

Risk Factors

Risks Relating to our Control by the State of São Paulo

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

The State of São Paulo (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**”), the appointment of our senior management and our operations and strategy. The State owned 71.5% of our common shares on April 30, 2004.

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 other holders of our common shares and holders of 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.

Each newly-elected Governor of the State typically makes 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, the current Governor, Mr. Geraldo Alckmin, appointed new senior officials for his administration, including Mr. Mauro Guilherme Jardim Arce as the new Secretary of the Energy, Water Resources and Sanitation Secretariat. Mr. Arce was also elected as Chairman of our Board of Directors. In addition, during the last twelve months our Board of Directors has appointed new executive officers, including our new chief executive officer and our new chief financial officer.

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, results of operations, financial condition or prospects.

We have overdue accounts receivables owed by the State 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 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 that we make to some of our former employees for which the State is required to reimburse us.

On December 31, 2003, we had accounts receivables due from the State and some State entities relating to the provision of water and sewage services totaling approximately R\$164.2 million, net of R\$401.7 million of amounts applied in respect of dividends due to the State Government. In addition, on December 31, 2003, we had R\$491.0 million in accounts receivable due from the State in respect of State-mandated special retirement and pension payments to some of our

former employees. 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. We have not established any provisions for any amounts owed to us by the State.

In September 1997, December 2001 and March 2004 we entered into agreements with the State under which the State agreed to settle amounts the State owes us in respect of water and sewage services provided to the State and State-controlled entities and 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 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 which we use but which are owned by the State. However, some of the agreements do not require the State to apply all dividends payable by us to the State to the repayment of amounts owed to us by the State. In addition, the agreements provide for an extended period of time before any transfer of the reservoirs to us is effected. Since the State entered into these agreements, it has applied some, but not all, of the dividend received by it from Sabesp to the repayment of amounts it owes to Sabesp.

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

We cannot assure you as to when or whether the State will pay overdue amounts owing to us, or as to whether the State will continue to apply dividends payable to the State to settle amounts owing to us by the State and 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 make, we cannot assure you that the amount of accounts receivables 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.

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, and we cannot assure you of the value to be given to these reservoirs or the timing of these transfers.

Under 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 receivables due from the State and of reimbursements due from the State for State-mandated special pension payments we have made. Under this agreement, the value of these reservoirs will be determined by an appraisal process prior to their transfer and amounts owing to us from the State are subject to an audit by a State-appointed auditor.

Under the December 2001 agreement, in July and August 2002 a State-owned construction company, on behalf of the State, and an independent appraisal firm, on behalf of Sabesp, 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 December 2001 agreement, the arithmetic average of these appraisals will be deemed to be the fair value of the reservoirs. Since we have made investments in these reservoirs, the arithmetic average of the appraisals submitted to our Board of Directors, R\$300.9 million, was net of a

percentage corresponding to these investments. Our Board of Directors approved the valuation reports which will now have to be submitted for approval by an extraordinary general meeting of shareholders. However, we cannot assure you as to when such meeting will take place and a final determination as to the fair value of these reservoirs will be made, when the transfer of the reservoirs will occur, or when the reimbursement of the values paid by us in relation to the State-mandated special pension and benefits will take place.

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 Sabesp by the State. The commencement of reimbursement payments with respect to pension amounts owed to Sabesp by the State has been postponed until these analyses are completed, the appraisal report is approved and the credit assignments relating to the transfer of the reservoirs described above are formalized. Under the December 2001 agreement, the original first payment was to be made in July 2002, but no payment in this respect has been made as of the date of this document. 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 pension amounts.

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 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 so 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 or additional maintenance or operational costs for these properties, our results of operations could be adversely affected.

Risks Relating to Our Business

The basic sanitation sector is not regulated in Brazil and the approval of any proposed regulations for the water and sewage industry may negatively affect our operations in the São Paulo Metropolitan Region as well as other areas that we serve.

The Brazilian Federal Congress has, from time to time, discussed proposals for regulation, which would establish directives for basic sanitation services. 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.

Law Project No. 4,147, for example, has been under the analysis of the Brazilian Federal Congress since February 21, 2001. This proposed new legislation and regulatory regime may grant to the new regulatory authorities the power to deny renewals of our concessions after they expire or to cancel existing ones. In addition, the proposed new legislation could 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 operating margins, by limiting our ability to pass our costs on to our customers. In addition, some changes have been introduced to the proposed legislation by which the State would share the authority with municipalities comprising the São Paulo metropolitan region. 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 annual report, neither Law Project No. 4,147 or any other proposed federal regulation for the water and sewage industry has been voted by the Brazilian Federal Congress or been sent to the Brazilian Senate for debate. However, representatives of the federal government have repeatedly informed the press that new regulation is expected to be proposed to the Brazilian Congress in the near future. Our Board of Directors has recently become aware that such new regulation, if proposed to the Brazilian Congress in the form presented to us, will have a negative effect on our operations in the São Paulo Metropolitan Region, as well as in other areas that we serve. Accordingly, we cannot anticipate when, in what terms, or if, Law Project No. 4,147 or any other proposed federal regulation will become effective.

