

**3.B. Capitalization and Indebtedness**

Not applicable.

**3.C. Reasons for the Offer and Use of Proceeds**

Not applicable.

**3.D. Risk Factors****Risks Relating to Brazil**

***The Brazilian government has exercised, and continues to exercise, significant influence over the Brazilian economy. This involvement, as well as Brazilian political and economic conditions, could adversely affect us and the market price of our shares and ADSs.***

The Brazilian government frequently intervenes in the Brazilian economy and occasionally makes significant changes in policy and regulations. The Brazilian government's actions to control inflation and other policies and regulations have often involved, among other measures, increases in interest rates, changes in tax policies, price and tariff controls, currency devaluations, capital controls and limits on imports. Our business, financial condition and results of operations, as well as the market price of our shares or American Depositary Shares, or ADSs, may be adversely affected by changes in public policy at federal, state and municipal levels with respect to public tariffs and exchange controls, as well as other factors, such as:

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

Uncertainty over whether the Brazilian government will implement changes in policy or regulation affecting these or other factors in the future may contribute to economic uncertainty in Brazil and to heightened volatility in the Brazilian securities markets and in the securities issued abroad by Brazilian issuers, which could have a material adverse effect on us and on our shares and ADSs.

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

Brazil experienced extremely high rates of inflation in the past. Inflation and the Brazilian government's measures to fight inflation have had significant negative effects on the Brazilian economy, contributing to economic uncertainty and heightened volatility in the Brazilian securities markets. The Brazilian government's measures to control inflation have often included maintaining a tight monetary policy with high interest rates, thereby restricting the availability of credit and reducing economic growth. The Special Clearing and Settlement System (*Sistema Especial de Liquidação e Custódia*), or SELIC, the official overnight interest rate in Brazil, at the end of 2006, 2007, 2008 and 2009 was 13.19%, 11.18% and 13.66% and 8.65%, respectively in line with the target rate set by the Brazilian Committee on Monetary Policy (*Comitê de Política Monetária*), or COPOM.

The annual rate of inflation, as measured by the General Market Price Index (*Índice Geral de Preços-Mercado*), or IGP-M index, has fallen from 9.95% in 2000 to 3.83% in 2006, increased to 7.75% in 2007 and increased to 9.81% in 2008. In 2009, there was a 1.71% deflation according to the IGP-M. Brazilian governmental actions, including interest rate decreases, intervention in the foreign exchange market and actions to adjust or fix the value of the *real*, may trigger increases in inflation. If Brazil again experiences high inflation, our costs and expenses may rise, we may be unable to increase our tariffs to counter the effects of inflation, and our overall financial performance may be adversely affected. In addition, a substantial increase in inflation may weaken investors' confidence in Brazil, causing a decline in the market value of our shares or ADSs.

Additionally, in the event of an increase in inflation, the Brazilian government may choose to raise official interest rates. Increases in interest rates would not only affect our cost of funding, but could also have a material adverse effect on us and may also adversely affect the market value of our shares or ADSs.

***Exchange rate instability may adversely affect us and the market price of our shares or ADSs.***

The Brazilian currency experienced frequent and substantial devaluations in relation to the U.S. dollar and other foreign currencies during the last decades. Throughout this period, the Brazilian government has implemented various economic plans and utilized a number of exchange rate policies, including sudden devaluations, periodic mini-devaluations during which the frequency of adjustments has ranged from daily to monthly, floating exchange rate systems, exchange controls and dual exchange rate markets. From time to time, there have been significant fluctuations in the exchange rate between the Brazilian *real* and the U.S. dollar and other currencies. For example, the *real* depreciated against the U.S. dollar by 9.3% in 2000, 18.6% in 2001 and 52.25% in 2002. The *real* appreciated 11.81%, 8.66% and 17.15% against the U.S. dollar in 2005, 2006 and 2007, respectively. In 2008, the *real* depreciated by 30.1% and in 2009, appreciated by 25.5% against the U.S. dollar. There can be no assurance that the *real* will not further depreciate against the U.S. dollar. As of December 31, 2008, the exchange rate was R\$2.3370 per US\$1.00. As of December 31, 2009, the exchange rate was R\$1.7412 per US\$ 1.00. On April 22, 2010, the exchange rate was R\$1.7626 per US\$1.00.

