

COMPANHIA DE SANEAMENTO BASICO DO ESTADO DE SAO PAULO-SABESP  
Form 20-F  
July 11, 2008

---

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 20-F**

**REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

**OR**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2007**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ or \_\_\_\_\_**

**OR**

**SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**Date of event requiring this shell company report \_\_\_\_\_**

**Commission file number 001-31317**

**Companhia de Saneamento Básico  
do Estado de São Paulo-SABESP**

(Exact name of Registrant as specified in its charter)

**Basic Sanitation Company  
of the State of São Paulo-SABESP**

(Translation of the Registrant's name into English)

**Federative Republic of Brazil**

(Jurisdiction of incorporation or organization)

**Rua Costa Carvalho, 300**

**05429-900 São Paulo, SP, Brasil**

(Address of principal executive offices)

**Rui de Britto Álvares Affonso**

**[raffonso@sabesp.com.br](mailto:raffonso@sabesp.com.br)**

**(+55 11 3388 8247)**

**Rua Costa Carvalho, 300 05429-900 São Paulo, SP, Brasil**

**Securities registered or to be registered pursuant to Section 12(b) of the Act:**

**Title of each class**

**Name of each exchange on which registered**

Common Shares, without par value  
American Depositary Shares, evidenced by American  
Depositary  
Receipts, each representing 2 Common Shares<sup>(1)</sup>

New York Stock Exchange\*

New York Stock Exchange

\* Not for trading purposes, but only in connection with the registration of American Depositary Shares pursuant to the requirements of the Securities and Exchange Commission.

(1) Until June 8, 2007, American Depositary Shares, evidenced by American Depositary Receipts, each representing 250 Common Shares.

**Securities registered or to be registered pursuant to Section 12(g) of the Act: None**

**Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act: None**

**Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the annual report.**

227,836,623 Common Shares, without par value, as of December 31, 2007

**Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.**

Yes No

**If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**

Yes No

**Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.**

Yes No

**Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):**

Large accelerated filer Accelerated filer Non-accelerated filer

**Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:**

U.S. GAAP International Financial Reporting Standards as issued by the International Accounting Standards Board Other

**If "Other" has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow**

Item 17 Item 18

**If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).**

Yes

No

---

## TABLE OF CONTENTS

<u>Presentation of Financial Information</u>	<u>2</u>
<u>Forward-Looking Statements Contained in this Annual Report</u>	<u>4</u>
<u>PART I</u>	<u>5</u>
<u>ITEM 1. Identity of Directors, Senior Management and Advisers</u>	<u>5</u>
<u>ITEM 2. Offer Statistics and Expected Timetable</u>	<u>5</u>
<u>ITEM 3. Key Information</u>	<u>5</u>
<u>ITEM 4. Information on the Company</u>	<u>21</u>
<u>ITEM 4A. Unresolved Staff Comments</u>	<u>56</u>
<u>ITEM 5. Operating and Financial Review and Prospects</u>	<u>57</u>
<u>ITEM 6. Directors, Senior Management and Employees</u>	<u>82</u>
<u>ITEM 7. Major Shareholders and Related Party Transactions</u>	<u>89</u>
<u>ITEM 8. Financial Information</u>	<u>95</u>
<u>ITEM 9. The Offer and Listing</u>	<u>104</u>
<u>ITEM 10. Additional Information</u>	<u>109</u>
<u>ITEM 11. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>123</u>
<u>ITEM 12. Description of Securities Other than Equity Securities</u>	<u>125</u>
<u>PART II</u>	<u>125</u>
<u>ITEM 13. Defaults, Dividend Arrearages and Delinquencies</u>	<u>125</u>
<u>ITEM 14. Material Modifications to the Rights of Security Holders and use of Proceeds</u>	<u>125</u>
<u>ITEM 15. Controls and Procedures</u>	<u>125</u>
<u>16.A. Audit Committee Financial Expert</u>	<u>128</u>
<u>16.B. Code of Ethics</u>	<u>129</u>
<u>16.C. Principal Accountant Fees and Services</u>	<u>129</u>
<u>16.D. Exemptions from the Listing Standards for Audit Committees</u>	<u>129</u>
<u>16.E. Purchases of Equity Securities by Issuer and Affiliated Purchases</u>	<u>129</u>
<u>PART III</u>	<u>130</u>
<u>ITEM 17. Financial Statements</u>	<u>130</u>
<u>ITEM 18. Financial Statements</u>	<u>130</u>
<u>ITEM 19. Exhibits</u>	<u>130</u>
<u>Signatures</u>	<u>132</u>
<u>Index to Financial Statements</u>	

## PRESENTATION OF FINANCIAL INFORMATION

In this annual report, references to *real*, *reais* or R\$ are to the Brazilian *real*, the official currency of Brazil. All references to U.S. dollars or US\$ are to United States dollars. Solely for the convenience of the reader, we have translated some of the *real* amounts contained in this annual report into U.S. dollars at a rate equal (unless otherwise indicated) to R\$1.7713 to US\$1.00, the commercial selling rate as of December 31, 2007 as reported by the Central Bank of Brazil, or the Central Bank. As a result of the recent fluctuations in the *real*/U.S. dollar exchange rate, the commercial selling rate may not be indicative of current or future exchange rates. Therefore, you should not read these translations as representations that any such amounts have been, could have been or could be converted into U.S. dollars at that or at any other exchange rate. See *Item 3.A. Selected Financial Data Exchange Rates* for information regarding exchange rates allocable to the Brazilian currency since January 1, 2002.

Our audited financial statements as of December 31, 2006 and 2007 and for the years ended December 31, 2005, 2006 and 2007 are included in this annual report. The financial statements as of and for the years ended December 31, 2005, 2006 and 2007 have been audited by Deloitte Touche Tohmatsu Auditores Independentes, São Paulo, Brazil. The selected financial data as of December 31, 2003 and 2004 is derived from our financial statements audited by Deloitte Touche Tohmatsu Auditores Independentes for the year ended December 31, 2003 and 2004, both included in previously filed annual reports.

Our audited financial statements are presented in *reais* and are prepared in accordance with the Brazilian Corporate Law Method, which is based on Brazilian Corporate Law (Law No. 6,404/76, as amended), the rules and regulations issued by the Brazilian Securities Commission (*Comissão de Valores Mobiliários*), or CVM, and the accounting standards issued by the Brazilian Institute of Independent Auditors (*Instituto dos Auditores Independentes do Brasil*), or IBRACON, hereinafter referred to as the Brazilian Corporate Law Method.

Like other Brazilian companies, we have the option of presenting our primary financial statements on the basis of accounting principles established in accordance with the Brazilian Corporate Law Method with a reconciliation to generally accepted accounting principles in the United States of America, or U.S. GAAP. Unless otherwise indicated, our financial statements and all financial data included in this annual report have been prepared in accordance with the Brazilian Corporate Law Method.

The Brazilian Corporate Law Method differs in significant respects from U.S. GAAP. Note 26 to our financial statements provides a description of the differences between the Brazilian Corporate Law Method and U.S. GAAP as they relate to our financial statements and a reconciliation from the Brazilian Corporate Law Method to U.S. GAAP, for periods presented therein, of our net income and shareholders' equity. The reconciliation from the financial statements prepared in accordance with the Brazilian Corporate Law Method to U.S. GAAP includes, among others, adjustments for differences related to the accounting for past revaluations of property, plant and equipment, historical inflation accounting and accounting for pension and other employee benefits.

All information related to liters, water and sewage volumes, number of employees, kilometers, water and sewage connections, population served, operating productivity, water production rate, sewage lines (in kilometers), savings achieved and investments in improvement programs have not been audited.

### Other Information

We do not have any subsidiaries.

In this annual report, unless the context otherwise requires, references to we, us, our, Company, or Sabesp refer to Companhia de Saneamento Básico do Estado de São Paulo Sabesp. Brazil refers to the Federative Republic of Brazil

and State refers to the State of São Paulo, which is also our controlling shareholder. The phrases Federal Government and Brazilian government refer to the federal government of the Federative Republic of Brazil and State government refers to the state government of the State of São Paulo.

Table of Contents

In this annual report, we refer to the São Paulo Metropolitan Region, the area where the Metropolitan Executive Office operates, comprising 38 municipalities, including the City of São Paulo. We refer to the Regional Systems, the area where the Regional Systems Executive Office operates, comprising 328 municipalities in the interior and coastline regions of the State of São Paulo. As of the date of this annual report, we provide water supply and sewage services to a total of 366 of the 645 municipalities in the State of São Paulo.

References to Water Coverage Ratio in this annual report mean the ratio between the number of residences connected to the water supply network, divided by the number of urban residences in a certain area. References to Sewage Coverage Ratio mean the ratio between the number of residences connected to the sewage collection network, divided by the number of urban residences in a certain area.

References to urban and total population in this annual report are estimated based on a research made by State System Foundation Data Analysis (*Fundação Sistema Estadual de Análise de Dados - SEADE*): Projections for the State of São Paulo - Population and Residences until 2025 ( *Projeções para o Estado de São Paulo - População e Domicílios até 2025* ).

**FORWARD-LOOKING STATEMENTS CONTAINED IN THIS ANNUAL REPORT**

This annual report includes forward-looking statements, principally in Items 3 through 5. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends affecting our business. These forward-looking statements are subject to risks, uncertainties and assumptions, including, among other things:

- general economic, political and other conditions in Brazil and in other emerging market countries;
- existing and future governmental regulation, including taxes on, and charges to, us;
- changes to tax laws in Brazil;
- inflation and currency devaluation in Brazil;
- the interests of our controlling shareholder, the State of São Paulo;
- our ability to collect amounts owed to us by our controlling shareholder and by municipalities;
- our ability to continue to use certain reservoirs within the present terms and conditions;
- our ability to continue to be able to pass on to our tariffs expenses that we incur in connection with the use of water;
- our capital expenditure program and other liquidity and capital resources requirements;
- limitations on our ability to increase and readjust tariffs;
- droughts, water shortages and climate events;
- power shortages or rationing in energy supply or significant changes in energy tariffs;
- our lack of formal concessions for the City of São Paulo and other municipalities including the cities comprising the São Paulo Metropolitan Region;
- municipalities' power to terminate our existing concessions;
- our ability to provide water and sewage services in additional municipalities and to maintain current rights to provide such services;
- the size and growth of our customers' base;
- our ability to maintain universalization of Water Coverage in the municipalities to which we provide water services and to increase Sewage Coverage Ratio;
- our ability to gain access to attractive financing in the future;
- our level of indebtedness and limitations on our ability to incur additional indebtedness;
- our costs relating to compliance with environmental laws and potential penalties for failure to comply with these laws;
- the outcome of our pending or future legal proceedings;
- our management's expectations and estimates concerning our future financial performance;
- the creation of the São Paulo State Sanitation and Energy Regulatory Agency - ARSESP and its impacts;
- other risk factors as set forth under *Item 3.D. Risk Factors*.

The words believe, may, will, estimate, continue, anticipate, plan, intend, expect and similar words identify forward-looking statements. In light of these risks and uncertainties, the forward-looking events and circumstances discussed in this annual report might not occur. Our actual results could differ substantially from those anticipated in our forward-looking statements. Forward-looking statements speak only as of the date they were made and we do not undertake the obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, unless required by law. Any such forward-looking statements are not guarantees of future performance and involve risks.

**PART I**

**ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS**

**1.A. Directors and Senior Management**

Not applicable.

**1.B. Advisers**

Not applicable.

**1.C. Auditors**

Not applicable.

**ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

**2.A. Offer Statistics**

Not applicable.

**2.B. Method and Expected Timetable**

Not applicable.

**ITEM 3. KEY INFORMATION**

**3.A. Selected Financial Data**

The data in this section as of December 31, 2006 and 2007 and for each of the three years ended December 31, 2007 have been derived from our audited financial statements, which appear elsewhere in this document. The selected financial data as of December 31, 2003, 2004 and 2005, and for each of the two years ended December 31, 2004 have been derived from our audited financial statements, which do not appear elsewhere in this document.

Our financial statements have been prepared in accordance with the Brazilian Corporate Law Method, which differs in significant respects from U.S. GAAP (see note 26 to our financial statements). You should read this selected financial data in conjunction with our financial statements and the related notes thereto included in this annual report. Solely for the convenience of the reader, *real* amounts as of and for the year ended December 31, 2007 have been translated into U.S. dollars at the selling rate as of December 31, 2007 of R\$1.7713 per US\$1.00.

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

**As of and for the year ended December 31,**

**2003                      2004                      2005                      2006                      2007**

**(in millions, except per share and per ADS data)**

**Brazilian Corporate Law Method**

	<b>R\$</b>	<b>R\$</b>	<b>R\$</b>	<b>R\$</b>	<b>R\$</b>	<b>US\$</b>
<b>Statement of operations data:</b>						
Net revenue from sales and services	4,130.8	4,397.1	4,953.4	5,527.3	5,970.8	3,370.9
Cost of sales and services	(2,067.1)	(2,253.4)	(2,376.4)	(2,616.8)	(2,695.7)	(1,521.9)
Gross profit	2,063.6	2,143.7	2,577.0	2,910.5	3,275.1	1,849.0
Selling expenses	(297.5)	(502.5)	(537.8)	(719.2)	(639.6)	(361.1)
Administrative expenses	(254.1)	(313.6)	(349.6)	(387.4)	(559.2)	(315.7)
Financial income (expenses), net	(346.5)	(503.7)	(447.0)	(563.3)	(560.9)	(316.7)
Income from operations <sup>(1)</sup>	1,165.5	823.9	1,242.6	1,240.6	1,515.4	855.5
Non-operating income (expenses), net	(54.5)	(33.9)	(25.4)	(50.9)	(35.1)	(19.9)
Income before taxes on income	1,111.1	790.0	1,217.2	1,189.7	1,480.3	835.6
Income tax and social contribution	(242.6)	(241.9)	(316.5)	(375.7)	(431.6)	(243.6)
Extraordinary item, net of income and social contribution taxes <sup>(2)</sup>	(35.1)	(35.1)	(35.1)	(35.1)	-	-
Net income	833.3	513.0	865.6	778.9	1,048.7	592.0
Net income per 1,000 common shares (per share in 2007)*	29.26	18.01	30.40	27.35	4.60	2.60
Net income per ADS	7.32	4.50	7.60	6.84	9.20	5.20
Dividends and interest on shareholders equity per 1,000 common shares (per share in 2007)*	17.70	5.37	12.23	9.51	1.32	0.75
Number of common shares outstanding at year end (in thousands of shares) <sup>(9)</sup> *	28,479,578	28,479,578	28,479,578	28,479,578	227,836	227,836
<b>Balance sheet data:</b>						
Cash and cash equivalents	281.0	105.6	280.2	328.2	465.0	262.5
Customer accounts receivables, net	1,056.2	1,227.9	1,332.5	1,407.9	1,486.7	839.3
Reimbursement for pension benefits paid	491.0	576.3	672.7	774.5	879.1	496.3
Short and long-term receivables from shareholders, net <sup>(3)</sup>	164.2	245.6	420.4	456.9	446.4	252.0

\*After June 4, 2007 our common shares have been traded considering a reverse stock split of 125 common shares into one common share. To convert from *Reais* per 1,000 common shares to *Reais* per share, for 2003, 2004, 2005 and 2006 the price per 1,000 common shares must be divided by 1,000 and multiplied by 125.