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 fees that may be assessed, or whether we will be able to pass on the cost of any of these fees to our customers.

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 accounts for a substantial majority of our sales and services rendered, and in 41 other municipalities in the State of São Paulo. We believe, however, 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. 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, 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. The City of São Paulo legislature approved Law 13,670 of November 25, 2003 that regulates articles 148 and 149 of the Organic Law of the City of São Paulo (*Lei Orgânica do Município de São Paulo*) in relation to public water supply and sewage services. The law establishes the Municipal System for the Regulation of Public Water Supply and Sewage Services (*Sistema Municipal de Regulação dos Serviços de Abastecimento de Água e Esgotamento Sanitário* or “**SIRE**”), creates and provides for the organization and operation of the São Paulo Regulatory Authority for Public Water Supply and Sewage Services (*Autoridade Reguladora dos Serviços de Abastecimento de Água e Esgotamento Sanitário de São Paulo* or “**ARSAE**”), and establishes the Municipal Sanitation Plan (*Plano Municipal de Saneamento* or “**PMS**”). Following the enactment of Law No. 13,670, the Governor of the State of São Paulo has filed a legal action alleging that the Law is unconstitutional, a result of which the enforcement of Law No. 13,670 has been suspended. The merits of such lawsuit have not yet been judged. We cannot assure when or if the suspension of Law 13,670 of November 25, 2003 will end, or if its renewed application would result in the City of São Paulo granting us a formal concession contract, or the terms of any concession contract.

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

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: 273 of these concessions expire between 2004 and 2010; and the rest expire between 2011 and 2030. Each of these concessions is automatically renewable for a period equal to its initial term, unless we or the municipality exercise the right to terminate the concession prior to the six-month period ending on the expiration date of the concession. If a substantial number of these municipalities choose not to renew their concessions, it could adversely affect our revenues and cash flows.

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.

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 the lower court. This decision was later reversed by the Court of Appeals of the State of São Paulo, which issued a preliminary order suspending that law. On August 2, 2002, a decision on this matter was rendered in favor of Sabesp by a lower court, but such decision is still subject to 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 business and results of operations.

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.

The conditions attached to the renewal of our authorization to abstract water from the Cantareira System may be unreasonably burdensome and could result in an increase in costs and a higher capital expenditure requirement.

We may abstract water from rivers or reservoirs only to the extent permitted by the Department of Water and Energy of the State of São Paulo (*Departamento de Águas e Energia Elétrica do Estado de São Paulo*). Under some circumstances, depending on the geographic location of the relevant river basin or reservoir, the approval of the National Water Agency (*Agência Nacional de Águas – ANA*) is also required. The term of these authorizations will vary depending on the granting authority, and their renewal must be approved by their original grantors.

The authorization to abstract water from the Cantareira System, which supplies approximately 48% of the water produced by Sabesp for the São Paulo Metropolitan Region, will expire in August 2004. Accordingly, we have filed a request for the renewal of the authorization before the Department of Water and Energy of the State of São Paulo on February 27, 2004, and before ANA on April 7, 2004.

The conditions upon which such governmental authorities will renew our authorization to abstract water from the Cantareira system are still unknown, and will only be disclosed on August 2004. If we are unable to negotiate any burdensome condition imposed by the State government we may be exposed to increase in costs and capital expenditures, which may negatively affect our results of operation.

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

On December 31, 2003, we had accounts receivables totaling R\$506.3 million from municipalities to which we provide water on a bulk basis. Of this amount, we estimate that approximately R\$63.2 million was between 90 and 360 days overdue and R\$382.1 million was more than 360 days overdue. In some cases, 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 receivables 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 do not pay amounts they owe us, our cash flows, results of operations and financial condition will be adversely affected.

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 have generally 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, 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%. In August 2003 we were able to raise our tariffs by 18.9%, except for the social and *favela* categories, which tariffs were increased by 9.0%. Also in August 2003 a new readjustment formula was approved by our Board of Directors. See "*Information on the Company – Customers – Tariffs*" below. 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\$4.3 billion in the period from 2004 through 2008, including approximately R\$883.0 million in 2004 and R\$880.0 million in 2005. 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. See "*Operating and Financial Review and Prospects - Liquidity and Capital Resources*" below.