In the event of a significant devaluation of the *real* in relation to the U.S. dollar or other currencies, our ability to meet our foreign currency-denominated obligations could be adversely affected, particularly because our tariff revenue and other sources of income are based solely in *reais*. In addition, because we have foreign currency-denominated indebtedness, any significant devaluation of the *real* will increase our financial expenses as a result of foreign exchange losses that we must record. We had total foreign currency-denominated indebtedness of R\$2,281.0 million and R\$1,746.4 million as of December 31, 2008 and 2009, respectively, and we anticipate that we may incur substantial amounts of foreign currency-denominated indebtedness in the future. In 2008, our results of operations were negatively affected by the 31.9% depreciation of the *real* against the U.S. dollar, which amounted to R\$438.9 million. In 2009, our results of operations were positively affected by the 25.5% appreciation of the *real* against the U.S. dollar, which amounted to R\$395.4 million. We do not currently have any hedging instruments in place to protect us against a devaluation of the *real* in relation to any foreign currency. A devaluation of the *real* may adversely affect us and the market price of our shares or ADSs.

***Developments and the perception of risk in other countries, especially in the United States and in emerging market countries, may adversely affect the market price of Brazilian securities, including our common shares and ADSs.***

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

The global financial crisis has had significant consequences, including in Brazil, such as stock and credit market volatility, unavailability of credit, higher interest rates, a general slowdown of the world economy, volatile exchange rates, and inflationary pressure, among others, which have and may continue to, directly or indirectly, materially and adversely affect our operating results, financial position and the price of securities issued by Brazilian companies.

***Changes in Brazilian GAAP for the convergence to IFRS may adversely impact our results.***

On December 28, 2007, the Brazilian government enacted law No. 11,638/07, as later supplemented by law No. 11,941/09, to amend Brazilian Corporate Law and introduce new accounting principles for the convergence of Brazilian GAAP to IFRS.

In 2009, the CPC issued several accounting standards approved by the CVM and the CFC, which are mandatory to all Brazilian publicly-held companies in 2010, including a retroactive application on financial statements for the year ended December 31, 2009, which will be presented for comparative purposes.

We are in the process of evaluating the potential effects of adoption of these new accounting rules, interpretations and guidelines, which may have a material impact on our financial statements, our profit and our dividends for the year ending December 31, 2010 and also for the year ended December 31, 2009, when presented for comparative purposes.

***Risks Relating to Our Control by the State of São Paulo***

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

The State of São Paulo, through its ownership of our common shares, has the ability to determine our operating policies and strategy, to control the election of a majority of the members of our board of directors and to appoint our senior management. As of April 22, 2010, the State owned 50.3% of our outstanding common shares.

The State has directed from time to time in the past, and may direct in the future, through its control of our board of directors, that we engage in certain business activities and make certain expenditures that promote political, economic or social goals but that do not necessarily also enhance our business and results of operations. See "Item 5.A. Operating and Financial Review and Prospects—Factors Affecting Our Results of Operations."

Newly elected Governors of the State typically make significant changes in our board of directors and senior management and, historically, the chairman of our board of directors has been the Secretary of State for the State Secretariat for Sanitation and Energy (*Secretaria de Saneamento e Energia do Estado de São Paulo*).

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

Historically, the State and some State entities have had substantial overdue accounts payable to us relating to (i) the provision of water and sewage services and (ii) State-mandated special retirement and pension payments that we make to some of our former employees for which the State is required to reimburse us. As of December 31, 2008 and 2009, the amounts owed to us by the State for the provision of water and sewage services totaled R\$234.3 million and R\$169.5 million, respectively. With respect to payment of pensions on behalf of the State, as of December 31, 2008 the State owed to us R\$1,365.7 million, of which we made provisions for loss in the amount of R\$409.1 million, due to the current stage of the negotiations with the State and the uncertainty regarding the recovery of the amount. As of December 31, 2009, the State owed to us R\$1,394.7 million with respect to payment of pensions on behalf of the State, of which we made provisions for loss in the amount of R\$471.6 million. Amounts owed to us by the State for water and sewage services and reimbursements for pensions paid may increase in the future.