Table of Contents**As of and for the year ended December 31,**

	2003	2004	2005	2006	2007
--	------	------	------	------	------

(in millions, except per share and per ADS data)

	R\$	R\$	R\$	R\$	R\$	US\$
Property, plant and equipment, net	13,376.6	13,523.5	13,613.6	13,837.5	14,060.1	7,937.7
Concession assets acquired, net	686.6	517.4	502.5	495.1	507.8	286.7
Total assets	16,590.1	16,783.8	17,431.1	18,000.0	18,663.4	10,536.5
Total short-term loans and financing	997.0	1,496.8	759.0	852.5	742.1	419.0
Total long-term loans and financing	6,267.3	5,553.8	5,905.2	5,474.3	4,943.1	2,790.7
Interest on shareholders' equity	504.1	152.9	348.2	270.8	300.7	169.8
Total liabilities	9,013.2	8,832.2	8,948.5	8,981.5	8,879.4	5,012.9
Shareholders' equity	7,576.9	7,951.6	8,482.5	9,018.5	9,784.0	5,523.6
<b>Other financial information:</b>						
Cash provided by operating activities <sup>(4)</sup>	1,655.3	1,441.1	1,737.6	2,020.8	2,215.6	1,250.8
Cash used in investing activities <sup>(4)</sup>	(650.8)	(675.5)	(643.2)	(850.0)	(881.7)	(497.8)
Cash used in financing activities <sup>(4)</sup>	(1,138.2)	(941.1)	(919.7)	(1,122.8)	(1,197.1)	(675.8)
Adjusted EBITDA <sup>(5)</sup>	2,076.5	1,926.5	2,285.6	2,446.1	2,698.8	1,523.7
Capital expenditures <sup>(4)</sup>	641.3	670.3	643.1	855.1	881.7	497.8
Depreciation and amortization	564.5	598.9	596.0	642.2	622.5	351.5

**As of and for the year ended December 31,**

	2003	2004	2005	2006	2007
--	------	------	------	------	------

(in millions, except per share and per ADS data)

**U.S. GAAP****Statement of operations data:**

	R\$	R\$	R\$	R\$	R\$	US\$
Net revenue from sales and services	4,130.8	4,397.1	4,953.4	5,527.3	5,970.8	3,370.9
Gross profit	1,853.3	1,953.1	2,383.2	2,704.8	3,122.3	1,762.7
Selling expenses	(323.4)	(521.5)	(555.4)	(737.3)	(648.1)	(365.9)
Administrative expenses	(276.3)	(324.1)	(350.2)	(428.7)	(609.9)	(344.3)
Income from operations <sup>(6)</sup>	1,136.5	1,073.0	1,470.2	1,451.4	1,840.9	1,039.3
Financial income (expenses), net	(329.4)	(479.2)	(401.9)	(542.3)	(520.8)	(294.0)
Net income	642.6	417.5	791.2	622.5	925.4	522.5
Net income per common shares- basic and diluted	2.82	1.83	3.47	2.73	4.06	2.29
Net income per ADS-basic and diluted	5.64	3.67	6.95	5.46	8.12	4.59

Weighted average number of common shares outstanding <sup>(9)</sup>	227,836,623	227,836,623	227,836,623	227,836,623	227,836,623	227,836,623
---	-------------	-------------	-------------	-------------	-------------	-------------

**Balance sheet data:**

Property, plant and equipment, net	15,268.9	15,347.2	15,393.9	15,473.5	15,621.0	8,818.9
Concession assets acquired, net	686.6	517.4	502.5	495.1	507.8	286.7
Total assets	17,630.4	17,704.5	18,209.8	18,498.7	18,928.9	10,686.4
Short-term loan financing	997.0	1,496.8	759.0	852.5	742.1	419.0
Long-term loan financing	6,267.3	5,553.8	5,905.2	5,459.9	4,925.4	2,780.7
Interest on shareholders equity	504.1	152.9	348.2	270.8	300.7	169.8
Total liabilities	11,604.3	11,339.7	11,388.4	11,200.5	11,037.3	6,231.2
Shareholders equity	6,085.6	6,364.8	6,821.4	7,298.2	7,891.6	4,455.3

## As of and for the year ended December 31,

	2003	2004	2005	2006	2007
<b>Operating data (at period end):</b>					
Number of water connections (in thousands)	6,044	6,358	6,489	6,609	6,767
Number of sewage connections (in thousands)	4,462	4,747	4,878	5,002	5,167
Percentage of population with water connections (%)	100	100	100	99	99
Percentage of population with sewer connections (%)	78	78	78	78	79
Volume of water billed during period (in millions of cubic meters)	1,765	1,692	1,759	1,807	1,847
Water loss percentage during period (average)(%) <sup>(7)</sup>	33.0	34.0	32.4	31.9	29.5
Water loss per connection (average) <sup>(8)</sup>	563	547	520	511	467
Number of employees	18,546	17,735	17,448	16,978	16,850

(1) Includes financial expenses, net.

(2) The extraordinary item charged to income in the years ended December 31, 2003, 2004, 2005 and 2006 relates to the amortization (over a five-year period) of the actuarial liability recorded on December 31, 2001 upon first time recognition of the defined benefits pension plan. The presentation of the charge as an extraordinary item is consistent with the instructions of the CVM and the Brazilian Corporate Law Method. For purposes of U.S. GAAP, the pension expense has been treated as a payroll expense from the first year presented.

(3) Short and long-term receivables from shareholders, net represent amounts due from the State for water and sewage services. See note 6 to our financial statements.

(4) Based upon the statements of cash flows for the years ended December 31, 2007, 2006 and 2005 included in note 28 to our financial statements and the statements of cash flows for the years ended December 31, 2004 and 2003 which are not included in this annual report.

(5) The inclusion of Adjusted EBITDA information aims at presenting a measure for our economic operating performance. Our Adjusted EBITDA means net income before financial expenses, net, income tax and social contribution tax (federal taxes on income), depreciation and amortization, non-operating income (expenses) and extraordinary item, net of income tax and social contribution. Adjusted EBITDA is not a measure of financial performance recognized under the Brazilian Corporate Law Method, and should not be considered individually or as an alternative for net income, as a measure of operating performance, or alternative for operating cash flows, or as a measure of liquidity. Our definition of Adjusted EBITDA or EBITDA may not be comparable with the definition of Adjusted EBITDA or EBITDA used by other companies. Our Adjusted EBITDA works as a general indicator of economic performance and it is not affected by debt restructurings, interest rate fluctuations, changes in tax burden or in depreciation and amortization levels. Consequently, we believe that Adjusted EBITDA works as an adequate tool to regularly compare our operating performance. Additionally, Adjusted EBITDA is used in covenants related to some of our financial commitments. We believe that Adjusted EBITDA allows a better understanding not only of our financial performance but also of our capacity to satisfy our liabilities and to raise funds for our capital expenditures and working capital. Adjusted EBITDA, however, has limitations that prevent it from being used as a measure of our profitability because it does not take into consideration other costs resulting from our business or certain other costs,

which could significantly affect our profits, such as financial expenses, taxes, depreciation, capital expenses and other related charges. Adjusted EBITDA calculation presented herein is in accordance with the rules issued by the Brazilian regulatory authorities, which set forth the Brazilian Corporate Law Method. The table below sets forth, for the periods indicated, the reconciliation between our net income with Adjusted EBITDA:

	For the year ended December 31,					
	2003	2004	2005	2006	2007	
	(in millions)					
	R\$	R\$	R\$	R\$	R\$	US\$
<b>Brazilian Corporate Law Method</b>						
Net income (loss)	833.3	513.0	865.6	778.9	1,048.7	592.0
<b>Add:</b>						
Financial expenses (income), net	346.5	503.7	447.0	563.3	560.9	316.7
Income tax and social contribution	242.6	241.9	316.5	375.7	431.6	243.6
Depreciation and amortization	564.5	598.9	596.0	642.2	622.5	351.5
Non-operating income (expenses), net	54.5	33.9	25.4	50.9	35.1	19.9
Extraordinary item, net of income and social contribution taxes	35.1	35.1	35.1	35.1	-	-
Adjusted EBITDA	2,076.5	1,926.5	2,285.6	2,446.1	2,698.8	1,523.7

(6) Under U.S. GAAP, income from operations is determined before financial expenses, net.

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

Table of Contents

(8) Measured in liters/connections per day, according to the new method of measuring our water losses, based on worldwide market practice for the sector. See *Item 4.B. Information on the Company Business Overview*.

(9) In 2007 we approved a reverse stock split of 125 common shares into one common share. Under U.S. GAAP the SFAS N°128 requires the retroactive restatement of earnings-per-share computations for stock dividends, stock splits, and reverse splits (see note 26 (r) to our financial statements).

**Exchange Rates**

Before March 14, 2005, there were two principal legal foreign exchange markets in Brazil, the commercial rate exchange market and the floating rate exchange market. On March 4, 2005, the Brazilian National Monetary Council (*Conselho Monetário Nacional*) enacted Resolution No. 3,265, pursuant to which the floating rate market and the commercial market were unified under the denomination exchange market, effective as of March 14, 2005. The new regulation allows the purchase and sale of foreign currency and the international transfer of *reais* by any person or legal entity, regardless of the amount, provided, however, the transaction is legal and subject to certain regulatory procedures.

Since 1999, the Central Bank has allowed the *real*/U.S. dollar exchange rate to float freely, and, since then, the *real*/U.S. dollar exchange rate has fluctuated considerably. Since the beginning of 2001, the Brazilian exchange market has been increasingly volatile, and, until early 2003, the value of the *real* declined relative to the U.S. dollar. The *real* appreciated against the U.S. dollar in 2003, 2004, 2005, 2006 and 2007. As of December 31, 2007, the exchange rate for U.S. dollars was R\$1.7713 per U\$1.00. In the past, the Central Bank has intervened occasionally to control unstable movements in foreign exchange rates. We cannot predict whether the Central Bank or the Brazilian government will continue to let the *real* float freely or will intervene in the exchange rate market through the return of a currency band system or otherwise. The *real* may depreciate or appreciate against the U.S. dollar substantially in the future. For more information on these risks, see *Item 3.D. Risk Factors Risks Relating to Brazil*.

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

	<b>Year-end</b>	<b>Average for year<sup>(1)</sup></b>	<b>Low</b>	<b>High</b>
	<b>(reais per U.S. dollar)</b>			
<b>Year</b>				
2003	2.8892	3.0715	2.8219	3.6623
2004	2.6544	2.9257	2.6544	3.2051
2005	2.3407	2.4341	2.1633	2.7621
2006	2.1380	2.1771	2.0586	2.3711
2007	1.7713	1.9483	1.7325	2.1556

	<b>Period-end</b>	<b>Average for period<sup>(2)</sup></b>	<b>Low</b>	<b>High</b>
	<b>(reais per U.S. dollar)</b>			
<b>Month</b>				
January 2008	1.7603	1.7743	1.7414	1.8301
February 2008	1.6833	1.7277	1.6715	1.7681

March 2008	1.7491	1.7076	1.6700	1.7491
April 2008	1.6872	1.6889	1.6575	1.7534
May 2008	1.6294	1.6605	1.6294	1.6949
June 2008	1.5919	1.6189	1.5919	1.6428

---

Source: Central Bank

(1) Represents the average of the exchange rates of each trading date.

(2) Represents the average of the lowest and highest rates in the month.

Exchange rate fluctuations will affect the U.S. dollar equivalent of the *real* price of our common shares on the Bovespa as well as the U.S. dollar equivalent of any distributions we make in *reais* with respect to our common shares.

**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 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 contracts;
- interest rates;
- exchange controls and restrictions, such as those which were briefly imposed in 1989 and 1990;
- currency fluctuations;
- inflation;
- liquidity of the Brazilian capital and lending markets;
- tax and regulatory policies; and
- other political, social and 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 official overnight interest rate in Brazil, (SELIC), at the end of 2005, 2006 and 2007 was 18.00%, 13.19% and 11.18%, respectively, in line with the target rate set by the Brazilian Committee on Monetary Policy (*Comitê de Política Monetária*), or COPOM. On June 30, 2008, the official interest rate in Brazil was 12.25% .



Table of Contents

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 and increased to 7.75% in 2007. If Brazil again experiences high inflation, our costs and expenses may rise and our overall financial performance may be adversely affected. In addition, a substantial increase in inflation may weaken investor's confidence in Brazil, causing the decline in the market value of 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, 18.7% in 2001 and 34.3% in 2002. Although the *real* appreciated 13.4%, 9.5% and 20.7% against the U.S. dollar in 2005, 2006 and 2007, respectively, no assurance can be given that the *real* will not depreciate against the U.S. dollar again. On June 30, 2008, the exchange rate was R\$ 1.5919 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* during a financial period will increase our financial expenses as a result of foreign exchange losses that we must record. We had total foreign currency-denominated indebtedness of R\$1,242.3 million as of December 31, 2007, and we anticipate that we may incur substantial amounts of foreign currency-denominated indebtedness in the future. Our overall results of operations were positively affected by the 20.7% appreciation of the *real* against the U.S. dollar in 2007, which amounted to R\$188.4 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 emerging market countries, may adversely affect our financing and the market price of our shares or ADSs.***

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

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

***We are controlled by the State of São Paulo, whose interests may differ from ours or from minority shareholders 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 December 31, 2007, the State owned 50.3% of our outstanding common shares.

Table of Contents

The State has from time to time in the past, and may in the future, through its control of our board of directors, direct that we engage in certain business activities and make certain expenditures that promote political, economic or social goals but that do not necessarily also enhance our business and results of operations. See *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 (1) the provision of water and sewage services and (2) State-mandated special retirement and pension payments that we make to some of our former employees for which the State is required to reimburse us. As of December 31, 2007, the amounts owed to us by the State for the provision of water and sewage services totaled R\$446.4 million and, with respect to payment of pensions on behalf of the State, the State owed us R\$879.1 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. Major Shareholders and Related Party Transactions Related Party Transactions*, and note 6 (ii), (iii), (iv), (v) 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. The second amendment signed on December 2007, does not require the application of dividends to offset accounts receivable from the State. The second amendment instead requires the: i) implementation of an electronic account management system; ii) structuring of the Rational Water Use Program (PURA) to ration the consumption of water and the amount of the water and sewage bills under the responsibility of the State; iii) establishment, by the State, of criteria for budgeting; iv) possibility of registering State bodies and entities in a delinquency system or reference file; v) possibility of interrupting water supply to State bodies and entities in the case of nonpayment of water and sewage bills. Furthermore, there can be no assurance that the government will pay the total amount owed to us. On March 26, 2008, the São Paulo State Government and we, entered into a commitment agreement for the settlement of outstanding debts related to the reimbursement of pension benefits. Pursuant to the commitment agreement, part of the amounts due to us with respect to payments of pensions on behalf of the State may be settled through the transfer to us of certain reservoirs in the Alto Tietê system that we use and are owned by the State. We are unable to predict whether and when these reservoirs will be transferred to us because 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*.

We cannot assure you as to when or if the State will pay overdue amounts owed to us. In addition, even though the State acknowledges its debts to us related to pension benefits, the State disagrees with the criteria adopted by us to grant and pay the benefits. The State based its disagreement on legal opinions issued by the State Attorney General, which restrict State actions and prevent the voluntary reimbursement of amounts paid by us. We will not waive the receivables from the State to which we consider ourselves to be legally entitled. Accordingly, we will take all possible actions to resolve the issue at all technical and court levels. Should this dispute persist, we will take all the necessary actions to protect our interests. Due to the State's history of not making timely payments to us in respect of services and of not reimbursing us in a timely manner for the payments of pensions on behalf of the State, we cannot assure you that the amount of accounts receivable owed to us by the State and some State entities will not significantly increase in the future. In addition, we have not established any provisions for any amounts due to us by the State, as

we do not expect to incur any significant losses relating to these amounts. If the State does not pay the amount it owes to us, we will be adversely affected.

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

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

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

***We cannot anticipate the effects that the new legislation enacted in January 2007 will have on the basic sanitation sector in Brazil.***

On January 5, 2007, Law No. 11,445 was enacted to regulate the basic sanitation industry in Brazil. Although this law has been enacted for more than one year, it is in its initial stage of implementation and we cannot anticipate the effects that it will have on our operations and business. In compliance with Law No. 11,445, the State of São Paulo created in December 2007, ARSESP – the São Paulo State Sanitation and Energy Regulatory Agency, which is the regulatory agency that regulates the basic sanitation services pertaining to the State, respecting their federal and municipal jurisdictions and prerogatives and exercising the following functions:

- complying with and enforcing state and federal basic sanitation legislation;
- publishing the organizational platform for the services, indicating the types of services provided by the state as well the equipment and facilities composing the system;
- assuming, where applicable, the legal attributions of the jurisdictional authority;
- establishing, in accordance with the tariff guidelines defined by the decree, tariffs and other manners for the compensation of services, adjusting and reviewing them to ensure the financial-economic balance of services and low-cost tariffs through mechanisms that increase service efficiency and lead to the appropriation of productivity gains by society; and
- to approve, oversee and regulate (including tariff issues) sewage treatment and wholesale water supply agreements entered into between the state supplier and other suppliers, pursuant to Article 12 of new basic sanitation law.

There are several uncertainties related to the new legislation which could have a material adverse effect on us. See *Item 4.B. Business Overview The Basic Sanitation Law Public Consortia Law and Cooperation Agreements.*

***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* ;



Table of Contents

- in some cases, we are required to continue providing services to certain municipalities to which we provide water on a wholesale basis that have overdue amounts owed to us and are not paying us on a regular basis and we cannot assure you as to when or whether these municipalities will pay us;
- our tariffs may not increase in line with increases in inflation and operating expenses, including taxes, or to increase them in a timely manner, due to political and legal constraints that may hinder us from passing on to our customers increases in our cost structure. 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* ;
- we are exposed to droughts that may adversely affect our water supply systems, resulting in a decrease in the volume of water distributed and billed as well as in the revenue from water supply; and
- we are dependent upon energy to conduct our operations and shortages or rationing of energy may prevent us from providing water and sewage services and may also cause material damages to our water and sewage systems when we resume operations. Also, we may not be able to pass on to customers significant increases in energy tariffs.

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

***We do not hold formal concessions to provide water and sewage services to 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.***

Our operations are concentrated in the City of São Paulo with which we have not entered into a concession contract. As of December 31, 2007, the City of São Paulo accounted for 56.3% of our sales and services rendered. In addition, we do not hold formal concessions in 36 other municipalities in the State of São Paulo, particularly in the municipality of Santos, in the coastal region, where we operate under a deed of authorization (*escritura pública de autorização*) and that has a significant population of approximately 428,000 as of December 31, 2007.

