks Relating to Brazil**

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

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

Actions taken by the Brazilian government concerning the economy may have important effects on Brazilian corporations and other entities, including us, and on market conditions and prices of Brazilian securities, including our equity and debt securities. Our financial condition and results of operations may be adversely affected by the following factors or the Brazilian government's response to them:

- currency devaluation and other exchange rate movements;
- inflation;
- currency 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.



The Brazilian Congress is currently conducting investigations, among other issues, in relation to allegations related to political campaign contributions which were not accounted for or disclosed, including contributions made to several important members of the present administration. Such allegations have resulted in the replacement of important government ministers and are occupying a significant portion of the agenda of the Brazilian Congress. These investigations could adversely affect public confidence, and any resulting reduction of economic activity in Brazil and could adversely affect our results of operations and the price of our shares and ADSs.

A presidential election will be held in Brazil in October 2006. The run-up to the presidential election may result in changes in existing policies, and the post-election administration may seek to implement new policies. In the years from 2001 to 2005 the Brazilian economy grew at an average annual rate of 2.2%, and the post-election administration may face domestic pressure to revise current economic policies to achieve higher growth rates. We cannot predict what policies will be adopted by the Brazilian government and whether these policies will negatively affect the economy or our business or financial condition or results of operations.

***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 shares or 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 a 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 2001 and 2002, the *real* devalued 15.7% and 34.3% respectively, while appreciating 22.3% in 2003, 8.8% in 2004 and 13.4% in 2005 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 because our tariff revenue and other sources of income are based solely in *reais*. In addition, because we have substantial foreign currency-denominated indebtedness, any significant devaluation of the *real* during a financial period will increase our financial expenses as a result of foreign exchange losses that we must record. We had total foreign currency-denominated indebtedness of R\$1,576.0 million as of December 31, 2005, and we anticipate that we may incur substantial amounts of foreign currency-denominated indebtedness in the future. Our overall results of operations were positively affected by the 13.4% appreciation of the *real* against the U.S. dollar in 2005, which amounted to R\$312.1 million. We do not currently have any hedging instruments in place to protect us against a devaluation of the *real* in relation to any foreign currency. A devaluation of the *real* would reduce the U.S. dollar value of distributions and dividends on our ADSs and could reduce the market price of our shares or ADSs.

***The Brazilian government's actions to combat inflation and public speculation about possible future action may contribute significantly to economic uncertainty in Brazil.***

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

Inflation, as measured by the General Price Index-Market, or the IGP-M (*Índice Geral de Preços de Mercado*), was 8.7% in 2003, 12.4% in 2004 and 1.2% in 2005. 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 cash flows, results of operations or financial condition. If Brazil experiences significant inflation in the future, our costs and expenses may rise, we may be unable to increase our tariffs to counter the effects of inflation, and our overall financial performance may be adversely affected.

In addition, a substantial increase in inflation may weaken investor confidence in Brazil, so that the market price of our equity and debt securities declines.

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

Brazilian Law No. 9,605 of February 12, 1998 provides that the corporate structure of a company may be disregarded if it impedes recovery for undue harm to the environment. We cannot assure you that, in the case of claim for environmental damage under this law, liabilities would be limited to shareholders capable of exercising control over the company at the time of such 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 of any Brazilian corporation under this law and cannot predict the circumstances in which this might happen.

***Because electrical power is essential to our operations, power shortages, rationing or instability of the electricity supply or significant increases in electricity tariffs may adversely affect our business.***

We are one of the major power consumers in the state of São Paulo and the use of electrical power is essential to our operations. In May 2001, the Federal Government announced measures to reduce power consumption in several regions of Brazil, including areas where we operate. We were not subject to such measures because we render essential services. However, instability of the power supply has caused and may cause in the future material damages to our water and sewage systems which could adversely affect our business. In addition, material shortages or reduction in the power supply (including those due to rationing programs) may adversely impact our results of operations and financial condition. Electricity tariffs increased by an average of 7.86% during the course of 2005, which in turn led to a R\$37.9 million increase in our electric power costs in 2005 compared to 2004. Further significant increases in electricity tariffs may have an adverse impact on our results of operations and financial condition.