We have entered into agreements with the State to settle these overdue amounts payable to us. For a detailed discussion of these agreements, see *“Item 7.B. Related Party Transactions,”* and Note 6 to our financial statements. Pursuant to these agreements, the amounts due with respect to water and sewage services could be settled through the application of dividends payable to the State by us to the repayment of amounts owed to us through December 2007. In December 2007, the State agreed to pay us the outstanding balance in the amount of R\$133.7 million (as of November 30, 2007), in 60 consecutive monthly installments, beginning on January 2, 2008, and the amount of R\$236.1 million relating to part of the accounts overdue and unpaid from March 2004 through October 2007 regarding the provision of water supply and sewage collection services. We agreed to pay the State the outstanding balance of dividends, in the form of interest on shareholders’ equity, due from March 2004 through December 2006, in the amount of R\$400.8 million, in the period from January through March 2008. In March 2008, we entered into a commitment agreement with the State for the settlement of outstanding debts related to the reimbursement of pension benefits. Pursuant to the commitment agreement, the amounts due to us with respect to payments of pensions on behalf of the State may be partially settled through the transfer to us of certain reservoirs in the Alto Tietê System that we use and are owned by the State. In November 2008, we entered into an Agreement with the State relating to payments of pension benefits made by us on its behalf. The State acknowledged that it owed to us R\$915.3 million (as of September 30, 2008) relating to payments of pension benefits made by us on its behalf. We accepted on a temporary basis the reservoirs in the Alto Tietê System as part of the payment in the amount of R\$696.3 million until the State transfers the property rights on the reservoirs to us. Since November 2008, the State has been paying the remaining balance in the amount of R\$219.0 million in 114 successive monthly installments, starting in November 2008. We are unable to predict whether and when these reservoirs will be transferred to us because the Public Prosecution Office of the State of São Paulo (*Ministério Público do Estado de São Paulo*) filed a civil public action alleging that a transfer to us of ownership of the Alto Tietê System reservoirs is illegal. See *“Item 8.A. Consolidated Statements and other Financial Information—Legal Proceedings—Other Legal Proceedings.”* The agreement also established that the parties should endeavor their best efforts to settle the outstanding balance due to us by the State in the amount of R\$450.4 million and we were expecting the State to recognize that it owed to us this amount. While we continue to negotiate directly with the State, we are not able to assure you that we will be successful in these negotiations. Accordingly, in 2008, we recorded a R\$409.1 million provision for losses and a R\$535.4 million provision for actuarial liability.

We cannot assure you when or if the State will pay the total overdue amounts owed to us. Due to the State’s history of not making timely payments to us in respect of services and of not reimbursing us in a timely manner for the payments of pensions on behalf of the State, we cannot assure you that the amount of accounts receivable owed to us by the State and some State entities will not significantly increase in the future.

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

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

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

***We cannot anticipate the effects that further developments of the Basic Sanitation Law and its interpretation will have on the basic sanitation industry in Brazil and on us.***

The Basic Sanitation Law was enacted on January 5, 2007. While it has been in effect for more than three years, it is still at early stages of implementation in Brazil and we continue to be unable to anticipate all the effects that it might have on our operations and business. There are still several uncertainties related to the Basic Sanitation Law interpretation. It is likely that the federal government will enact a presidential decree to regulate certain issues that remain unclear under the Basic Sanitation Law. We cannot anticipate what issues the presidential decree might regulate nor the effects that it would have on our business and operations, if any. If the federal government enacts a decree that contains unfavorable terms to us, we could have a material adverse effect.