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, 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 contract 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 sanitation legislation, Law No. 11,445, enacted in January 2007, 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 to provide services to municipalities. We cannot anticipate the terms and conditions of these contracts and their effects on the provision of our services in these municipalities, particularly with respect to the City of São Paulo which is awaiting a court ruling regarding the ownership of services in metropolitan regions.

In the case of the City of São Paulo, in November 2007, we entered into a cooperation agreement with the City of São Paulo that determined certain basic sanitation and environmental actions and resolved outstanding financial obligations of the City of São Paulo until it is possible to formalize definitive legal instruments that assure stability in the provision of public basic sanitation services, regardless of the substance of the legal ruling currently awaited.

Furthermore, we cannot assure you when and if there will be changes to the conditions under which we currently provide water and sewage services to these municipalities without holding formal concessions and we cannot anticipate their effects on the provision of our services in the City of São Paulo and in these other municipalities.

Table of Contents

We may face difficulties to continue 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 2007, we were a provider of water and sewage services to 366 municipalities, although, due to judicial orders, we had temporarily stopped operating three of them (Araçoiaba da Serra, Cajobi e Monte Alto). We have recently resumed providing service to Monte Alto. As for the other two municipalities (Araçoiaba da Serra and Cajobi) we are still in litigation. Even if we cannot resume providing services to these municipalities, there will be no major impact on us as: i) revenue from these operations account for less than 0.2% of our total revenues, and ii) we will continue to be entitled to indemnities related to the assets invested in these municipalities and not yet amortized. Substantially all of these concessions have 30-year terms. As of December 31, 2007, we had 106 program contracts in place. In December 2008, 104 concession contracts will expire or be under negotiation with the respective municipalities. Between 2009 and 2034, 117 concession contracts will expire. The remaining concession contracts have no expiration date. As of December 31, 2007, the carrying value of our assets at the municipalities with concession contracts under negotiation or expiring in 2007 and 2008 totaled R\$ 2.02 billion and revenues from these municipalities for the year ended December 31, 2007 totaled R\$935 million.

In case certain municipalities continue to require our provision of water and sewage services, we cannot assure you that we will obtain in the new contracts the same terms under which we currently provide services to them because the new basic sanitation law prevents us from planning, regulating and monitoring our services and it requires a more stringent control by the municipalities or by the São Paulo State Sanitation and Energy Regulatory Agency (ARSESP), which was created by the São Paulo State government through Supplementary Law 1,025 of December 7, 2007.

In case certain municipalities no longer require our provision of water and sewage services, we may be adversely affected. See *Item 4.B. Business Overview Our Operations* and *Item 4.B. Business Overview Government Regulation Public Consortia Law and Cooperation Agreements*.

We may also face difficulties in continuing to provide water and sewage services to certain municipalities by means of new contracts because of an increase in competition and in case we are outbid from a public bidding process.

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

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

In 1997, the municipality of Santos enacted a law expropriating our water and sewage systems in Santos. In 1995, the municipality of Diadema terminated the concession contract that had been entered into with us prior to the expiration of the agreement. There are pending legal proceedings discussing both the expropriation carried out by the municipality of Santos and early termination by the municipality of Diadema. We continue to provide water and sewage services to Santos and sell water on a wholesale basis to 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 concessions before the contractual expiration date. Exercise of concession termination rights by substantial numbers of municipalities could have a material adverse effect on us.

Law No. 11,445/07, the new basic sanitation law, provides that the parties to new contracts have to establish the amount of the compensation in the agreement for the unamortized portion of the investment in case of termination of the agreement prior to the contractual expiration date. In the event there is no agreement between the parties for the unamortized portion of the investment to be repaid to the service provider in case of termination of the agreement prior to the contractual expiration date, the new law determines a default provision, i.e., the valuation of the investment by an independent expert based on the economic value or revaluation of the book value of the investment. This default provision of Law No. 11,445/07 may also be applicable to current concessions but in the absence of mutual agreements, the calculation of the indemnity is based on the terms and conditions of the previous agreement. In addition, we cannot anticipate the effects of this law on the amount of, and enforceability of the right to, compensation and how Brazilian courts will enforce the provisions of Law No. 11,445/07.

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

Our capital expenditure program requires substantial liquidity and capital resources of approximately R\$5.87 billion in the period from 2007 through 2010, of which we spent R\$ 921.1 million in 2007 and we expect to spend R\$1,574.0 million in 2008.

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 international multilateral agencies and development banks at attractive interest rates. Changes in the policies of the Federal Government regarding the financing of water and sewage services, or our failure to continue to benefit from long-term financing from domestic and international multilateral agencies and development banks at attractive interest rates may impair our ability to meet our obligations or finance our capital expenditure program and could have a material adverse effect on us.

As a general rule, financial institutions and other institutions authorized to provide credit by the Central Bank may only provide loans to public sector entities, such as us, up to a certain percentage of the entities' 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 national and international financial institutions or development agencies and issuing debt securities in both the domestic and international capital markets. These legal limitations could adversely affect our ability to continue our capital expenditure program.

We are also subject to financial covenants limiting our ability to incur additional indebtedness, whether denominated in *reais* or foreign currency. Under these covenants, we would have been able to borrow up to an additional R\$3,329.8 million as of December 31, 2007. These contractual limitations 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 conform to environmental requirements and potential environmental responsibilities***

Our facilities are subject to extensive Brazilian federal, state, local levels, regulatory laws, and environmental covenants relating to the protection of human health and the environment. 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, indemnification. Since environmental laws and their enforcement by Brazilian authorities are becoming more stringent, our capital expenditures and expenses for environmental compliance may increase substantially. 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. For further information on these lawsuits, See *Item 8.A. Consolidated Statements and other Financial*

*Information Legal Proceedings.*

Civil lawsuits and inquiries involving environmental matters are in large part related to the discharge of untreated sewage into waterways and the disposal of sludge from water and sewage treatment stations. However, we are committed to fulfilling environmental obligations, seeking to work proactively and preventively. We have pledged to cooperate with oversight agencies and with the Public Prosecutors Office, with which it has established commitments and formalized the terms of our compliance.

Table of Contents

Our compliance requirements have been implemented with extreme technical and administrative rigor, aiming to conform with environmental requirements. Our compliance with the commitments arising from these agreements and instruments is provided for in the budget.

Given the need to periodically renew licenses and authorizations, We have been enhancing our management instruments used to monitor our operations and facilities in terms of our compliance with the technical requirements of the licenses and authorizations currently in force and the needs related to the regulatory compliance of the existing operational park. Environmental feasibility and compliance analyses are present in all phases of our new projects, including the conception, installation and operational phases.

***Due to pending cases in the Brazilian Supreme Court, there is potential instability in the legal framework with respect to which governmental authority has the right to plan and regulate basic sanitation services in metropolitan areas.***

We are aware of two lawsuits (Ações de Inconstitucionalidade: ADIN 1842-5 Rio de Janeiro and ADIN 2.077 -3 Bahia) pending in the Brazilian Supreme Court that involve constitutional issues related to the level of public governmental authority (states, municipalities or groups of municipalities) that has the right to plan and regulate basic sanitation services delivered in metropolitan areas, as well as the right to execute concession and program agreements.

Although the State of São Paulo is not party to either of these cases and the decisions in each of these cases will not bind the State of São Paulo, any municipality in the State of São Paulo or their contractual relations with us, the outcome will likely influence future decisions of state and federal courts in the State of São Paulo with respect to similar lawsuits.

We cannot assure you when the lawsuits will be determined nor do we know how we will be affected by the outcome of these lawsuits. If municipalities are granted the right to plan and regulate basic sanitation services in metropolitan areas, they may decide to hold public biddings or even provide basic sanitation services on their own instead of executing a concession or program agreement with us, in which case, we are likely to face a substantial increase in competition from other bidders and municipalities.

***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 lawyers, we have provisioned a total aggregate amount of R\$945.3 million as of December 31, 2007 to cover probable losses related to legal proceedings. However, this provision does not cover all legal proceedings involving monetary claims filed against us and it may be insufficient to cover our liabilities related to these claims. Any unfavorable judgment in relation to these proceedings may have an adverse effect on us. For more information, see *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 the United States, and these investments are generally 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 in the United States. 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 in the United States. The ten largest companies in terms of market capitalization represented approximately 54.7% of the aggregate market capitalization of the Bovespa as of December 31, 2007. The top ten stocks in terms of trading volume accounted for approximately 51%, 46.4% and 45.8% of all shares traded on the Bovespa in 2005, 2006 and 2007 respectively.

***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 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 depository for our ADSs will hold the *reais* it cannot convert for the account of the ADR holders who have not been paid. The depository will not invest the *reais* and it will not be liable for the interest.

***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 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 Brazilian 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, 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.

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

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

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

Sales of a substantial number of our common shares or the anticipation of such sales could decrease the trading price of our common shares and ADSs. As of December 31, 2007, we had 227,836,623 common shares outstanding, including 114,508,087 shares held by the State. As a consequence of the issuance of common shares or sales by the State or other existing shareholders, the market price of our common shares and, by extension, our ADSs may decrease significantly. As a result, a holder may not be able to sell his or her securities at or above the price he or she paid for them.

***Mandatory arbitration provisions in our by-laws may limit the ability of a holder of our ADSs to enforce liability under 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 São Paulo Stock Exchange Arbitration Rules in the São Paulo Stock Exchange 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. The State is currently not permitted by law to sell its control shares. As a result, a court in the United States might require that a claim brought by 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 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.

## ITEM 4. INFORMATION ON THE COMPANY

### 4.A. History and Development of the Company

Companhia de Saneamento Básico do Estado de São Paulo-SABESP is a *sociedade de economia mista*, a mixed capital company, incorporated on November 1, 1973, with limited liability of unlimited duration, duly organized and operating under Brazilian Corporate Law. Our principal executive offices are located at Rua Costa Carvalho, 300, 05429-900 São Paulo, SP, Brazil. Our telephone number is (55-11 3388-8000). Our agent for service of process in the United States is CT Corporation System, with offices at 818 West Seventh Street Team 1, Los Angeles, CA 90017. As set forth in Article 2 of our by-laws, our corporate purpose is to plan, provide and operate basic sanitation services throughout the territory of the State of São Paulo, and sell these services and the related benefits that directly or indirectly arise in connection with these services. Under Article 63 of Supplementary Law 1,025 of December 7, 2007, we were permitted to expand our operational scope geographically and to add new types of services related to environmental sanitation and energy. See *Item 4.B. Business Overview Public Consortia Law and Cooperation Agreements* .

We operate water and sewage systems in the State of São Paulo in which the City of São Paulo, Brazil's largest city, is located. According to the Brazilian Institute of Geography and Statistics (*Instituto Brasileiro de Geografia e Estatística*), or IBGE, the State of São Paulo is Brazil's most populous state and the state with the highest gross domestic product, or GDP, in Brazil. We had net revenue from sales and services of R\$5,970.8 million (US\$3,370.9 million) and net income of R\$1,048.7 million (US\$592.0 million) for 2007. We had total assets of R\$18,663.4 million (US\$10,536.5 million) and shareholders' equity of R\$9,784.0 million (US\$5,523.6 million) as of December 31, 2007.

We provide water and sewage services to a broad range of residential, commercial, industrial and governmental customers in 366 of the 645 municipalities in the State of São Paulo, including the City of São Paulo. We also supply water on a wholesale basis to six municipalities in the São Paulo Metropolitan Region in which we do not operate water systems. For the year ended December 31, 2007, the São Paulo Metropolitan Region (including the municipalities to which we provide water on a wholesale basis) and the Regional Systems accounted for 75.8% and 24.2% of our gross revenue from sales and services, respectively.

As of December 31, 2007, we provided water services to approximately 23.0 million people, approximately 59% of the urban population of the State of São Paulo, with a universalization of Water Coverage through 62,318 kilometers of water pipes and mains to approximately 6.8 million water connections. As of December 31, 2007, we provided sewage services to approximately 18.9 million people through 40,608 kilometers of sewer lines to approximately 5.2 million sewage connections. In addition, we currently sell water on a wholesale basis to six municipalities with a total estimated population of approximately 3.2 million.

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

In addition, our capital expenditure budget is subject to approval by the legislature of the State and is approved in conjunction with the budget of the State Secretariat for Sanitation and Energy (*Secretaria de Saneamento e Energia do Estado de São Paulo*) as a whole. Our financial statements and accounting records are subject to review by the

State Accounts Tribunal (*Tribunal de Contas*), as are all accounts of the State.

**Our Strengths**

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

Table of Contents

*Well-established business with significant size and scale.* We provide water services directly and through other public companies to approximately 26.2 million people (including the municipalities to which we provide water services on a wholesale basis), having a universalization of Water Coverage as of December 31, 2007, and sewage services to approximately 18.9 million people, having a Sewage Coverage Ratio of 79% as of December 31, 2007. From 2004 to 2007, our net revenue from sales and services has increased by an average of 10.8% per year.

*Operations in Brazil's most populous and wealthy state.* The State of São Paulo, part of the most developed and economically active region of Brazil, is the most populous state in Brazil, with an estimated population of 41.3 million as of December 31, 2007. The City of São Paulo had an estimated population of 10.9 million as of December 31, 2007, with 19.7 million inhabitants in the São Paulo Metropolitan Region. Based on its GDP, the State of São Paulo is the wealthiest state and largest economy in Brazil. The GDP of the State of São Paulo was approximately R\$727.1 billion in 2005, representing approximately 34% of Brazil's total GDP. The State of São Paulo generates more revenues from water and sewage services than any other Brazilian state.

*High-quality operations.* We believe that we adhere to high standards of service and utilize the best available technology in the sanitation business to control the quality of the water captured, produced and distributed. All 16 of our water quality control laboratories operate in accordance with NBR ISO/IEC 17,025 with 12 of these 16 laboratories accredited by INMETRO (National Institute of Metrology, Standardization and Industrial Quality), thereby assuring the quality of the test results. Moreover, the laboratories and field teams use the latest equipment to detect substances controlled by regulations and have highly trained teams to handle contingencies and customer complaints. We believe our technology enhances the efficiency and quality of our operations.

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

*Strong corporate governance practices.* In 2002, we joined the *Novo Mercado*, the highest corporate governance listing segment of the São Paulo Stock Exchange (*Bolsa de Valores de São Paulo - Bovespa*). We are committed to maintaining certain corporate governance practices and disclosure requirements in addition to those already required under Brazilian law. Sabesp has integrated, as of December 1<sup>st</sup>, 2007, the Bovespa Corporate Sustainability Index (ISE), being the only company from the sanitation sector to be part of this index, which reflects the performance of our actions representing its high level of commitment with sustainability and social responsibility. These corporate governance practices requires that we increase shareholders' rights and to enhance the quality of information provided to our shareholders.

*Expansion opportunities.* We had a Sewage Coverage Ratio of 79% as of December 31, 2007, and plan to increase this level to 84% by 2010 by adding over 791,700 sewage connections. In addition, there are municipalities in the State of São Paulo in which we currently do not operate water or sewage concessions or to which we currently supply water solely on a wholesale basis, which represent a total population of approximately 15.9 million. Our strong presence in the State and experience in providing water and sewage services place us in a privileged position to expand our Sewage Coverage Ratio in municipalities where we only provide water services and to expand our water and sewage services to municipalities where we are not yet operating, not only in the State of São Paulo but also in other states of Brazil and abroad.

**Our Strategy**

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

Table of Contents

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

*Ensure the quality and availability of our services in our existing service area.* Our goal is to maintain universal coverage of water services with a high standard of quality and availability. We intend to continue providing universal water services and meet population growth by adding 652,100 water connections by 2010 and to increase our Sewage Coverage Ratio to 84% by 2010. To ensure the quality and availability of our services, we also intend to improve customer relations by shortening response times for customer installations as well as through a focused public relations program to enhance our image. In addition, we are also developing short, medium and long-term marketing strategies, such as client segmentation and tailor-made solutions for each type of client, which we believe will help us increase our customers base.

*Maintain our operating geographic base and expand the scope of our business.* We intend to maintain our operating base through the execution of new agreements. To this end, we are also seeking to develop closer relationships with the municipal governments that we serve to increase customer loyalty and thereby increase our revenues. In addition, pursuant to article 63 of Supplementary Law 1,025, we were permitted to expand our business, including the possibility of providing urban rainwater management and drainage services, urban cleaning services and solid waste management services, in addition to authorizing the planning, operation and maintenance of energy production, storage, conservation and commercialization systems for internal use as well as for third parties. In addition, the new rules simplified the process of the expanding operations in Brazil and abroad, authorizing us to (i) participate in the controlling group or capital of other companies, (ii) create subsidiaries, which may associate with other companies as both majority or minority shareholders, (iii) form consortiums with Brazilian and foreign companies, including other state or municipal basic sanitation companies, as lead company or otherwise, with the objective of expanding operations, combining technologies and expanding investments in basic sanitation services.

*New business platform.* Sabesp Environmental Solutions program is a new business platform that has as its main objectives to gain customer fidelity and expand our large industrial, commercial and residential customer base. The products and services are aimed at big customers who want to benefit from our knowledge and technology in the sustainability, environmental preservation and water resource management fields.