**Risks Relating to our Common Shares and ADSs*****Restrictions on the movement of capital out of Brazil may impair the ability of holders to receive dividends and distributions on, and the proceeds of any sale of, the common shares underlying our ADSs.***

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

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

***Holders of our common shares and ADSs may not receive any dividends or interest on shareholders' equity.***

According to our by-laws, we must generally pay our shareholders at least 25.0% of our annual net income as dividends or interest on shareholders' equity, as determined and adjusted under the Corporate Law Method. This adjusted income may be capitalized, used to absorb losses or otherwise appropriated as allowed under the Corporate Law Method and may not be available to be paid as dividends or interest on shareholders' equity. We may not pay dividends or interest on shareholders' equity to our shareholders in any particular fiscal year if our Board of Directors determines that such distributions would be inadvisable in view of our financial condition.

***If a holder exchanges ADSs for common shares, he or she risks losing the ability to remit foreign currency abroad and Brazilian tax advantages.***

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

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

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

The Brazilian securities markets are substantially smaller, less liquid, more concentrated and more volatile than major securities markets in the United States and other jurisdictions. The relatively small market capitalization and illiquidity of the Brazilian equity markets may substantially limit a holder’s ability to sell the common shares underlying our ADSs at the price and time he or she desires.

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

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

***The protections afforded to minority shareholders in Brazil are different from those in the United States and other jurisdictions and may be more difficult to enforce.***

Under Brazilian law, the protections afforded to minority shareholders are different from those in the United States and other jurisdictions. In particular, the case law with respect to shareholder disputes is less developed under Brazilian law than under US law and the laws of other jurisdictions and there are different procedural requirements for bringing shareholder lawsuits, such as shareholder derivative suits. As a result, in practice it may be more difficult for our minority shareholders to enforce their rights against us or our directors or controlling shareholder than it would be for shareholders of a non-Brazilian company.

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

Sales of a substantial number of our common shares – or the anticipation of such sales – could decrease the trading price of our common shares and ADSs. As of December 31, 2005, we had 28,479,577,827 common shares outstanding, including 14,313,511,871 shares held by the State. As a consequence of the issuance of common shares or sales by the State or other existing shareholders, the market price of our common shares and, by extension, our ADSs may decrease significantly. As a result, a holder may not be able to sell his or her securities at or above the price he or she paid for them.

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

Under our by-laws, any disputes among us, our shareholders and our management with respect to the application of *Novo Mercado* rules, the Brazilian Corporate Law and the application of the rules and regulations regarding Brazilian capital markets will be resolved by arbitration conducted pursuant to the São Paulo Stock Exchange Arbitration Rules in the São Paulo Stock Exchange Arbitration Chamber. Any disputes among shareholders, including holders of ADSs, and disputes between us and our shareholders, including holders of ADSs, will also be submitted to arbitration. The State is currently not permitted by law to sell its control shares. As a result, a court in the United States might require that a claim brought by a holder of ADSs predicated upon the US securities laws be submitted to arbitration in accordance with our by-laws. In that event, a purchaser of ADSs would be effectively precluded from pursuing remedies under the US securities laws in the US courts.

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

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

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

Holders may exercise voting rights with respect to the common shares represented by our ADSs only in accordance with the deposit agreement relating to our ADSs. There are no provisions under Brazilian law or under our by-laws that limit the exercise by 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, but only if we request the depositary to do so. 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 may adversely affect the Brazilian economy and, therefore, the market prices of our common shares and ADSs, as well as of our debt securities.***

The market for securities issued by Brazilian companies is influenced by economic and market conditions in Brazil and, to varying degrees, market conditions in other Latin American and emerging market countries. Although economic conditions are different in each country, the reaction of investors to developments in one country may have a material adverse effect on the market value of securities of Brazilian companies. If there is a crisis in another emerging market country, investor demand for Brazilian securities, including our common shares and ADSs, as well as our debt securities may decline. This may adversely affect the trading value of our common shares or ADSs as well as our debt securities and any such decline in trading value would create obstacles or otherwise impede our access to capital markets and financing for our future operations.