In addition, the new regulatory agency of the State of São Paulo for the basic sanitation industry, the ARSESP, has so far regulated our tariff structure and adjustments according to the same structure and adjustment formula that we ordinarily follow. Pursuant to a cooperation agreement among the State and some municipalities, the ARSESP also regulates our tariffs in municipalities that selected ARSESP to perform the task of regulating our tariffs. Since 2008, the ARSESP has been developing new concepts that might be included in the tariff structure and adjustment formula. The ARSESP expects to release a revised tariff structure and adjustments formula in 2011. We cannot anticipate additional changes that the ARSESP will implement on our tariff structure and adjustment formula nor the effects that these changes will have on us, in particular because our contractual rights under the concession agreements may not fully protect us due to its general open-ended nature. If the changes are unfavorable to us, we could have a material adverse effect. Moreover, the ARSESP also enacted certain rules establishing (i) the general conditions for the services we render, (ii) the communication process for any failure in our services and (iii) the penalties for deficiencies in the services. We are currently evaluating the enforceability and legality of these rules. The compliance with the rules enacted by ARSESP may adversely affect us.

Finally, under the Basic Sanitation Law we are required to have enforceable contractual arrangements with every municipality we serve by December 31, 2010. We may not be in a position to comply with this requirement depending on the final decision of the Brazilian Supreme Court with respect to the titularity of the basic sanitation services in the metropolitan regions. However, the Basic Sanitation Law does not provide for any penalty or fine in case of non-compliance with this legal requirement. If any penalty or fine is duly imposed on us due to our non-compliance with this legal requirement, we could have a material adverse effect. We are currently renegotiating 82 concession agreements with municipalities located outside the São Paulo metropolitan regions that expired since 2005. From 2010 through 2030, 80 concession agreements will expire. In addition, we do not hold formal concessions to provide water and sewage services to 32 municipalities located in metropolitan regions, including the city of São Paulo.

***Our revenues depend mainly on the water and sewage services we render to the city of São Paulo. We do not hold formal concession agreements to provide these services to the city of São Paulo and several other municipalities that we serve, and therefore may not be able to enforce our rights to continue to provide services in these municipalities.***

Our operations are concentrated in the city of São Paulo, with which we have not entered into a concession agreement. In the year ended December 31, 2008, the city of São Paulo accounted for 55.5% of our gross revenues and, as of December 31, 2008, 67.3% of our total assets. In addition, we do not hold formal concessions in 31 other municipalities in the State of São Paulo, including the municipality of Santos, which is located in the coastal region and has, as of December 31, 2009, a population of approximately 429,000 people, where we operate under a deed of authorization (*escritura pública de autorização*).

Because we do not hold concessions or contractual rights to provide services in some of these municipalities, we may not be able to effectively enforce our right to continue to provide services or face difficulties in being timely paid for the services 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 municipal governmental actions, judicial decisions 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 agreement with us to provide water and sewage services in the city of São Paulo. For a detailed discussion of these initiatives, see *"Item 4.B. Business Overview—Government Regulation—Concessions."*

The Basic Sanitation Law sets December 31, 2010 as the deadline for water and sewage service companies, such as us, to regularize the provision of water and sewage services to municipalities, in case there is no formal concession agreement to provide services to municipalities. We cannot anticipate the terms and conditions of these concession agreements and their effect on the provision of our services in these municipalities.

In addition, it remains uncertain whether state or municipal governments have the authority to plan and regulate basic sanitation services rendered to metropolitan regions, as well as the right to execute concession and program agreement. This issue is under discussion at the Brazilian Supreme Court, in a suit initiated by third parties. If the Brazilian Supreme Court grants this authority to municipal governments, under certain circumstances, we may be required to cease our operations in certain areas of the São Paulo metropolitan region in the event that certain municipalities opt to use another water and sewage service provider. This uncertainty also creates an obstacle for us to enter into formal agreements with city of São Paulo because we are unable to anticipate which governmental authority will be deemed to have the authority to do so.