*Continue to expand our existing service areas and provide our services in other municipalities.* Our goal is to expand our sewage collection and treatment services. A significant portion of our capital expenditure program, of approximately R\$5.87 billion between 2007 and 2010, is designed to achieve this goal. We also regularly explore the possibility of executing agreements for the provision of water and sewage services in municipalities of the State of São Paulo in which we currently have no operations or to which we currently supply water solely on a wholesale basis, representing a total population of approximately 15.9 million. We evaluate possible expansion opportunities in terms of proximity to our existing service areas to maximize return on investment and improve our financial performance. We also intend to study, and take advantage of, opportunities in other Brazilian states and in other countries to expand our services and increase our market share.

Table of Contents

*Continue to prudently manage our levels of indebtedness.* Our total financial indebtedness decreased by 11%, from R\$6,326.7 million in 2006 to R\$5,685.2 million in 2007. This drop was mainly due to the settlement of the 1<sup>st</sup> Series of our 6th debenture in the amount of R\$ 231.8 million and to the amortization of domestic financing installments. In addition, in the period, our total foreign denominated debt recorded a 15.6% drop, from R\$ 1,472.7 million to R\$ 1,242.3 million, as a result of the appreciation of the *real* versus the U.S. dollar and the amortization of international financing installments. Pursuant to our current capital expenditure program, we have budgeted investments in the amount of approximately R\$5.87 billion from 2007 through 2010. This capital expenditure program is most likely to involve an increase in overall indebtedness during the forthcoming years of projected investments.

*Improve operating efficiency and reduce water losses.* We seek to reduce both physical water losses and non-physical water losses. To obtain reductions that are more significant and more consistent over the long term, we began to structure based on the integration and expansion of our existing activities. The program is currently involved in planning and prioritizing measures to be taken at individual locations. These measures are prioritized in accordance with their location of application, with a focus on the municipalities and industries supplied that present the highest loss rates, with the objective of optimizing the application of resources. A fundamental aspect of this program is to make significant efforts to renew infrastructure in order to reduce physical water losses. We are also seeking to reduce physical water losses by continuing to shorten the average time for the detection and repair of leaks in the system, for which we are planning the implementation of measurement and control districts to improve operational management. We are also seeking to reduce non-physical water losses by upgrading and replacing inaccurate water meters and intensifying efforts involving irregularities in active and inactive connections.

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

### **State of São Paulo**

The State of São Paulo is one of 26 states that, together with the Federal District of Brasília, constitute the Federative Republic of Brazil. The State of São Paulo is located in the southeastern region of the country, which is, according to IBGE, the most developed and economically active region of Brazil, and which includes the States of Minas Gerais, Espírito Santo and Rio de Janeiro. The State of São Paulo lies between the States of Rio de Janeiro and Minas Gerais to the north, the State of Paraná to the south, Mato Grosso do Sul to the west and the Atlantic Ocean to the east.

The State of São Paulo occupies 3.0% of Brazil's land mass and encompasses an area totaling approximately 96,000 square miles. According to the State of São Paulo Data System (*Fundação Sistema Estadual de Análises de Dados - SEADE*), the State of São Paulo had an estimated population as of December 31, 2007 of 41.3 million.

As of December 31, 2007, the City of São Paulo, the State of São Paulo's capital, had an estimated population of 10.9 million, with 19.7 million inhabitants in the greater São Paulo Metropolitan Region. The São Paulo Metropolitan Region encompasses 39 cities and is the second largest metropolitan area in the Americas and among the four largest metropolitan areas in the world, according to the United Nations' World Urbanization Prospects, 2000 Revision. The São Paulo Metropolitan Region accounted for approximately 48% of the population of the State of São Paulo as of December 31, 2007.

According to IBGE, in 2005, the most recent year for which this data is available, the GDP of the State of São Paulo was approximately R\$ 727.1 billion, representing approximately 34% of Brazil's total GDP, making it the largest economy of any state in Brazil, based on GDP. The State of São Paulo is the leading Brazilian state in terms of manufacturing and industrial activity, also according to IBGE, with a strong position in car manufacturing, pharmaceuticals, computer production, steel making and plastics, among others, as well as the leading position in the

banking and financial services industries. The State of São Paulo is the most important exporting state in Brazil, according to the Brazilian Ministry of Development, Industry and Foreign Trade (*Ministério do Desenvolvimento, Indústria e Comércio Exterior*).

## History

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

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

A major restructuring of the entities providing water and sewage services in the State of São Paulo occurred in 1968 with the creation of the *Companhia Metropolitana de Água de São Paulo*, or COMASP, which purpose was to provide potable water on a wholesale basis for public consumption in the municipalities making up the São Paulo Metropolitan Region. All assets relating to the production of potable water for the São Paulo Metropolitan Region previously owned by the Department of Water and Sewers were transferred to COMASP. In 1970, the *Superintendência de Água e Esgoto da Capital*, or SAEC, was created by the State government to distribute water and collect sewage in the City of São Paulo. All assets previously owned by the Department of Water and Sewers in connection with these activities were transferred to SAEC. Also in 1970, the State created the *Companhia Metropolitana de Saneamento de São Paulo*, or SANESP, to provide sewage treatment services for the São Paulo Metropolitan Region. All assets previously owned by the Department of Water and Sewers in connection with those activities were transferred to SANESP. The Department of Water and Sewers was subsequently closed.

On June 29, 1973, COMASP, SAEC and SANESP merged to form our company with the purpose of implementing the directives of the Brazilian government set forth in the National Water Supply and Sanitation Plan (*Plano Nacional de Saneamento*). The National Water Supply and Sanitation Plan was a program sponsored by the Brazilian government, which financed capital investments in, and assisted in the development of, state-controlled water and sewage companies. Since our formation, other State governmental and State-controlled companies involved in water supply and sewage collection and treatment in the State of São Paulo have been merged into us. As set forth in Article 2 of our by-laws, our corporate purpose is to plan, provide and operate basic sanitation services throughout the territory of the State of São Paulo, and sell these services and the related benefits that directly or indirectly arise in connection with these services. Under Article 63 of Supplementary Law 1,025 of December 7, 2007, we were permitted to expand our operational scope geographically and by the addition of new types of services related to environmental sanitation and energy. See *Item 4.B. Business Overview – Public Consortia Law and Cooperation Agreements* .

## Corporate Organization

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

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

Table of Contents

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

**Capital Expenditure Program**

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

From 1998 through 2007, our capital expenditure program totaled R\$7.3 billion, primarily to build up our infrastructure and for our efforts to reduce water losses. We have budgeted investments in the amount of approximately R\$5.87 billion from 2007 through 2010. We invested R\$678.2 million in 2005, R\$904.9 million in 2006 and R\$ 921.1 million in 2007.

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

	<b>Forecast Capital Expenditures</b>				
	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2007-2010</b>
	<b>(in millions of reais)</b>				
Water	336	563	622	755	2,276
Sewage	487	907	824	814	3,032
Others	137	104	145	176	562
<b>Total</b>	<b>960</b>	<b>1,574</b>	<b>1,591</b>	<b>1,745</b>	<b>5,870</b>

Our capital expenditure program from 2007 through 2010 will continue to focus on achieving our targets by making regular investments and expanding our infrastructure as well as making investments in our program for the reduction of water losses throughout the 366 municipalities that we serve. The following is a description of the main projects in our capital expenditure program.

***Metropolitan System Investment Program******Metropolitan Water Program***

Demand for our water services has grown steadily over the years in the São Paulo Metropolitan Region and has exceeded at times the capacities of our water systems. As a result, prior to September 1998, certain part of our customers in this region received water only on alternate days of the week. We refer to this as rotation. In order to remedy this situation, we implemented the Metropolitan Water Project to improve regular water supply to the entire São Paulo Metropolitan Region. This program terminated in 2000 and the rotation was eliminated, but we have maintained our investment projections for the São Paulo Metropolitan Region. In 2005, 2006 and 2007, we invested R\$75.0 million, R\$53.0 million, and R\$130.9 million respectively, in this region.

***Tietê Project***

The Tietê River crosses the São Paulo Metropolitan Region and receives most of the region's run-off and wastewater. The environmental status of the river reached a critical level in 1992. As a way of reversing the situation, the State of São Paulo created a recovery program designed to reduce pollution of the Tietê River by installing sewage collection lines along the banks of the Tietê River and its tributaries. These lines collect raw sewage and deliver it to our sewage

treatment facilities. We completed the first phase of the program during the years of 1992 and 1998.

In connection with the first phase of the Tietê Project, in June 1998, we completed the construction of three additional sewage treatment facilities and invested a total of US\$1.1 billion, of which US\$450.0 million was financed by the Inter-American Development Bank, US\$100.0 million was financed by Caixa Econômica Federal and US\$550.0 million was funded by us.

We are currently in the second phase of the Tietê Project, for which we budgeted for additional capital expenditures of approximately US\$500.0 million from 2000 through 2008, US\$200.0 million of which is financed by the Inter-American Development Bank. We have also entered into a loan agreement and an on-lending agreement with the Brazilian National Bank for Social and Economic Development (Banco Nacional de Desenvolvimento Econômico e Social), or BNDES, for R\$60.0 million and R\$180.0 million, respectively, to finance this second phase. As of December 31, 2007, we had invested US\$436.0 million in this phase of the Tietê Project.

Table of Contents

The main objective of this second phase is the continuity of the expansion and optimization of the sewage systems of the São Paulo Metropolitan Region, primarily focusing on actions that allow the destination of a higher volume of raw sewage to the sewage treatment facilities that were built in the first phase of the Tietê Project.

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

As of December 31, 2007, we owed US\$249.7 million to the Inter-American Development Bank for the financing it provided. For further information on the agreement entered into with the Inter-American Development Bank, see *Item 5.B. Operating and Financial Review and Prospects - Liquidity and Capital Resources Capital Sources*. We now provide secondary treatment to approximately 62% of the sewage collected in the São Paulo Metropolitan Region. The five principal sewage treatment facilities in the São Paulo Metropolitan Region have an aggregate installed capacity of 18 cubic meters of sewage per second and currently treat an aggregate of 13 cubic meters of sewage per second. Currently, raw sewage is delivered to our secondary treatment facilities along the Tietê River and the Tamanduateí River before treated sewage is discharged into those rivers. We plan to build additional collection lines to direct more raw sewage to our treatment facilities.

*Alto Tietê Public Private Partnership (PPP)*

In June 2008 we entered into a Public Private Partnership, or PPP, with Cab Spat, a special purpose company whose main shareholders are Cab Ambiental and Galvão Engenharia. Cab Spat will be responsible for (i) expansion of Tiaçupeba Water Treatment Plant capacity from 10 cubic meters per second to 15 cubic meters per second, (ii) construction of 17.7 kilometers of water network and mains, (iii) construction of 4 water storage tanks with total capacity of 70,000 cubic meters, (iv) installation of boosters, and (v) construction of pumping stations. The total capital expenditure for these investments will amount to approximately R\$300 million. Cab Spat will also provide dams, civil works and electromechanical maintenance; operation services such as sludge treatment and complementary services of water transmission and supply. The total amount expected to be paid by us at the end of this 15 year contract is approximately R\$1.3 billion, including services and investments.

*Corporate Water Loss Reduction Program*

In the second semester of 2007 we started to structure a Corporate Water Loss Reduction Program, with a ten-year span. The aim of this program is to obtain more consistent and faster reduction of water losses, through the integration and expansion of our existing loss reduction programs and through the assuring of the availability of funds and technology.

*Water Source Program*

The objective of this program is the promotion of urban development and social inclusion to mitigate the pollution problems in all water reservoir systems of the São Paulo Metropolitan Region. In this program we will be responsible for the expansion of sewage systems, pre-treatment of streams and development of more sophisticated treatment facilities. We expect to launch this program in 2008 with the conclusion foreseen for 2013. The total expected investment of this program is US\$281.8 million and will be carried out with resources from the World Bank and participant matching funds. Our participation in this Program is US\$125.0 million.

*Clean Stream Program*

This program is a partnership between the State Government, through Sabesp, and the municipality of São Paulo, which aims at cleaning and revitalizing the main municipal streams in a two-year period, with investments of approximately R\$200 million. The aim of this program is the improvement of the sanitary sewage system and the clean-up of the surrounding area of streams, which will benefit approximately 2.4 million people. Of the 42 major streams selected in this first stage, 12 have already been cleaned. Our participation in this Program is approximately R\$177.0 million.

*Regional Systems Investment Programs*

We currently have a number of projects in progress and planned for the Regional Systems, including projects relating to abstraction of water and collection, removal and final disposal of sewage. We spent R\$222.0 million, R\$331.2 million and R\$381.3 million on these projects in 2005, 2006 and 2007, respectively, and we have budgeted for additional capital expenditures of approximately R\$2.4 billion from 2007 through 2010. Following are the major programs

*Environmental Recovery Program for the Baixada Santista Metropolitan Region      Programa Onda Limpa*

On August 6, 2004, we entered into a credit agreement with Japan Bank for International Cooperation, or JBIC, for the financing of the Environmental Recovery Program for the Baixada Santista Metropolitan Region, which was

guaranteed by the Federative Republic of Brazil, for a total amount of R\$382.8 million. For further information on the agreement entered into with the JBIC, see *Item 5.B. Operating and Financial Review and Prospects Liquidity and Capital Resources Capital Sources*. The total investment to be made with respect to this project for sewage systems is approximately R\$1.2 billion and the balance will be our responsibility, for which we will seek further financial support from local and international public banks and agencies. The first disbursements under this agreement began in August 2005 with the commencement of the management agreement. The construction works began in the second quarter of 2007. The main goals of this program are to improve and expand the water and sewage systems in the municipalities comprising the Santos Metropolitan Region. As of December 2007, the total disbursements for this program reached R\$57 million.

### *Mambu/Branco Water Production System*

This program seeks to increase and improve the Mambu/Branco Water Production System, which will make possible the expansion of water production to supply municipalities in the Southern Baixada Santista Region, increasing production by 1.0 m<sup>3</sup>/s and treatment by 1.6 m<sup>3</sup>/s. The total investment on the project is approximately R\$336.9 million, of which R\$241.2 million involves funds from Caixa Econômica Federal (CEF) and the remainder under the responsibility of Sabesp. Construction works of the project are expected to start in the second half of 2008.

## **Research and Development**

Our policy is to invest continually in the modernization of equipment and in the technology needed to identify, evaluate and improve our provision of basic sanitation services while promoting environmental protection and maintaining our competitiveness and profitability. Our research and development function is divided into committees according to strategy and complexity. In 2005, 2006 and 2007, we spent R\$4.7 million, R\$4.9 million and R\$3.4 million, respectively, on research and development. We have also partnered with several research institutions.

## **4.B. Business Overview**

### **Our Operations**

We provide water and sewage services to 366 municipalities in the State of São Paulo either under concession contracts or under another form of legal arrangement. We also provide water services on a wholesale basis.

Because of the enactment of new legislation regarding basic sanitation in Brazil, Law No. 11,445/07, we currently operate under two different contractual environments: (1) for the concession contracts that have already expired, we will negotiate a new contract model that follows the terms and conditions of the new legislation, and (2) for the concession contracts that have not expired, we will continue to operate under the terms and conditions of the previous concession contracts, except in circumstances where the new legislation is automatically applicable. For further information on this topic, see *The Basic Sanitation Law - Public Consortia Law and Cooperation Agreements*.

The new basic sanitation legislation, Law No. 11,445/07, establishes the date of December 31, 2010 as the deadline for water and sewage services companies, such as us, to establish a formal contract with municipalities with whom we do not currently have one in place.

### **Concessions**

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

Under the terms of the new basic sanitation law, Law No. 11,445/07, existing concessions will remain in effect until payment of compensation is made based on the valuation of investments. The new law provides that our new concession contracts be planned, overseen and regulated by the municipalities together with the State under a new model of associated management that will allow for better control, supervision, transparency and efficiency in the provision of public services.

At the end of 2007 we were a provider of water and sewage services to 366 municipalities, although, due to judicial orders, we had temporarily stopped operating three of them (Araçoiaba da Serra, Cajobi e Monte Alto). We have recently resumed providing service to Monte Alto. As for the other two municipalities (Araçoiaba da Serra and Cajobi) we are still in litigation. Even if we cannot resume providing services to these municipalities, there will be no major impact on us as: i) revenue from these operations account for less than 0.2% of our total revenues, and ii) we will continue to be entitled to indemnities related to the assets invested in these municipalities and not yet amortized.

Table of Contents

Substantially all of these concessions have 30-year terms. As of December 31, 2007, we had 106 program contracts in place. In December 2008, 104 concession contracts will expire or be under negotiation with the municipalities. Between 2009 and 2034, 117 concession contracts will expire. The remaining concession contracts have no expiration date. Some of the expired concession contracts have been extended for a short term while we negotiate the terms and conditions of the termination of the previous contract and the terms and conditions for the new contract. Despite the expiration of the contracts, we continue to provide water and sewage services to all municipalities.

In February 2006, we created a new division to manage the renewal of expiring concessions. The main responsibility of this division, which reports directly to the Chief Executive Officer, is to renew and thus maintain the existing base of municipalities that we currently operate and formalize contracts under the new model of associated management.