***Changes in Brazilian tax laws may have an adverse impact on the taxes applicable to a disposition of the ADSs.***

According to Law No. 10,833, enacted on December 29, 2003, the disposition of assets located in Brazil by a nonresident to either a Brazilian resident or a non-resident is subject to taxation in Brazil, regardless of whether the disposition occurs outside or within Brazil. In the event that the disposition of assets is interpreted to include a disposition of the ADSs, this tax law could result in the imposition of withholding taxes on a disposition of ADSs by a non-resident of Brazil to another non-resident of Brazil. Due to the fact that no judicial guidance as to Law 10,833's application yet exists, we are unable to predict whether an interpretation applying such tax laws to dispositions of ADSs between non-residents could ultimately prevail in the courts of Brazil.

**ITEM 4. INFORMATION ON THE COMPANY****General**

Companhia de Saneamento Básico do Estado de São Paulo-SABESP is a *sociedade de economia mista*, a mixed capital company with limited liability of unlimited duration, duly organized and operating under Brazilian corporation law. Our principal executive offices are located at Rua Costa Carvalho, 300, 05429-900 São Paulo, SP, Brazil. Our telephone number is (55-11 3388-8000). Our agent for service of process in the United States is CT Corporation System, with offices at 111 Eighth Avenue, New York, New York 10011. As set forth in Article 2 of our by-laws, our corporate purpose is to plan, provide, operate and market basic sanitation services throughout the territory of the state of São Paulo, including the capture, collection, processing and distribution of water, as well as the collection, removal and final disposal of sewage and sludge. Since March 2006, we are also authorized to provide these services in all national territory and abroad.

We believe we are one of the largest water and sewage service providers in the world based on customers in 2005. We operate water and sewage systems in the state of São Paulo in which the City of São Paulo, Brazil's largest city, is located. According to the Brazilian Institute of Geography and Statistics, or IBGE, the state of São Paulo is Brazil's most populous state and the state with the highest GDP in Brazil. We had net revenue from sales and services of R\$4,953.4 million (U.S.\$2,116.2 million) and net income of R\$865.6 million (U.S.\$369.8 million) for 2005. We had total assets of R\$17,435.2 million (U.S.\$7,448.7 million) and shareholders' equity of R\$8,482.5 million (U.S.\$3,623.9 million) as of December 31, 2005.

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

As of December 31, 2005, we distributed water to approximately 22.6 million people, which we believe includes approximately 60% of the urban population of the state of São Paulo, through approximately 58,000 kilometers of water pipes and mains to approximately 6.5 million water connections. As of December 31, 2005, we provided sewage services to approximately 18.3 million people through 37,181 kilometers of sewer lines to approximately 4.9 million sewage connections. In addition, we currently sell water on a wholesale basis to six municipalities having an estimated urban population of approximately 3.1 million inhabitants.

The State, our controlling shareholder, is required by our by-laws and State law to own at least one-half plus one of our common (voting) shares. The State currently owns 50.3% of our outstanding common shares. As a mixed capital company, we are an integral part of the governmental structure of the State. Our strategy and major policy decisions are formulated in conjunction with the Energy, Water Resources and Sanitation Secretariat of the State as part of the overall strategic planning for the State. The majority of the members of our Board of Directors and our Executive Committee are nominated by the State Council for Protection of Capital of the State (*Conselho de Defesa de Capitais do Estado de São Paulo-CODEC*), a State agency presided over by the Secretary of the State Treasury and reporting directly to the Governor.

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