On November 14, 2007, we entered into an agreement with the city of São Paulo to establish the conditions for the provision of water and sewage services, and environmental utility services in the city of São Paulo. The scope of this agreement may be limited by the Brazilian Supreme Court, but it will remain effective with respect to the services that remain under the authority of the city of São Paulo. In December 2008, the São Paulo city council approved in an initial vote the proposed law No. 558/08, which authorizes the Executive Power to legally bind the city of São Paulo to an agreement with ARSESP and us in order to ensure stability in the rendering of services. This project was approved in the first week of June 2009, authorizing the Executive Power to execute the agreement for a 30-year period. This period can be extended for an additional 30-year period. However, we will be required to offer minimum guarantees and certain services to the city of São Paulo, as part of the provision of water and sewage services. See *“Item 4.B. Business Overview—Our Operation—Operations in the São Paulo Metropolitan Region and Other Metropolitan Regions.”* A draft of the agreement was submitted to a public hearing. We cannot anticipate the final results of the public hearing or when the agreement will be executed.

We cannot assure you when or whether there will be changes to the conditions under which we currently provide water and sewage services to these municipalities with which we do not hold formal concession agreements. We cannot anticipate the effects of the Brazilian Supreme Court decision on the provision of our services in the city of São Paulo and in these other municipalities located in metropolitan regions, either of which may cause a material adverse effect on us.

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

Our industry is specifically affected by the following risks associated with the provision of water and sewage services:

- we may become subject to substantial water-related and sewage-related charges imposed by governmental water agencies of the State and of the federal government related to the abstraction of water from, or dumping of sewage into, water resources controlled by these agencies, which we may not be able to pass on to our customers. See *“Item 4.B. Business Overview—Government Regulation—Water Usage”*;

- the degradation of watershed areas may affect the quantity and quality of water available to meet our customers’ demand. See *“Item 4.A History and Development Of the Company – Capital Expenditure Program”*;

- our tariffs may not increase in line with increases in inflation and operating expenses, including taxes, or increase in a timely manner, which may hinder us from passing on to our customers increases in our cost structure. These constraints may also have an adverse effect on our capability to fund our capital expenditure program and financing activities, and to meet our debt service requirements. See *“Item 5.A. Operating and Financial Review and Prospects—Factors Affecting Our Results of Operations—Effects of Tariff Increases”*;

- in some cases, we are required to continue providing services to certain municipalities to which we provide water on a wholesale basis that have overdue amounts owed to us and are not paying us on a regular basis and we cannot assure you of when or whether these municipalities will pay us in a timely manner;

- we are exposed to eventual droughts that may adversely affect our water supply systems, resulting in a decrease in the volume of water distributed and billed as well as in the revenue derived from water supply distribution services. See *“Item 5.A. Operating and Financial Review and Prospects—Factors Affecting Our Results of Operations—Effects of Drought”*; and

- we are dependent upon energy to conduct our operations and eventual shortages or rationing of energy may prevent us from providing water and sewage services and may also cause material damage to our water and sewage systems when we resume operations. Also, we may not be able to pass on to our customers significant increases in energy tariffs.

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

***We may face difficulties in continuing to provide water and sewage services in the municipalities we serve and we cannot assure you that these municipalities will continue to require our provision of services under the same terms.***

At the end of 2008 and 2009, we were a provider of water and sewage services to 365 and 366 municipalities, respectively. Since 2007, we have entered into 174 30-year term program agreements with municipalities, of which 14 were entered into in 2009. These 174 municipalities accounted for 8.2% of our total revenues for the year ended December 31, 2009 and 8.7% of our total assets as of December 31, 2009. By December 31, 2009, 82 of our concession agreements had expired and are under renegotiation. These 82 municipalities accounted for 12.1% of our total revenues for the year ended December 31, 2009 and 12.9% of our total assets as of December 31, 2009. From 2010 to 2030, 80 concession agreements will expire. These 80 concession agreements accounted for 9.1% of our total revenues for the year ended December 31, 2009 and 6.4% of our total assets as of December 31, 2009. The remaining 32 concession agreements have indefinite terms and account for 65.7% of our total revenues for the year ended December 31, 2009 and 72.0% of our total assets as of December 31, 2009.

We cannot assure that these municipalities will continue to require our services and enter into new concession agreements or program agreements with us. These municipalities may choose to assume the direct provision of water and sewage services or promote a public bidding process to select another water and sewage service provider. Depending on the eligibility requirements to participate in the public bidding processes, we may not qualify to participate in some or all of these public bidding processes. If we participate in these public bidding processes, we cannot assure you that we will win the bid.