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

- We assume all responsibility for providing water and sewage services in the municipality;
- According to the municipal laws that authorized these concessions, we could collect the tariffs for our services without prior authorization of the municipality. The readjustment of our tariff will follow the parameters established by Federal Law No. 11,445/07 as well as the new state regulatory authority created ARSESP;
- The assets comprising the existing municipal water and sewage systems are transferred from the municipality to us. Until 1998, we acquired municipal concessions and the existing water and sewage assets in exchange for our common shares issued at book value. Since 1998, we have acquired concessions and water and sewage assets by paying the municipality an amount equal to the present value of 30 years of estimated cash-flows, assuming at least a 12.0% discount factor to us, from the concession being acquired. Payment is made in cash;
- As a general rule, to date we are exempt from municipal taxes, and no royalty is payable to the municipality with respect to the concession;
- We are granted rights of way on municipal property for the installation of water pipes and mains and sewer lines; and
- Upon termination of the concession, or upon cancellation for any reason, we are required to return the assets comprising the municipality's water and sewage system to the municipality and the municipality is required to pay us the non-amortized book value of our assets relating to the concession.

Under concession contracts executed prior to 1998, the reimbursement for these assets may be through payment of either:

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

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

Edgar Filing: COMPANHIA DE SANEAMENTO BASICO DO ESTADO DE SAO PAULO-SABESP - Form 20-F  
same assumptions used to determine the value of the concession at its inception (adjusted for inflation).

Table of Contents

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

Our new contract model follows the provisions of the newly enacted Law No. 11,445/07. The main contractual provisions are: joint execution of responsibilities related to planning, supervision and regulation of services, appointment of regulatory authority of services and periodic disclosure of accounts, among others.

Furthermore, the economic and financial equations in new contracts must be based on discounted cash flow methodology and on the reclassification of returnable assets as our own preexisting assets with any assets related to new investments considered in our possession, which may use and manage this asset.

According to Article 42 of the new basic sanitation law, investments made during the contractual period are the property of the applicable Municipality, which in turn generates receivables for us that are to be recovered through the commercial operation of services, and these receivables may also be used as guarantees in funding operations.

Another important development was that the negotiations included exemptions from municipal taxes applicable on our operational areas and the possibility of the revaluation of our assets that existed prior to the applicable new contracts in cases involving the early resumption of services by the concession authority.

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

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

In addition, there is currently ongoing litigation with respect to municipalities that intend to expropriate our water and sewage systems or to terminate concession contracts prior to paying us any indemnification. For example, among others, we have pending proceedings with the municipalities of Santos, Sandovalina, Presidente Prudente and Itapira. For a detailed discussion on these proceedings, see *Item 8.A. Financial Information Consolidated Statements and other Information Legal Proceedings Other Legal Proceedings*.

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

We do not hold a formal concession to provide water and sewage services to the City of São Paulo, which accounts for 56.3% of our revenue, and to 36 other municipalities in the State of São Paulo. None of these other municipalities has a significant population, other than the municipality of Santos, which has a population of approximately 428,000. We believe that we have a vested and exclusive right to provide water and sewage services to the City of São Paulo and these other municipalities based, in some cases, upon a deed (*escritura pública*) and also, among other things, based on our ownership of the water and sewage systems serving the City of São Paulo and these other municipalities and certain succession rights resulting from the merger that formed us.

The new basic sanitation law, provides that, in case of termination of the relationship with the aforementioned municipalities with which we have not entered into a concession contract, an indemnification should be paid by the municipalities to us, in amounts to be calculated by studies and appraisals.

Table of Contents

On November 14, 2007, the Company and the Municipality of São Paulo entered into an Agreement to establish the conditions that ensure the stability in the provision, of water supply and sewage, and environmental utility services in the city of São Paulo, see note 23 to our financial statements.

***Wholesale Operations***

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

***Execution of Sewage Services Agreements with Municipalities***

We provide wholesale sewage services to the municipalities of Mogi das Cruzes, Santo André, São Caetano, Mauá and Diadema. The negotiation of the agreement for the provision of wholesale sewage services with the municipality of Santo André had the intervention of the Public Prosecution Office, and in other municipalities it was a result of our efforts concerning the environment and the awareness of the municipal public authorities related to environmental issues. Through these agreements, in 2007 we treated about 2.9 million cubic meters of sewage per month from these municipalities. This is an example of our social-environmental responsibility and commitment. In 2007, the revenues from these services were approximately R\$8.0 million.

**Description of Our Activities**

As set forth in Article 2 of our by-laws, our corporate purpose is to plan, provide and operate basic sanitation services throughout the territory of the State of São Paulo, and sell these services and the related benefits that directly or indirectly arise in connection with these services. Under Article 63 of Supplementary Law 1,025 of December 7, 2007, we were permitted to expand our operational scope geographically and to add new types of services related to environmental sanitation and energy. *See Item 4.B. Business Overview Public Consortia Law and Cooperation Agreements* .

***Water Operations***

Our supply of water to our customers generally involves abstraction of water from various sources, subsequent treatment and distribution to customers premises. In 2007, we produced approximately 2,873.7 million cubic meters of water. The São Paulo Metropolitan Region currently is, and has historically been, our core market, accounting for approximately 72% of water invoiced by volume in 2007.

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

	<b>Year ended December 31,</b>		
	<b>2005</b>	<b>2006</b>	<b>2007</b>
<b><i>Produced</i></b>	<b>(in millions of cubic meters)</b>		

São Paulo Metropolitan Region	2,088.9	2,134.8	2,115.0
Regional Systems	741.2	752.0	758.7
<b>Total</b>	<b>2,830.1</b>	<b>2,886.8</b>	<b>2,873.7</b>
<i>Invoiced</i>			
São Paulo Metropolitan Region	997.8	1,030.8	1,046.8
Wholesale	258.7	263.4	274.3
Regional Systems	502.4	513.0	525.9
<b>Total</b>	<b>1,758.9</b>	<b>1,807.2</b>	<b>1,847.0</b>

Table of Contents

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

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

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

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

	<b>Year ended December 31,</b>		
	<b>2005</b>	<b>2006</b>	<b>2007</b>
	<b>(in millions of reais)</b>		
São Paulo Metropolitan Region	4,044.2	4,534.1	4,888.1
Regional Systems	1,312.1	1,449.9	1,560.1
Total revenue from sales and services	5,356.3	5,984.0	6,448.2

***Water Resources***

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

In order to supply water to the São Paulo Metropolitan Region, we rely on 20 reservoirs of non treated water and 182 reservoirs of treated water, which are located in the areas under the influence of the eight water producing systems which comprise the interconnected water system of the São Paulo Metropolitan Region. Resource availability, or volume of water available at the source for public distribution in these areas, is 71.6 cubic meters per second, due to the conclusion of the barriers of the Alto Tietê system. Total current capacity, or volume of water that can be treated from the interconnected water system of the São Paulo Metropolitan Region, is 67.0 cubic meters per second and has been designed to reach 75.2 cubic meters per second in 2009. Average verified production or volume treated during

2007 on the interconnected water system of the São Paulo Metropolitan Region was 65.7 cubic meters per second. The Cantareira, Guarapiranga and Alto Tietê systems, as a whole, supply approximately 83.9% of the water we produced for the São Paulo Metropolitan Region in 2007.

The Cantareira system accounts for approximately 47.2% of the water that we provided to the São Paulo Metropolitan Region (including the municipalities to which we provide water on a wholesale basis), which represented 75.8% of our operating revenue for 2007. The authorization (*outorga*) for the Cantareira system to use the water in the Piracicaba water basin was renewed on August 6, 2004 for a period of ten years.

Table of Contents

With respect to water usage, federal and state agencies are authorized to collect charges from entities, such as us, for the abstraction of water from, or dumping of sewage into, water resources. Since February 2004 we have been incurring expenses in connection with the use of water from the Paraíba do Sul River Basin and since January 2006 from the Piracicaba, Capivari and Jundiá River Basin. Our tariff readjustment formula takes into consideration the variation of expenses considered as non-administrable, which these expenses fall under. We expect to continue to be able to pass on these expenses to our customers. However, we are uncertain as to the likely charges that may be assessed in connection with the abstraction of water from or the dumping of sewage into other water resources that we use, or whether we will be able to continue to pass on the cost of all of these charges to our customers. For more information on water usage regulation, see *Water Usage*.

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

<b>System</b>	<b>Production rate<sup>(1)</sup> (in cubic meters per second)</b>
Cantareira	31.0
Guarapiranga	13.8
Alto Tietê	10.3
Rio Claro	3.8
Rio Grande (Billings reservoir)	4.8
Alto Cotia	1.0
Baixo Cotia	0.9
Ribeirão da Estiva	0.1
 Total production rate	 65.7

(1) Average of the twelve months ended December 31, 2007.

We own all of the reservoirs in our production systems other than the Guarapiranga and Billings reservoirs and a portion of some of the reservoirs of the Alto Tietê system, which is owned by other companies controlled by the State. We currently do not pay any charges with respect to the use of these reservoirs. In December 2001, we entered into an agreement with the State whereby the State, among other things, agreed to transfer the remaining reservoirs in the Alto Tietê system to us. However, the transfer of these reservoirs is currently being disputed and we are not certain whether this transfer will be legally allowed. See *Item 8.A. Financial Information Consolidated Statements and other Information Legal Proceedings Other Legal Proceedings*.

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

Statewide, we estimate that we are able to supply nearly all of the demand for water in all of the areas where we operate, subject to droughts and extraordinary climate events. We were able to meet the demand for water in the São Paulo Metropolitan Region, primarily as a result of our water conservation program, reductions in water loss, and the installation of new water connections. In 2006, we installed 156,139 new water connections and in 2007 we installed 173,739 new water connections.

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

In order to reach the final customer, the water is stored and transported through a complex and interconnected system comprising 31,136 kilometers of water mains and 182 reservoirs. This water system requires permanent operational supervision, engineering inspection, maintenance, quality monitoring and measurement control.

To ensure the continued provision of regular water supply in the São Paulo Metropolitan Region, we intend to invest R\$1.2 billion from the years 2007 until 2010 to increase our water production and distribution capacities as well as to improve the water supply systems. In 2007, total investment in water amounted to R\$288,6 million.

**Water Treatment.** We treat all water at our water treatment facilities prior to placing it into our water distribution network. We operate 198 treatment facilities, of which the eight largest, located in the São Paulo Metropolitan Region, account for approximately 72% of all water we produce. The type of treatment used depends on the nature of the source and quality of the untreated water. Water abstracted from rivers requires extensive treatment, while water drawn from groundwater sources requires less treatment. All water treated by us also receives fluoridation treatment.

Table of Contents

**Water Distribution.** We distribute through our own networks of water pipes and mains, ranging in size from 2.5 meters to 100 millimeters in diameter. Storage tanks and pumping stations regulate the volume of water flowing through the networks to maintain adequate pressure and continuous water supply. As of December 31, 2007, our water network contained 62,318 kilometers of water pipes and mains and 6.8 million water connections. The following table sets forth the total number of kilometers of water pipes in our network for the periods indicated.

	<b>As of December 31,</b>		
	<b>2005</b>	<b>2006</b>	<b>2007</b>
Water distribution pipes and mains (kilometers)	58,000	61,469	62,318
Number of connections (in thousands)	6,489	6,609	6,767

More than 90% of the water pipes in our water distribution network are made of cast iron or polyvinylchloride (PVC). Distribution pipes at customers' residences typically are made from high-density polyethylene tubing. Our water mains are mostly made of steel, cast iron or concrete.

As of December 31, 2007, our water distribution pipes and mains included:

- 31,136 kilometers in the São Paulo Metropolitan Region; and
- 31,182 kilometers in the Regional Systems.

We have 373 storage tanks in the São Paulo Metropolitan Region with a total capacity of 1.8 million cubic meters, and 1,650 storage tanks in the Regional Systems. We have 122 treated water pumping stations in the São Paulo Metropolitan Region aqueduct system, including stations at treatment facilities, intermediate trunk transfer pumping stations and small booster stations serving local areas.

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

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

Table of Contents

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

	2007		2008	2009	2010	2007-2010
	Forecast	Actual	(in thousands)			
São Paulo Metropolitan Region	86.7	108.4	96.9	89.3	87.6	360.5
Regional Systems	62.1	65.3	70.0	75.0	84.4	291.6
Total System	148.8	173.7	166.9	164.3	172.0	652.1

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

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

Using this calculation method, as of December 31, 2007, we experienced 553 liters/connections per day of water losses in the São Paulo Metropolitan Region and 339 liters/connections per day in the Regional Systems, averaging 467 liters/connections per day. We plan to reduce water losses in both regions to 420 liters/connections per day for the São Paulo Metropolitan Region and 284 liters/connections per day for the Regional Systems, which we expect will result in a total reduction to 364 liters/connections per day by 2010. Based on water loss percentage (see footnote 7 Item 3. A), we intend to reduce water losses from 29.8% to 24% in the São Paulo Metropolitan Region, and from 28.9% to 25% in the Regional Systems. In 2007, we experienced 29.5% in water losses and we expect to decrease the water losses to 24% in 2010.

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

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

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

physical water losses are:

- the introduction of technically advanced valves to regulate water pressure throughout the water mains to correspond to downstream consumption needs each day. These valves are programmed to respond automatically to variations in demand. During peak usage, the flow of water in the pipes is at its highest point; however, when demand decreases, pressure builds up in the water mains and the resulting stress on the network can cause significant water loss through cracks and an increase in ruptures of the pipes. The intelligent valves are equipped with probes programmed to feed data to the valve to reduce or increase pressure to the water mains as water usage fluctuates. As of December 31, 2007, we had installed 1,595 valves at strategic points in the network, with 985 valves installed in the São Paulo Metropolitan Region and 610 in the Regional Systems. We plan to install 142 additional valves by the end of 2008;

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

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

In general, the State of São Paulo has excellent quality water from underground or superficial water sources. However, urbanization and disorganized occupation of some areas of the São Paulo Metropolitan Region ended up reducing the quantity of water in mains in the southern area of the São Paulo Metropolitan Region and in the coastal region. Currently, we successfully treat this water to make it potable. We also work to recover the quality of water of mains and invest in improvements of our treatment systems to guarantee the quality and availability of water in the next years.

Water quality is monitored in all stages of the distribution process, including at the water sources, water treatment facilities and on the distribution network. We have 15 regional laboratories, one central laboratory, and laboratories located in all water treatment facilities that monitor water quality and purity as required by standards set by us and as required by law, which employ approximately 300 technicians, biologists, engineers and chemists. Our laboratories perform an average of 130,000 analyses per month on distributed water, with samples collected from residences. Our central laboratory located in the City of São Paulo is responsible for organic compound analysis using the chromatographic and spectrometric methods, as well as heavy metals analysis by atomic absorption technique. All of our laboratories have obtained ISO 9001/2000 certification and twelve of our sixteen water control and quality laboratories have obtained a NBR ISO/IEC 17025 accreditation (General requirements for the competence of testing and calibration laboratories) awarded by INMETRO (National Institute of Metrology, Standardization and Industrial Quality).

All chemical products used for water treatment are analyzed and follow strict specifications set out in recommendations made by the National Sanitation Foundation, or NSF, and the Brazilian Association of Technical Rules (*Associação Brasileira de Normas Técnicas*), or ABNT and American Water Works Association (AWWA), to eliminate toxic substances that are harmful to human health.

Table of Contents

From time to time, we face problems with the proliferation of algae, which may cause an unpleasant taste and odor in the water. In order to mitigate this problem, we work on two fronts: (1) fighting algae growth at the water resource, resulting in our detection of no significant algae growth in 2007, and (2) using advanced treatment processes at the water treatment facilities, which involves the use of powdered activated carbon and oxidation by potassium permanganate. The algae growth creates significant additional costs because of the higher volumes of chemicals used to treat the raw water. We participate in the Water Source Program (Programa Mananciais) together with other organizations engaged in the promotion of urban development and social inclusion to mitigate the pollution problem in all systems of the São Paulo Metropolitan Region. In addition, we also participate in the Clean Stream Program, a joint program with State Government, through us, and the Municipal of São Paulo to clean up important streams in this region. See *Capital Expenditure Program - Water Source Program and Clean Stream Program* .

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

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

### ***Sewage Operations***

We are responsible for the collection and removal of sewage through our sewage systems and for its subsequent disposal with or without prior treatment. As of December 31, 2007, we collected approximately 83% and 72% of all the sewage produced in the municipalities in which we operate in the São Paulo Metropolitan Region and the Regional Systems, respectively, accounting for approximately 79% of all the sewage produced in the municipalities in which we operated in the State of São Paulo during 2007.

**Sewage System.** The function of our sewage system is to collect, remove and dispose of sewage. As of December 31, 2007, we were responsible for the operation and maintenance of 40,608 kilometers of sewer lines, of which approximately 21,141 kilometers are located in the São Paulo Metropolitan Region and 19,467 kilometers are located in the Regional Systems.