Historically, a significant portion of our financing needs has been met by financing provided by lenders controlled by the federal government. To the extent the policies of the federal government regarding the financing of water and sewage services change, our ability to finance our capital expenditure program may be impaired.

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.

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\$517.4 million at December 31, 2003. 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 business.

Droughts and our water consumption reduction program may result in a decrease in the volume of water billed and the revenues 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. Brazil recently experienced a prolonged and severe drought, which commenced in 1999 and ended in 2001. As a result of this drought, 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. Throughout 2003 rain levels were again below average resulting in a weak replenishment of our reservoirs, particularly in the Cantareira System, the largest system of the Metropolitan Region of São Paulo. In order to minimize the effects of this drought, in March 2004 Sabesp approved a water consumption reduction incentive program based on a bonus system, pursuant to which customers who achieve their consumption reduction goal will be entitled to a 20% discount on their water bill. This incentive program is scheduled to last 6 months as from March 15, 2004 and will encompass most of the customers in the São Paulo Metropolitan Region supplied by the Metropolitan Aqueduct System. Although we expect our billing amount to decrease, we are unable to estimate the impact of this program on our revenues. We cannot assure you that any continuous drought in the future will not materially adversely affect our water supply and, accordingly, our business and results of operations.

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 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 Government. 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. 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\$403.8 million to cover losses related to legal proceedings considered probable. This provision does not cover, however, all legal proceedings involving monetary claims filed against us. Any unfavourable judgment in relation to these proceedings may have an adverse effect on our cash-flow and results of operation.

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 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, 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, 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 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:

- 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.

Brazil's President, Luiz Inacio Lula da Silva, was elected in October 2002 and took office on January 1, 2003. In the period leading up to and following his election, there was substantial uncertainty regarding the policies that the new government would pursue, including the potential implementation of macroeconomic policies that differed significantly from those of the prior administration. This uncertainty resulted initially in a loss of confidence in the Brazilian capital markets and the devaluation of the *real*. The new administration has, however, continued most of the former administration's economic and administrative policies and the initial adverse market sentiment towards the new administration has substantially reversed during 2003. Accompanying this positive sentiment the *real* appreciated 22.3% against the U.S. dollar in 2003. However, there remains some uncertainty over the possibility of different policies being adopted by the government which may, once again, contribute to economic uncertainty in Brazil and to heightened volatility in Brazilian securities. Any substantial negative reaction to the policies adopted by the Brazilian government from time to time could adversely affect the Company's business, condition (financial or other), revenues, results of operations and prospects and the market price of our common shares and ADSs.

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 2000, 2001 and 2002, the *real*

devalued 8.5%, 15.7%, 34.3% respectively, while appreciating 22.3% in 2003 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 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\$3,012.7 million on December 31, 2003, and we anticipate that we may incur substantial amounts of foreign currency-denominated indebtedness in the future. For example, our overall results of operations for 2003 were significantly positively affected by 65% due to the appreciation of the *real* against the U.S. dollar in 2003.

A devaluation would reduce the U.S. dollar value of distributions and dividends on our 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 equity and debt securities to fall.

Historically, Brazil experienced high rates of inflation. Inflation itself, as well as the governmental efforts to combat inflation, has 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 *Índice Geral de Preços de Mercado* (the General Price Index-Market, or the IGP-M), was 20.1% in 1999, 10.0% in 2000, 10.4% in 2001, 25.3% in 2002 and 8.7% in 2003. 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 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 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 of any Brazilian corporation under this law and cannot predict the circumstances in which this might happen.

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.

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, 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 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 subject to different corporate rules and regulations as a Brazilian company and holders may 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 State of Delaware or the State of New York, or in other jurisdictions outside Brazil. In addition, the rights of holders of our ADSs or common shares under the Brazilian corporation law to protect their 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.

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.

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 March 31, 2004, we had 28,479,577,827 common shares outstanding, including 20,376,674,058 shares held by the State of São Paulo. 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 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.

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

A holder may not be able to exercise the preemptive rights relating to the common shares underlying his or her 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 our 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, a holder may receive only the net proceeds from the sale of his or her preemptive rights by the depositary or, if the preemptive rights cannot be sold, they will be allowed to lapse.

A non-Brazilian holder of our ADSs may find it more difficult than our Brazilian shareholders do 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. 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.

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 as well as investors' responses to those conditions.

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 other emerging market countries. Accordingly, adverse developments in other emerging market countries could lead to a reduction in the demand for, and market prices of, our common shares and ADSs, as well as our debt securities.