In case we are successful in renegotiating our concession agreements or entering into program agreements with the municipalities whose concession agreements expired or will expire, we cannot assure you that the new concession or program agreements will have the same terms under which we currently provide services to these municipalities because the Basic Sanitation Law prevents us from planning, regulating and monitoring our services and it requires more stringent control by the municipalities or by the ARSESP.

In case certain municipalities assume the direct provision of water and sewage services or promote a public bidding process to select another water and sewage service provider, or the new terms or conditions of the concession or program agreements are less favorable to us, we may be materially and adversely affected. See “Item 4.B. Business Overview—Our Operations” and “Item 4.B. Business Overview—Government Regulation—Public Consortia Law and Cooperation Agreement for Joint Management.”

***Municipalities may, under certain circumstances, terminate our concessions before their expiration and the indemnification may be inadequate to recover the full value of our investments.***

The concessions we hold are subject to early termination provisions, which entitle municipalities to terminate our concessions prior to their expiration date under certain circumstances. Municipalities may terminate our concessions if we fail to comply with our obligations under the relevant concession agreement or applicable law, or if the municipality determines, through an expropriation proceeding, that terminating our concession prior to its expiration date is in the public interest. If any municipality terminates our concession before the expiration date, we are entitled to be indemnified for the unamortized portion of our investments, but the indemnification may not be sufficient for us to recover the full value of our investments. Further, under the terms of the Constitution of the State of São Paulo, municipalities may pay the indemnification over a term of 25 years. However, the Brazilian Supreme Court stayed the application of this provision of the Constitution of the State of São Paulo in 1997 and the decision remains valid until final judgment.



In 1997, the municipality of Santos enacted a law expropriating our water and sewage systems in Santos. There are pending legal proceedings discussing the expropriation carried out by this municipality. In 1995, the municipality of Diadema terminated the concession agreement that had been entered into with us prior to the expiration of the concession agreement. We and the municipality of Diadema settled the lawsuit in 1996, but the municipality of Diadema did not comply with this settlement. In December 2008, we entered into a memorandum of understanding with the State of São Paulo, the municipality of Diadema and State Secretariat for Sanitation and Energy (Secretaria de Saneamento e Energia do Estado de São Paulo). This memorandum establishes our agreement to conclude negotiations and settle all outstanding amounts. In addition, it indicates our intent to develop a share infrastructure for the provision of water and sewage services. This memorandum of understanding stayed the collection proceedings we had filed against the municipality of Diadema. We continue to provide water and sewage services to the city of Santos and supply water on a wholesale basis to the city of Diadema. For further information on these lawsuits, see “Item 8.A. Consolidated Statements and other Financial Information—Legal Proceedings.”

We cannot assure you that other municipalities will not seek to terminate their concession agreements before the contractual expiration date. The early termination of concession agreements by municipalities, our inability to receive adequate indemnification for the investments we made, or the payment of indemnification due to us over a long period, may have a material adverse effect on us.

The Basic Sanitation Law has established new provisions governing the indemnification of water and sewage service providers in case of early termination of concession agreements by a municipality and reduced the term over which indemnification must be paid to four years. These provisions may also be applicable to concession agreements entered into prior to the enactment of the Basic Sanitation Law, as long as these concession agreements do not have a contractual indemnification provision in case of early termination. Nevertheless, we cannot anticipate the effects of the new Basic Sanitation Law on the amount of, and enforceability of the right to, indemnification and how Brazilian courts will enforce the provisions of the Basic Sanitation Law.

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

Our capital expenditure program will require substantial liquidity and capital resources of approximately R\$8.6 billion in the period from 2009 through 2013. We recorded R\$1.7 billion and R\$1.8 billion in 2008 and 2009, respectively, with our capital expenditure program.

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

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

We are also subject to financial covenants limiting our ability to incur additional indebtedness, whether denominated in *reais* or foreign currency. For further information on these covenants, see “Item 5.B. Operating and Financial Review and Prospects.” These financial covenants may prevent us from completing our capital expenditure program, which could have a material adverse effect on us.