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

	<b>As of December 31,</b>		
	<b>2005</b>	<b>2006</b>	<b>2007</b>
Sewage lines (kilometers)	37,181	39,126	40,608
Sewage connections (thousands)	4,878	5,002	5,167

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

Industrial sewage has physical, chemical and/or biological characteristics that are qualitatively different from household effluents, and may eventually cause damage to or overload sewage collection and treatment systems, pose risks to the safety and health of operators and adversely affect the environment. To avoid such events, current environmental legislation establishes standards for the discharge of these effluents into the public sewage system. These standards are defined in Article 19 of State Decree 8,468 of September 8, 1976 and the related amendments. To ensure compliance with legislation, periodic audits are made of the sewage produced by all industrial clients and we also request self-monitoring reports from sewage-producing sources.

Table of Contents

The discharge of these effluents into the public sewage system is based on technical and administrative procedures. Before the discharge is permitted, we carry out acceptance studies that assess the capacity of the public sewage system to receive the discharge as well as the compliance with regulations. Upon the conclusion of these studies, the technical and commercial conditions for receiving the discharge are established, which are then formalized in a document signed by the company and the effluent producer. Failure to comply with these conditions can lead to the suspension of the connection and notification of the environmental protection agency (CETESB) in order for the applicable measures to be taken. Effluents from our sewage treatment facilities (*Estações de Tratamento de Esgotos ETEs*) must comply with discharge standards established by federal and state regulations and also must comply with emission standards and observe the water quality of the bodies of water established by federal and state legislation. Emission standards consist of a set of parameters that must be verified before the effluents are discharged into a body of water. Quality standards are based on the classification of bodies of water, taking into account the expected use of the water, with these standards becoming more stringent for bodies of water with more important use profiles.

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

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

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

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

	2007		2008	2009	2010	2007-2010
	Forecast	Actual	(in thousands)			
São Paulo Metropolitan Region	81.2	86.5	100.5	87.2	84.2	353.0
Regional Systems	58.9	65.0	63.9	82.4	233.4	438.6
Total	140.1	151.5	164.4	169.6	317.6	791.6

***Sewage Treatment and Disposal.*** In 2007, approximately 62% and 76% of the sewage we collected in the São Paulo Metropolitan Region and the Regional Systems respectively, or 66% of the sewage we collected in the State of São Paulo, was treated at our treatment facilities and afterwards discharged into receiving water bodies such as inland

waters and the Atlantic Ocean, in accordance with applicable legislation. Our sewage treatment facilities have a finite capacity. Flows in excess of this capacity are discharged directly, untreated, to inland waters and the Atlantic Ocean. Currently we operate 453 sewage treatment facilities and eight ocean outfalls.

The treatment consists of the removal of pollutants from sewage. The method to be used depends upon the physical, chemical and biological characteristics of the wastewater.

In the Metropolitan Region of São Paulo, the treatment used in the large treatment facilities is activated sludge, where there is a liquid phase and a solid phase which involves the sludge.

The activated sludge process was developed in England in 1914. It is widely used for the treatment of domestic and industrial sewage. The work consists of a system in which a biological mass grows, forms flakes, is continually recirculated and put in contact with organic matter, always with the presence of oxygen (aerobic).

Table of Contents

The activated sludge process is strictly biological and aerobic, in which the raw sewage and the activated sludge are intimately mixed, agitated and aerated in units known as secondary decanters where the solid part is separated from the treated wastewater. The settled sludge returns to the aeration tank or is removed for specific treatment.

We operate 47 activated sewage treatment facilities, each of which also contains a primary treatment facility. The five largest activated sewage treatment facilities located in the São Paulo Metropolitan Region have treatment capacity of approximately 18 cubic meters of sewage per second.

Sewage treatment in the Regional Systems will vary according to the particularities of each area. In the interior region, treatment consists largely of stabilization ponds where the organic matter is treated and discharged to receiving waters. There are 366 secondary treatment facilities in the interior region which have treatment capacity of approximately 10.5 cubic meters of sewage per second.

The majority of sewage collected in the coastal region receives treatment and disinfection and is then discharged into rivers and into the Atlantic Ocean. We have 67 sewage treatment facilities in the coastal region.

Our trunk lines are currently not sufficiently extensive to transport all sewage collected by us to our treatment facilities. As a result, a portion of the sewage collected by us is released untreated into receiving waters, resulting in high levels of pollution in these bodies of water. We are a party to a number of legal proceedings related to environmental matters. See *Item 8.A. Financial Information Consolidated Statements and other Information Legal Proceedings*. In addition, our capital expenditure program includes projects to increase the amount of sewage that we treat. See *Capital Expenditure Program and Government Regulation Sewage Requirements*.

**Sludge Disposal.** Sludge removed from the primary and secondary treatment processes typically contains water and a very small proportion of solids. We use filter presses, belt presses and centrifugation machines to abstract the water from the sludge. In 2007, we produced approximately 49,291 tons of sludge-dry base, of which 44,491 tons were discharged into landfills and the remainder was used for agricultural purposes. In addition, we are testing new technologies for sludge disposal as fertilizer in forest projects, fuel development and concrete manufacturing.

## Customers

We currently operate water and sewage systems in 366 of the 645 municipalities in the State of São Paulo. In addition, we currently sell water on a wholesale basis to six municipalities with a total population of approximately 3.2 million. The following table provides a breakdown of total revenues by geographic market for the periods indicated.

	<b>Year ended December 31,</b>		
	<b>2005</b>	<b>2006</b>	<b>2007</b>
	<b>(in millions of reais)</b>		
São Paulo Metropolitan Region	4,044.2	4,534.1	4,888.1
Regional Systems	1,312.1	1,449.9	1,560.1
Total revenue from sales and services	5,356.3	5,984.0	6,448.2

## Competition

We believe there are at least two reasons behind a possible increase in our participation in the domestic sanitation market. There are 274 municipalities in the State of São Paulo that operate their own water and sewage systems and that collectively have a population of approximately 12.6 million, or approximately 31% of the population of the State of São Paulo, excluding the population of the municipalities to which we provide water services on a wholesale basis. In addition, there are private water companies which provide water and sewage services to a small number of municipalities in the State of São Paulo, which may indicate a potential opportunity for the increase of our market share.

Table of Contents

In general, we do not face any competition in the municipalities in which we provide water and sewage services. However, governments of these municipalities may also compete with us, if they resume the water and sewage services that were granted to us and start providing these services directly to the local population. In this case, the municipal governments would be required to indemnify us for the unamortized portion of our investment. See *Our Operations Concessions*. In the past, municipal governments have terminated our concessions contracts before the expiration date. Also, municipal governments have tried to expropriate our assets in an attempt to resume the provision of water and sewage services to local populations. See *Item 8.A. Financial Information Consolidated Statements and other Information Legal Proceedings*. We negotiate expired concession contracts and concession contracts to be expired with the municipalities in an attempt to maintain our existing areas of operations.

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

**Billing Procedures**

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

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

Water and sewage bills can be paid at some banks and other locations in the State of São Paulo. These funds are paid over to us and average service fees between R\$0.29 and R\$1.15 per transaction are charged for collection and remittance of these payments.

Customers must pay their water and sewage bills by the due date if they wish to avoid paying a fine. We generally charge a penalty fee and interest on late bill payments. In 2005, 2006 and 2007, we received, respectively, payment of 90.8%, 91.5% and 92.8% of the amount billed to our retail customers, and 91.1%, 92.5% and 92.5% of the amount billed to those customers other than State entities, within 30 days after the due date. With respect to wholesale sales, in 2005, 2006 and 2007, we received payment of 60.6%, 61.4% and 65.2%, respectively, of the amount billed within 30 days.

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

**Tariffs**

The readjustment of our tariff will follow the parameters established by the new basic sanitation law as well as the São Paulo State Sanitation and Energy Regulatory Agency's (ARSESP) parameters, procedural steps and terms and will be

held once a year. The readjustment will be announced 30 days prior to the effective date of the new tariffs which will occur in September, and last for a period of at least 12 months. We believe that for fiscal year 2008, ARSESP will adopt the adjustment formula that we have been using since August 2003.

Tariffs have historically been adjusted once a year and for periods of at least 12 months. We raised tariffs in June 2001, in July 2002 and in August 2003. We increased our tariffs for water and sewage services by 6.8% on August 29, 2004 and by 9.0% on August 31, 2005. On August 31, 2006, we increased our tariffs by 6.71% . On September 10, 2007, tariffs rose by 4.12%, except for water supply and sewage collection tariffs for consumption of more than 20 cubic meters in non-residential categories, which were adjusted by the cumulative inflation from August 2006 to July 2007 in the IPCA index published by IBGE, which came to 3.74% .

Table of Contents

We established a new tariff schedule, effective May 2002, for commercial and industrial customers that consume at least 5,000 cubic meters of water per month and that enter into demand agreements with us for at least one-year terms. In October 2007, the minimum volume for the formalization for the agreement declined from 5,000 m<sup>3</sup>/month to 3,000 m<sup>3</sup>/month. We believe this tariff schedule will help prevent our commercial and industrial customers from switching to the use of private wells.

On August 29, 2003, we developed and implemented a new readjustment formula for our tariffs to better reflect changes in our cost structure. According to this formula, the cost components of the Tariffs Readjustment Index, or IRT, are separated into two parts ( Part A and Part B ), where Part A encompasses all costs related to energy, to water and sewage treatment materials, to federal, state and local taxes, and to financial compensation due to use of water resources; and where Part B encompasses all other costs and expenses. The readjustment of Part A is based on the price variation observed in its components during the preceding 12-month period. Part B is adjusted by the IPCA index.

We establish separate tariff schedules for our services in each of the São Paulo Metropolitan Region and each of the interior and coastal regions which comprise our Regional Systems. Each tariff schedule incorporates regional cross-subsidies, taking into account the customers type and volume of consumption. Tariffs paid by customers with high monthly water consumption rates are higher tariffs than our costs of providing the water service. We use the excess tariff billed to high-volume customers to compensate for the lower tariffs paid by low-volume customers. Similarly, tariffs for non-residential customers are established at levels that subsidize residential customers. In addition, the tariffs for the São Paulo Metropolitan Region generally are higher than tariffs in the interior and coastal regions.

We divide tariffs into two categories: residential and non-residential. The residential category is subdivided into standard residential, social and *favela* (shantytowns). The residential social tariffs apply to residences of low-income families, residences of persons unemployed for up to 12 months and collective living residences. The *favela* tariffs apply to residences in shantytowns characterized by a lack of urban infrastructure. The latter two sub-categories were instituted to assist lower-income customers by providing lower tariffs for consumption. The non-residential category consists of:

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

Sewage charges in each region are fixed and are based on the same volume of water charged. In the São Paulo Metropolitan Region and the coastal region, the sewage tariffs equal the water tariffs. In the interior region, sewage tariffs are approximately 20% lower than water tariffs. Wholesale water rates are the same for all municipalities served. We also make available sewage treatment services to those municipalities in line with the applicable contracts and tariffs. In addition, various industrial customers pay an additional sewage charge, depending on the characteristics of the sewage they produce.

Each category and class of customer pays tariffs according to the volume of water consumed. The tariff paid by a certain category and class of customer increases progressively according to the increase in the volume of water consumed. The following table sets forth the water and sewage services tariffs by (1) customer category and class and (2) volume of water consumed charged during the years and period stated in the São Paulo Metropolitan Region, which accounted for approximately 75.8% of our gross revenue from sales and services in 2007.



Table of Contents

Customer Category Consumption (in cubic meters per month)	As of December 31,		
	2005	2006	2007
	(reais/cubic meter) <sup>(1)</sup>		
<b>Residential:</b>			
<b>Basic Residential:</b>			
0-10 <sup>(2)</sup>	1.12	1.19	1.24
11-20	1.74	1.86	1.94
21-50	4.36	4.65	4.84
Above 50	4.81	5.13	5.34
<b>Social:</b>			
0-10 <sup>(2)</sup>	0.38	0.40	0.42
11-20	0.66	0.70	0.73
21-30	2.31	2.47	2.57
31-50	3.30	3.52	3.67
Above 50	3.65	3.89	4.05
<b>Favela (shantytown):</b>			
0-10 <sup>(2)</sup>	0.29	0.30	0.32
11-20	0.33	0.35	0.36
21-30	1.09	1.16	1.21
31-50	3.30	3.52	3.67
Above 50	3.65	3.89	4.05
<b>Non-Residential:</b>			
<b>Commercial/Industrial/Governmental:</b>			
0-10 <sup>(2)</sup>	2.24	2.39	2.49
11-20	4.36	4.65	4.84
21-50	8.41	8.97	9.31
Above 50	8.75	9.34	9.69
<b>Commercial/Not-for-profit entities:</b>			
0-10 <sup>(2)</sup>	1.12	1.19	1.24
11-20	2.19	2.34	2.44
21-50	4.22	4.50	4.67
Above 50	4.37	4.66	4.83
<b>Government entities with reduction agreement:</b>			
0-10 <sup>(2)</sup>	1.68	1.79	1.87
11-20	3.27	3.49	3.63
21-50	6.31	6.73	6.98
Above 50	6.56	7.00	7.26

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

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

In 2007, the average tariff calculated for the Regional Systems was approximately 30% below the average tariff of the São Paulo Metropolitan Region.

During mid-1999 until mid-2001, we did not raise our tariffs, due to a State policy of not increasing tariffs for some public services. In June 2001, we increased our average tariffs by approximately 13.1%, which was broadly in line

with the prevailing inflation rates in Brazil since mid-1999, and in August 2002 we raised our tariffs by approximately 8.2% . Using a new readjustment formula approved by our board of directors, in August 2003 we raised our tariffs for water and sewage services by approximately 18.9%, and in August 2004 we raised our tariffs for water and sewage services by approximately 6.8% .

The application of the formula in 2005 would result in a tariff increase of 11.12%, part of which increase is attributable to the increase in the federal taxes. Because this increase was much higher than the accumulated inflation levels for the corresponding period, we decided to adjust the tariff by 9%, effective August 31, 2005. The remaining percentage (1.94%) was deferred to the 2006 tariff adjustment. On August 31, 2006, we increased our tariffs by 6.71% . In 2004, we initiated certain studies for the restructuring of our tariffs. These studies include a study of our costs, taking into account economic efficiency, future costs of operation and payment capacity of low-income families. We have also prepared a marketing strategy for the segmentation of our clients and of the market, taking into consideration specific characteristics and commercial potential as well as proposals for improvement of our tariff policies. The analysis of the results of the study indicated the need for adjustments in the tariff levels per customer category. On September 10, 2007, we applied a non-linear adjustment of 4.12% per customer category except for water supply and sewage collection tariffs for consumption of over 20 cubic meters of non-residential category, which were adjusted by the cumulative inflation from August 2006 to July 2007 in the IPCA index published by IBGE, which came to 3.74% .

Table of Contents

We concluded a study on this topic in January 2006 and our board of executive officers created a team to evaluate and, if needed, to update and report the actions necessary for the implementation of the recommendations of the study. However, with the enactment of Federal Law No. 11,445/07, tariff regulation must be performed by an independent regulatory entity. ARSESP has been chosen to work as the independent regulatory entity, regulating our tariffs, pursuant to a cooperation agreement between the Municipality and the State. With respect to other municipalities where ARSESP has not been explicitly selected to perform this task, we will depend on legal interpretation to conclude whether it will be the independent entity in charge of regulating tariffs. We believe that for 2008 ARSESP will be in charge of tariff adjustments for all municipalities currently operated by us with the sole exception of Lins, a municipality which has already decided to create its own independent regulatory entity. See *Government Regulation Tariff Regulation in the State of São Paulo* for additional information regarding our tariffs.

**Energy Consumption**

The use of energy is material to our operations, and as a result we are one of the largest users of energy in the State of São Paulo, which represents 1.9% of the total energy consumption in the State of São Paulo. We obtain energy primarily from *Companhia Energética São Paulo*, or CESP, pursuant to a long-term contract expiring in 2012. To date, we have not experienced any major disruptions in energy supply. Any significant disruption of energy to us could have a material adverse effect on our business, financial condition, results of operations or prospects.

Energy prices have a significant impact on our results of operations. An average increase of 17.5% in 2004 negatively affected our results of operations. In 2005, we migrated 43% of our energy requirements to the free market where we can more efficiently negotiate the supply of energy. In 2007, 46% of our total energy consumption occurred under free market rates. See *Item 5. Operating and Financial Review and Prospects*.

**Insurance**

We maintain insurance covering, among other things, fire or other damage to our property, office buildings and third-party liability. We also maintain insurance coverage for directors and officers liability (D&O insurance). We currently obtain our insurance policies through public bids involving major Brazilian and international insurance companies in Brazil. As of December 31, 2007, we had paid a total aggregate amount of R\$4.61 million in premiums, covering approximately R\$688.5 million on assets, third-party liabilities and D&O insurance. We do not have insurance coverage for business interruption risk because we do not believe that the high premiums for such insurance are justified by the low risk of major interruption. In addition, we do not have insurance coverage for liabilities arising from water contamination or other problems involving our water supply to customers and for environmental related liabilities and damages. We believe that we maintain insurance at levels customary in Brazil for the type of business in which we are engaged.