***We are subject to cost increases to comply with environmental law requirements and potential environmental liability that could have a material adverse effect on us.***

Our facilities are subject to extensive Brazilian federal, state and municipal laws and regulations and environmental covenants relating to the protection of human health and the environment. These laws and regulations limit or prohibit emissions or spills of effluents and toxic substances, such as raw sewage, produced in connection with our operations. Current and past disposal and emissions practices may result in the need for us to clean up or retrofit our facilities at substantial costs and could result in substantial liabilities. We could be subject to civil public actions and criminal, administrative and other civil proceedings for non-compliance with environmental laws and regulations, which could expose us to civil penalties and criminal sanctions, such as fines, closure orders and significant indemnification obligations. Since environmental laws and their enforcement by Brazilian authorities are becoming more stringent, our capital expenditures and expenses for environmental compliance may increase substantially. Expenditures required for compliance with environmental laws and regulations may result in reductions in other strategic investments that we have planned, which could negatively affect us. We are a party to a number of civil public actions related to environmental matters, with regard to which we are unable to calculate our estimated amount of potential liability. In addition, due to more stringent enforcement of environmental laws by Brazilian courts, we may be required to pay substantial fines and indemnifications in amounts that may vary widely from those currently anticipated. Any unfavorable judgment in relation to these proceedings or any material unforeseen environmental liabilities may have a material adverse effect on us. For further information on these lawsuits, see "Item 8.A. Consolidated Statements and other Financial Information—Legal Proceedings."

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

We are a party to a number of legal proceedings involving significant monetary claims. These legal proceedings include, among others, civil, environmental, tax, labor, condemnation and other proceedings. A substantial monetary judgment against us in one or more of these legal proceedings may have a material adverse effect on us. Based on advice from our legal counsel, we have provisioned a total aggregate amount of R\$1,468.8 million as of December 31, 2009 to cover probable losses related to legal proceedings. This provision does not cover all legal proceedings involving monetary claims filed against us and it may be insufficient to cover our liabilities related to these claims. Any unfavorable judgment in relation to these proceedings may have a material adverse effect on us. For more information, see "Item 8.A. Consolidated Statements and other Financial Information—Legal Proceedings."

#### **Risks Relating to Our Common Shares and ADSs**

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

Investing in securities that trade in emerging markets, such as Brazil, often involves greater risk than investing in securities of issuers in major securities markets, and these investments are often considered to be more speculative in nature. The Brazilian securities market is substantially smaller, less liquid, more concentrated and can be more volatile than major securities markets. Accordingly, although you are entitled to withdraw the common shares underlying the ADSs from the depositary at any time, your ability to sell the common shares underlying the ADSs at a price and time at which you wish to do so may be substantially limited. There is also significantly greater concentration in the Brazilian securities market than in major securities markets. The ten largest companies in terms of market capitalization represented approximately 50.4% of the aggregate market capitalization of the BM&FBOVESPA as of December 31, 2009. The top ten stocks in terms of trading volume accounted for approximately 45.8%, 53.14% and 50.4% of all shares traded on the BM&FBOVESPA in 2007, 2008 and 2009, respectively.

***Investors who exchange ADSs for common shares may lose their ability to remit foreign currency abroad and to obtain Brazilian tax advantages.***

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

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

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

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

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

Under our by-laws, any disputes among us, our shareholders and our management with respect to the application of *Novo Mercado* rules, Brazilian Corporate Law and the application of the rules and regulations regarding Brazilian capital markets will be resolved by arbitration conducted pursuant to the BM&FBOVESPA Arbitration Rules in the Market Arbitration Chamber. Any disputes among shareholders, including ADR holders, and disputes between us and our shareholders, including ADR holders, will also be submitted to arbitration. As a result, a court in the United States might require that a claim brought by an ADR holder predicated upon the U.S. securities laws be submitted to arbitration in accordance with our by-laws. In that event, a purchaser of ADSs would be effectively precluded from pursuing remedies under the U.S. securities laws in the U.S. courts.

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

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

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

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