**Environmental Matters**

Our operations interact directly with the environment. As such, protecting the environment and social and environmental responsibility are our fundamental principles. We seek to be recognized as a global reference of excellence in the provision of environmental sanitation services .

Sustainability is one of our fundamental principles and values. We balance our financial results with environmental preservation and social development.

In early 2007, we adopted a new management model that treats environmental issues as a strategic objective and implemented some changes that give our corporate organization a greater focus on environmental issues. Environmental management was introduced into the new Technology, Project and Environment Department, which

includes the Environmental Management Superintendence,. An Environmental Legislation Department was also created. To establish integrated operations and manage specific environmental issues in the regions where we operate, each one of our divisions will have an Environmental Management Center to act as operational environmental management agents, thereby accelerating the flow of information. As a result, the many environmental initiatives and programs will be developed by the various divisions, which will also be responsible for implementing our Environmental Policy.

The challenge is enormous, given our size and diversity and the decentralized management of our business.

To help fulfill our mission, several environmental targets have been established, including:

- ISO 14001 certification of 10% of operating units by 2010, which corresponds to 65 water and/or sewage treatment stations;
- maximizing opportunities to participate in the carbon market;
- maximizing the opportunities to efficiently generate electricity;
- drafting of an Environmental Balance Sheet in 2008, with the launch of initiatives to structure environmental accounting in 2007 in order to improve the Company's balance sheet so as to recognize and emphasize investments in the environment that are not related to the core business; and
- identification of alternatives for the recycling and final disposal of water and sewage from treatment stations through partnerships with research institutions and the CETESB Environmental Agency.

The implementation and operation of water and sewage systems are subject to strict federal, state and municipal laws and regulations on environmental and water-resource protection. In São Paulo State, the Environmental Sanitation Technology Company (CETESB) is the governmental entity responsible for the control, supervision and licensing of potentially polluting activities, pursuant to State Law 997 of March 31, 1976, which regulates the control of environmental pollutants.

The control and planning instruments defined by this law include environmental licensing (State Law 997/76, CONAMA Resolution 05/88, CONAMA Resolution 237/97, State Decree 47,400/02, State Decree 47,387/02), standards for effluent emissions and water quality of bodies of water (State Decree 8,468/76 and CONAMA Resolution 357/05) and concessions for the rights to use and interfere with water resources (DAEE Ordinance 717/96).

Projects with significant environmental impact are subject to specific studies prepared by multidisciplinary teams that present a series of recommendations focused on minimizing the environmental impact. These studies are then submitted for analysis and approval by the government authorities. The licensing process is composed of three stages, which include the following licenses:

- prior license - granted in the planning stage, approving the location and concept and attesting to the project's environmental feasibility.
- installation license - authorizing the beginning of works for the installation of the project, subject to the compliance with the approved plans, programs and projects, including environmental control measures and other necessary technical requirements.
- operation license - authorizing the operation of a unit or activity subject to compliance with the technical requirements contained in the installation license.

We have made considerable efforts to protect water sources in order to improve environmental conditions and preserve the São Paulo Metropolitan Region's water resources, through sewage collection and treatment, or indirectly through environmental programs and initiatives. These latter efforts exceed our legal obligations and involve several sectors of society, including elementary and high schools, universities, neighborhood associations and



Another important part of our policy is to implement water conservation programs to minimize the impact of our operations, including the reuse of effluents from sewage treatment stations and the encouragement of the rational use of water with specific programs.

### **Government Regulation**

Basic sanitation services in Brazil are subject to an extensive federal, state and local legislation and regulation that, among other things, regulates:

- the granting of concessions to provide water and sewage services;
- the implementation of public private partnerships;
- the need of a public bidding process for the appointment of private water and sewage services providers;
- the need of setting up an agreement for the appointment of public water and sewage services providers;
- the joint management of public services through cooperation, allowing for a program contract without the need for a public bidding process for the service provider, subject to the condition that the planning, execution and monitoring activities are not executed;
- regulation of water and sewage services;
- water usage;
- water quality and environmental protection; and
- governmental restrictions on the incurrence of indebtedness applicable to state-controlled companies.

### **General**

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

Article 216 of the Constitution of the State of São Paulo provides that, by law, the State must provide the conditions for efficient management and adequate expansion of water and sewage services rendered by its agencies and State-controlled companies or any other concessionaire under its control. State law authorized our formation to plan, provide and operate water and sewage services in the State and also acknowledged the autonomy of the municipalities.

Pursuant to Article 175 of the Brazilian Constitution, the furnishing of public services, such as water and sewage services, is the responsibility of the applicable public authority. However, any such public authority has the right to furnish these services directly or through a concession granted to a third party.

Law No. 11,107/05 (Consortium Law) and Law No. 11,445/07, the basic sanitation law, enacted on January 5, 2007, have caused significant impacts in the development of the state sanitation policy and the regulatory structuring of the industry.

Because we are the legal concessionaire for the State of São Paulo for water supply and sewage services, serving approximately 60% of the State's population and providing sanitation services through concession contracts, we notice the impacts of this legislation on the expiration of our contracts in the 1970's when the Brazilian Sanitation Plan (*Plano Nacional de Saneamento*), or PLANASA, was created.

The Consortium Law has caused important changes in the relationship among municipalities, states and public sanitation services providers, most notably mixed capital companies, such as us, because of the implementation of the program contracts as a substitute for concession contracts.

In addition, Law No. 11,445/07 in its role of general guideline for the development of the Brazilian sanitation industry, addresses the conditions of validity for the delegation of water supply and sewage services, the exercise of ownership by the granting authority and the regulatory conditions for the industry. The new basic sanitation law also provides for a significant amendment to Article 42 of the Concessions Law which establishes the termination of concessions prior to the due expiration date and the reversibility conditions of unamortized assets. The amendment requires that the service provider be compensated for unamortized assets, prioritizing an agreement between the parties setting out the criteria for calculation and payments of indemnity.

### **The Basic Sanitation Law**

On January 5, 2007, Law No. 11,445 was enacted establishing nationwide guidelines for basic sanitation and seeking to create solutions that are adequate for the reality of each state and municipality, facilitating the technical cooperation between the state and municipalities. In addition, the Federal Government will enact its public policy to facilitate access to financing alternatives that are compatible with the costs and terms of the sanitation industry, in substitution of the PLANASA model.

The new basic sanitation law establishes the following principles for basic sanitation public services: universalization, integrality, efficiency and economic sustainability, transparency of actions, social control and integration of infrastructure and services with the management of water resources.

This law does not define the ownership of the sanitation services, but establishes the minimum liability for the exercise of ownership, such as the development of the sanitation plan, definition of the person responsible for regulation and control, establishment of the rights and obligations of the users and of the social control mechanisms. It also defines the regionalized performance of the services (i.e., one single provider serves two or more owners, for which there may be one plan for the combination of services).

In addition, the new basic sanitation law defines the guidelines and objectives of the federal basic sanitation policy to be observed when securing public funds generated or operated by agencies or entities of the Federal Government, and foresees the possibility of having subsidies as an instrument of social policy to ensure access to basic sanitation services to everyone, particularly the low-income population. The subsidies may be granted either directly, through tariffs or indirectly, depending on the characteristics of the beneficiaries and on the source of the funds.

Furthermore, the law also provides that the sanitation services may be interrupted by the service provider, in the event of default of payment of the tariffs by the customer, among other reasons, after written notice, as long as minimum health requirements are met.

Finally, the legislation establishes the criteria for the reversal of assets at the time of termination of the agreement and with regard to the concessions, such as those that have expired or are effective for an indefinite term, or those that were not formalized by an agreement. In addition, the law provides the calculation and value of the indemnity that must be calculated by a specialized institution chosen by mutual agreement between the parties.

In the absence of mutual agreement, the calculation of the indemnity is based on the terms and conditions of the previous agreement, or in the absence thereof, upon economic valuations or book value revaluation of the investment. It should also be calculated by a specialized institution chosen by mutual agreement between the parties.

Payment is to be effected in up to four, equal and successive, annual installments, with a guarantee, being the first payment payable by no later than the end of the financial year in which the reversal occurs.

**Concessions**

Concessions for providing water and sewage services are formalized by agreements executed between the state or municipality, as the case may be, and a concessionaire to which the performance of these services is granted in a given municipality or region. Our concessions normally have a contractual term of up to 30 years, although some of our concessions have an indefinite term of effectiveness. However, our concessions in general can be revoked at any time if certain standards of quality and safety are not met, or in the event of default of the terms of the concession contract.

Table of Contents

A municipality that chooses to assume the control of its water and sewage services must terminate the current relationship by means of evaluation of the value of the investments to compensate the service provider. Subsequently, the municipality will be in charge of rendering services or of conducting a public bidding process to grant the concession to potential concessionaires, including agreements with public companies directly. Although the Constitution of the State of São Paulo determines that the relevant municipality would have to pay us for the unamortized book value of the assets related to the concession and assume any correlated debt, with the exclusion of any amounts that have been paid to us by the municipality, upon termination or non-renewal of the concession, the payment for termination may not be effected immediately, and any termination could negatively affect our cash flows, operating results and financial situation.

The Federal Concessions Law and the State Concessions Law require that the granting of a concession by the government be preceded by a public bidding process. However, the Federal Public Bidding Law provides that a public bidding process can be waived in certain circumstances, including in the case of services to be provided by a public entity created for such specific purpose on a date prior to the effectiveness of this law, provided that the contracted price is compatible with what is practiced in the market. Furthermore, a provision of the Federal Constitution determines waiver of the public bidding requirement in similar situations. Based on this provision, the municipalities granted concessions with waiver of public bidding processes to us after the enactment of the Federal Constitution. Currently, the new basic sanitation law provides that the program contract can be executed with waiver of a public bidding process.

Municipal Law No. 13,670, dated November 25, 2003, created the Municipal System for Regulation of Water Supply and Sanitary Sewage Services (*Sistema Municipal de Regulação dos Serviços de Abastecimento de Água e Esgotamento Sanitário*), providing for their constitution and operation and also establishing the Municipal Sanitation Plan (*Plano Municipal de Saneamento*). According to this Law, the Mayor of the City of São Paulo has powers to grant and monitor formal concessions for water and sewage services in the City of São Paulo. Subsequent to Law No. 13,670, the Governor of the State filed a legal action claiming that this law was unconstitutional and, as a consequence, the applicability of Law No. 13,670 was suspended. On April 20, 2005 the court ruled, by majority of votes, in favor of the Governor of the State. The City of São Paulo appealed the decision and a final decision is still pending to this date.

**Public Consortia Law and Cooperation Agreements**

On April 6, 2005, the Federal Government enacted Law No. 11,107, which regulates Article 241 of the Brazilian Constitution. This new regulation provides general principles to be observed when public consortia enter into contracts with the Brazilian political divisions and subdivisions (the Federal Government, states, the Federal District and municipalities) aiming at the joint management of public services of common interests.

Federal Decree No. 6,017/07, which regulated the Public Consortia Law and Cooperation Agreements, sets forth the manner in which new agreements will be entered into.

On January 13, 2006, the Governor of the State of São Paulo enacted State Decree No. 50,470, amended by State Decree No. 52,020, of July 31, 2007, which provides for the rendering of water and sewage services in the State of São Paulo. According to this Decree, we may enter into agreements with municipalities in connection with the provision of water and sewage services by means of the so-called program contract. In addition, the Decree establishes that we will continue to render services in the areas where the concession is granted by the State.

Based on the aforementioned statutes, in January 2007 we executed our first program contract with the municipality of Lins, located in the State of São Paulo, which continues to be responsible for oversight and regulation. Subsequently, we formalized agreements with other municipalities in the state of São Paulo, with the transfer of these duties to the

State of São Paulo through a partnership agreement.

On June 8, 2006, the State of São Paulo enacted the Decree No. 50,868 creating the Commission for the Regulation of Sanitation Service of the State of São Paulo to provide the State of São Paulo with a more independent regulatory ability in relation to sanitation services. The Commission for the Regulation of Sanitation Service of the State of São Paulo was directly subordinated to the State Secretariat for Sanitation and Energy.

Table of Contents

The main duty of the Commission for the Regulation of Sanitation Service of the State of São Paulo was the conduction of studies for the creation of a regulatory agency for the basic sanitation industry and the presentation of legal and regulatory measures, which resulted in the publication of Supplementary Law 1,025 of December 7, 2007, creating the São Paulo State Sanitation and Energy Regulatory Agency (ARSESP).

ARSESP regulates the basic sanitation services pertaining to the State, respecting the federal and municipal jurisdictions and prerogatives and exercising the following functions:

- complying with and enforcing state and federal basic sanitation legislation;
- publishing the organizational platform for the services, indicating the types of services provided by the state as well the equipment and facilities composing the system;
- assuming, where applicable, the legal attributions of the jurisdictional authority;
- establishing, in accordance with the tariff guidelines defined by the decree, tariffs and other manners for the compensation of services, adjusting and reviewing them to ensure the financial-economic balance of services and low-cost tariffs through mechanisms that increase service efficiency and lead to the appropriation of productivity gains by society; and
- to approve, oversee and regulate (including tariff issues) sewage treatment and wholesale water supply agreements entered into between the state supplier and other suppliers, pursuant to Article 12 of the new basic sanitation law.

Regarding municipal basic sanitation, ARSESP oversees, control and regulate (including tariff issues) services that have been delegated by municipalities to the state through shared management resulting from cooperation agreements to formalize the program contracts between municipalities and us for the execution of these services. If possible and convenient for the municipality, it can act on concession contracts made prior to the current industry legislation.

The remuneration due to ARSESP for its regulation, control and oversight activities will result from the charging of a rate established at 0.50% (zero point five percent) of the annual total invoiced obtained directly from the provision of services, net of taxes. Although this rule has been in effect since January 1, 2008, we are awaiting publication of the ARSESP regulations that define the means of payment. We believe revenues originated from services that are not subject to ARSESP's regulation will not be affected by this 0.50% charge, although there is no assurance this will be the ultimate resolution.

Supplementary Law 1,025/07 also amended paragraphs 5, 7 and 8 and added paragraphs 9 and 10 to Article 1 of State Law 119/73, which created us, expanding the range of services that we can render, with the inclusion of urban rainwater drainage and management, urban cleaning and solid waste management, as well as the operation of power generation, storage, conservation and sales activities, for own or third-party use.

In addition, the new rules simplified the process for the expansion of our business in Brazil and abroad, authorizing us:

- to participate in the controlling block or the capital of other companies;
- to create subsidiaries, which may become majority or minority shareholders in other companies; and

- to establish partnerships with national or foreign companies, including other state or municipal basic sanitation companies in order to expand our activities, share technology and expand investments related to basic sanitation services.

Supplementary Law 1,025/27 also maintained the State Sanitation Committee (CONESAN) created by Supplementary Law 7,750/92 as an advisory and decision-making strategic committee to define and implement the state basic sanitation policy, with the support of the State Secretariat for Sanitation and Energy, which works with the River Basin Committees to prepare proposals for sanitation plans and monitoring.

Finally, this legislation also maintained the State Sanitation Fund (FESAN), linked to the State Secretariat for Sanitation and Energy, to collect and manage resources to support the programs approved by the State and to foster the development of technology, management, human resources and of the institution and the system of sanitation information, as well as other support programs, which will be regulated by decree.

### **Public-Private Partnerships and Growth Acceleration Plan**

The Public-Private Partnership, or PPP, is a form of contract with the public administration used for the concession of services only to private enterprises, as well as for construction works coupled with the provision of services. PPPs are regulated in the State of São Paulo by Law No. 11,688 enacted on May 19, 2004. PPPs may be used for: (1) implantation, expansion, improvement, reform, maintenance, or management of public infra-structure; (2) provision of public services; and (3) exploitation of public assets and non-material rights belonging to the State.

Payment is conditional upon performance. The payment may be collected through: (1) fares paid by users; (2) assignment of credits belonging to the Public Administration, except taxes; and (3) transfer of rights related to the commercial exploitation of public assets.

Law No.11,688 also authorized the creation of Companhia Paulista de Parcerias – CPP. CPP may grant guarantees, enter into insurance contracts, and participate in PPP contracts. CPP is fully owned by the São Paulo State Government.

In January 2007, the President of Brazil announced a new Growth Acceleration Plan, known as the PAC , that includes major investments in infrastructure services, including the service provision of water and sewage, housing, as well as highways, airports, ports, energy, that would benefit the poor population of Brazil. The Plan calls for a total investment of R\$504.0 billion through 2010 and most part of this amount would be provided by state-owned companies and the private sector, while the rest would come from the federal government. Of this total, R\$40 billion investment is for the sanitation sector.

### **Public Bidding Procedures**

Pursuant to the Federal Public Bidding Law, the public bid process commences with publication by the granting authority in the federal, state or municipal official gazette, as the case may be, and another leading Brazilian newspaper, of an announcement that it will carry out a public bidding contest pursuant to provisions set forth in an *edital* (invitation to bid). The invitation to bid must specify, among other terms:

- the purpose, duration and goals of the bid;
- the participation of bidders, either individually or forming a consortium;
- a description of the qualifications required for adequate performance of the services covered by the bid;
- the deadlines for the submission of bids;

- the criteria used for selection of the winning bidder; and
- a list of the documents required to establish the bidder's technical, financial and legal capabilities. The invitation to bid is binding on the granting authority. Bidders may submit their proposals either individually or in consortia, as provided for in the invitation to bid.

Table of Contents

After receiving proposals, the granting authority will evaluate each proposal according to the following criteria, which must have been set forth in the invitation to bid:

- the technical quality of the proposal;
- lowest cost or lowest public service tariff offered;
- a combination of the criteria above; or
- the largest amount offered in consideration for the concession.

The *Edital* bid the concession power to its terms.

The provisions of the State Public Bidding Law parallel the provisions of the Federal Public Bidding Law.

The Federal and State bidding laws will apply to us in the event that we seek to secure new concessions. Moreover, these bidding laws currently apply to us with respect to obtaining goods and services from third parties for, among other things, our business operations or in connection with our capital expenditure program, in each case subject to certain exceptions.

### **Water Usage**

In July 2000, the National Water Agency, a federal agency under the Ministry of the Environment, was established to develop the National System for Water Resources Management. According to existing law, federal and state agencies are authorized to collect charges related to water usage from entities, such as us, for the abstraction of water from, or dumping of sewage into, water resources controlled by these agencies. The charges collected by these agencies will be used to sponsor studies, programs, projects and constructions provided for in the Water Resources Plan (*Plano de Recursos Hídricos*) and for the payment of expenses concerning the creation of the Federal System for Water Resources Managing (*Sistema Nacional de Gerenciamento de Recursos Hídricos*), as well as administrative costs regarding the bodies and entities pertaining thereto and they may be loaned or provided as grants or subsidies to governmental agencies and corporations, including us, for use in the development and maintenance of water resources.

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

State law establishes the basic principles governing the development and use of water resources in the State of São Paulo in accordance with the State Constitution. These principles include:

- rational utilization of water resources, with service to the population identified as having priority;
- optimizing the economic and social benefits resulting from the use of water resources;
- protection of water resources against actions which could compromise current and future use;
- defense against critical hydrographic events which could cause risk to the health and safety of the population or economic and social losses;

- development of hydro transportation for economic benefit;
- development of permanent programs of conservation and protection of underground water sources against pollution and excessive exploitation; and

- prevention of erosion of land in urban and rural areas, with a view to protecting against physical pollution and silting of water resources.

In order to implement these principles, authorizations granting a right of use are required from the relevant public authority for water usage (whether for collection, release of effluents or other otherwise), modification of the regime and modification of the quality or the quantity of the existing water. In the case of rivers under the Federal Government's domain (rivers crossing more than one state), the National Water Agency is the public authority which grants the authorization. With respect to the rivers under a state's domain, the applicable state authority has jurisdiction to grant the right of use. In the State of São Paulo, the State Department of Water and Energy is the public authority responsible for granting such authorizations. Our main operating units have been granted water usage rights, however we also have several operating units where water grants are not fully in place. To help obtain the remaining water grants, we have established a Corporate Program for the Legalization of Grants.

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

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

State Law 12,183 of December 29, 2005 established the basis for the fees charged for the use of the water resources owned by the State of São Paulo. To implement this fee, the law provides for, among other things, the participation of the Basin Committees, the creation of Basin Agencies and the organization of a registered list of water resource users. The Committee's proposals regarding the amounts to be charged at the basins must be approved by the State Water Resource Council, with the approval and setting of the amounts to be applied at each water basin formalized by a decree issued by the State Governor. Article 4 of the law also established that, until December 2009, the fees charged for the use of water resources by public or private basic sanitation (water and sewage) companies will correspond to 50% of the established amount, provided these companies demonstrate they are making investments with their own funds in studies, projects and works aimed at the removal and treatment of sewage. The law also provides for penalties for the failure to pay fees that range from a fine of 2% and interest on arrears on the value of the debt to the suspension or loss of water resource use rights, which are imposed at the discretion of the water resource authority and in accordance with the applicable regulations.

### **Water Quality**

Administrative Rule No. 518/04, issued by the Ministry of Health of the Federal Government provides the standards for drinking water for human consumption in Brazil. This rule conforms to the U. S. Safe Drinking Water Act and the regulations enacted by the U.S. Environmental Protection Agency, establishing rules for sampling and limits related to substances that are potentially hazardous to health.

In compliance with Brazilian law, the physical-chemical, organic and bacteriological analyses carried out for water quality control follow the methodologies of the Standard Methods for Water and Wastewater (21<sup>st</sup> edition) of the American Water Works Association.

Decree No. 5,440/05 provides for the obligation to disclose the quality of water to consumers. We have been complying with these regulations by publishing the relevant information in monthly bills and annual reports delivered to all consumers that we serve.

**Sewage Requirements**

State law sets forth regulations regarding pollution control and environmental protection in the State of São Paulo establishing limits for the discharge of emissions and disposal of waste that impact the water, air and soil. State law provides that, in areas in which there exists a public sewage system, all effluents of a polluting source must be discharged to such system. It is the responsibility of the polluting source to connect itself to the public sewage system.

Table of Contents

All effluents to be discharged are required to meet certain characteristics, which allow such effluents to be treated by our treatment facilities and discharged in an environmentally safe manner. Effluents which exceed such characteristics are prohibited from being discharged into the public sewage system. State legislation also establishes that liquid effluents, except those related to basic sanitation, be subjected to pre-treatment so that they meet the required mandatory levels before being discharged into the public sewage system.

Environmental Sanitation Technology Company (*Companhia de Tecnologia de Saneamento Ambiental*) or CETESB, a State-controlled company under the jurisdiction of the Secretariat of the Environment of the State, is authorized under State law to monitor discharges of pollutants into the environment and to enforce the requirements of State law. CETESB is responsible for operating Installation and Operation Licenses issued to sewage treatment facilities and other pollution sources. We have a program aimed at cleaning up the Tietê River, called the Tietê Project, which was launched in 1992 and is considered the largest basic sanitation program ever implemented in Brazil. The Tietê Project is included in our capital expenditure program, and involves work for the collection, removal and treatment of sewage to expand and optimize the basic sanitary sewage system in the São Paulo Metropolitan Region.

The disposal of sludge must also meet the requirements of State law. CETESB also regulates the discharge of effluents into bodies of water and must approve all of our treatment facilities in accordance with federal regulations. Water resource legislation in the State of São Paulo establishes the charging of fees for the discharge of treated effluents into bodies of water, however, this provision is currently in the final stages of implementation.

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

**Tariff Regulation in the State of São Paulo**

The tariffs we set for our services are to some extent subject to Federal and State regulation.

On December 16, 1996, the Governor of the State issued a decree which approved the existing tariff system and allowed us to continue to set our own tariffs. We used to set our tariffs based on the general objectives of maintaining our financial condition and preserving social equity in terms of the provision of water and sewage services to the population while providing a return on investment. The Governor's decree also directs us to apply the following criteria in determining our tariffs:

- category of use;
- capacity of the water meter;
- characteristics of consumption;
- volume consumed;
- fixed and floating costs;
- seasonal variations; and
- social and economic conditions of residential customers.

In determining tariffs, we may also consider the costs associated with the exploitation of basic sanitation services, depreciation, provision for bad debts, amortization of expenses and adequate remuneration for investments. We

usually submit new tariffs to the Governor of the State for approval. We implemented a new readjustment formula designed to better reflect costs in August 2003. See *Business Overview Tariffs*.

Table of Contents

However, with the enactment of Federal Laws No. 11,445/07 and No. 11,107/05, we were prohibited from planning, inspecting and regulating services, which included determining the tariff policy to be adopted. These activities are to be exercised by the entity of the State that controls the services, which, with the exception of the responsibility for planning, may delegate the exercise of the other applicable responsibilities. Pursuant to Federal Law No. 11,445/07, tariff regulation is to be performed by an independent regulatory entity. Municipalities can choose to delegate tariff regulation to the State's independent regulatory agency (ARSESP) instead of creating their own regulatory agency. Considering (i) that, with the sole exception of the Municipality of Lins, no other municipality has decided to create its own regulatory entity so far and that many municipalities have already delegated regulation to ARSESP, we believe that at least in the near future ARSESP will be in charge of regulating tariffs for most of the concession contracts and program contracts entered into by us. However, we cannot be certain that other municipalities will not take the same decision as Lins.

Regarding tariff regulation for the year of 2008, we believe there will be no major changes in the policy currently in use by us, considering that ARSESP has just been established and will probably have insufficient time to implement a new tariff formula regulation for 2008.

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

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

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

In addition to the specific regulation mentioned above, we are also subject to general rules such as periodic readjustments established by Law No. 9,069/95 which established, among other things, the *Real Plan*.

**Governmental Restrictions on Incurrence of Debt**

On June 30, 1998, the Central Bank issued a resolution amending certain conditions that must be observed with respect to the external credit operations (i.e., foreign currency borrowings) of states, the Federal District of Brasilia, municipalities and their respective *autarquias* (agencies), foundations and non-financial companies, including us. This resolution provides, among other things, that, with certain exceptions applicable to the importation of goods and services:

- the proceeds of external credit operations must be exclusively used to refinance outstanding financial obligations of the issuer, with preference given to those obligations that have a higher cost and a shorter term,

and, until used for such purposes, the proceeds shall remain deposited, as directed by the Central Bank, in a pledged account; and

- the total amount of the contractual obligation must be subject to monthly deposits in a pledged account, equal to the total debt service obligation, including principal and interest, divided by the number of months that the obligation is to be outstanding.

The Central Bank resolution further provides that the requirements described above do not apply to financing transactions involving multilateral or official organizations such as the World Bank, the Inter-American Development Bank or the JBIC. The Central Bank regulation implementing this resolution provides, among other things, that the account referred to in the first bullet point above must be an account opened in a federal financial institution, which is to hold such funds until released for the purpose of refinancing outstanding obligations of the issuer. The Central Bank regulation further provides that the account described in the second bullet point above must be an escrow account to be opened in a federal financial institution and to secure the payment of principal and interest on the external debt.

Our external credit transactions are also subject to the approval of the National Treasury Secretariat and the Central Bank, which, after reviewing the financial terms and conditions of the transaction, will issue an approval for the closing of the foreign exchange transaction relating to the entry of the funds into Brazil and, following such entry and at our request, an electronic certificate of registration through which all scheduled payments of principal, interest and expenses will be remitted by us. The electronic certificate of registration grants the borrower access to the market for foreign exchange.

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

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

The National Monetary Council resolutions limit the amount that Brazilian financial institutions may lend to public sector companies, such as us. Financing of projects which are put up for international bid and any financing in *reais* provided to the Brazilian counterpart of such international bids are excluded from these limits.

#### **4.C. Organizational structure**

Not applicable.

#### **4.D. Property, Plant and Equipment**

Our principal properties consist of reservoirs, water treatment facilities, water distribution networks consisting of water pipes, water mains, water connections and water meters, sewage treatment facilities, and sewage collection networks consisting of sewer lines and sewage connections. As of December 31, 2007, we owned 198 water treatment facilities and 62,318 kilometers of water pipes and mains, 461 sewage treatment facilities and 40,608 kilometers of sewer lines, as well as 16 water quality control laboratories.

We own our headquarters building and all other major administrative buildings. We have pledged some of our properties as collateral to the Federal Government in connection with a long-term financing transaction we have entered into with the World Bank that was guaranteed by the Federal Government. We have also pledged part of our assets in the amount of R\$249.0 million as collateral with respect to our indebtedness under the Special Program for Payment of Federal and Social Security-Related Taxes in Installments (*Programa de Parcelamento Especial para Impostos Federais e Previdenciários*), or PAES program, as set forth by Law No. 10,684, dated May 30, 2003. Three of our properties in the amount of R\$60.5 million were pledged as collateral for the financing granted by the International Bank for Reconstruction and Development, the last installment related to this financing was paid in April, 2007, but so far the Federal Government has not released the properties.

As of December 31, 2007, the total net book value of our property, plant and equipment was R\$14,567.9 million, including concession assets acquired (intangible assets).

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

**ITEM 4A. UNRESOLVED STAFF COMMENTS**

Not applicable.

## ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

*The following management's discussion and analysis of financial condition and results of operations should be read in conjunction with our audited financial statements included in this annual report. This annual report contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those discussed in the forward-looking statements as a result of various factors, including, without limitation, those set forth in Risk Factors.*

*The financial statements in this annual report have been prepared in accordance with the Brazilian Corporate Law Method, which differs in certain significant respects from U.S. GAAP. We have included a discussion below of the material differences between the Brazilian Corporate Law Method and U.S. GAAP related to each critical accounting policy in our audited financial statements. For additional information regarding other differences between the Brazilian Corporate Law Method and U.S. GAAP, please see note 26 to our financial statements.*

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

### 5.A. Operating and Financial Review and Prospects

#### Overview

We operate water and sewage systems in the State of São Paulo, including in the City of São Paulo, Brazil's largest city, and in more than one-half of the other municipalities in the State of São Paulo. We also make wholesale sales of water to six additional municipalities in which we do not operate water systems.

The São Paulo Metropolitan Region, which includes the City of São Paulo, is our most important service territory. With a population of approximately 19.7 million, the São Paulo Metropolitan Region accounted for approximately 75.5%, 75.8% and 75.8% of our gross revenue from sales and services in 2005, 2006 and 2007, respectively. Approximately 70.8% of the property, plant and equipment reflected on our balance sheet as of December 31, 2007 is located in this region. In an effort to respond to demand in the São Paulo Metropolitan Region and because the region represents the principal opportunity to increase our net revenue from sales and services, we have dedicated a major portion of our capital expenditure program to expand the water and sewage systems and to increase and protect water sources in this region. Our capital expenditure program is our most significant liquidity and capital resource requirement.

#### Factors Affecting Our Results of Operations

Our results of operations and financial condition are generally affected by our ability to raise tariffs, general economic conditions in Brazil and, in some previous periods, meteorological conditions. In 2005, hydrological conditions improved and with the increase in efficiencies in our system, we were able to increase capacity and production. We were therefore able to increase revenues reflecting both operational improvement and greater demand arising from the end of our water usage reduction bonus program. In 2006, our results of operations and financial condition were affected by an increase in the invoiced volume of water and sewage, as well as by a decrease in our financial expenses, as a result of our strategy to actively manage our capital market debts. Additionally, in 2006, our results of operations and financial condition was negatively affected by the adjustment of R\$ 93.8 million, as a result of an analysis and conciliation procedure related to the accounting balance of our accounts receivable. In 2007, the volume of lawsuit decisions allowed our management to evaluate the contingency process and based on this evaluation, we quantified the lawsuits involving customers, considering the most recent history of favorable and unfavorable court decisions to improve our estimate of liability.



***Effects of Tariff Increases***

Our results of operations and financial condition are highly dependent upon our ability to increase tariffs for our water and sewage services. Since the passing of Federal Law 11,445/07 on December 5, 2007, as a general rule, ARSESP will be responsible for setting, adjusting and reviewing tariffs, taking into consideration among other factors the following:

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

For the fiscal year of 2008, we believe that ARSESP will adopt the adjustment formula that we have been using since August 2003.

Tariffs have often failed to keep up with inflation during periods of high inflation in the past. During the past few years, we generally have been able to raise tariffs in line with increases in cost of sales and services and operating expenses and to support our liquidity and capital resource requirements. In 2000, we did not raise tariffs due to the State policy for that year of not increasing tariffs for many public services. In June 2001, however, we increased our average tariff by approximately 13.1%, which was broadly in line with prevailing inflation rates in Brazil since mid-1999 as measured by the consumer price index, and in August 2002, we increased our tariffs by 8.2% . In August 2003, we increased our tariffs for water and sewage services by 18.9%, in August 2004 we raised our tariffs for water and sewage services by 6.8% and in August 2005 we raised our tariffs for water and sewage services by 9.0% . In August 2006, we increased our tariffs by 6.71% . In September 2007, we applied a nonlinear adjustment of 4.12% for categories of use and of 3.74% for tariffs for the supply of water and collection of sewage for consumption greater than 20 cubic meters for non-residential categories of use.

Since August 2003, our tariffs have been determined using a transparent formula which accounts for inflation, covers our operating costs and other expenses and provides for a return on investment. Tariffs have historically been adjusted once a year and for periods of at least 12 months.

As of December 2007, readjustment of our tariffs will continue to be set each year, but will be dependent on the parameters established by Federal Law 11,445/07 as well as regulatory agency parameters. Our readjustments will be announced 30 days prior to the effective date of the new tariffs, which will occur in September of each year, and will remain in place for a period of at least 12 months. Regarding tariff regulation for the year 2008, we believe there will be no major changes in the policy currently in use by us, considering that ARSESP has just been established and will probably have insufficient time to implement a new tariff formula regulation for 2008.

The following table sets forth, for the periods indicated, the percentage increase of our tariffs, as compared to three inflation indices:

	<b>Year ended December 31,</b>			
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
Increase in Average Tariff <sup>(1)</sup>	6.8%	9.0%	6.7%	4.12%
	6.6%	4.5%	2.5%	4.4%

Inflation	<i>Índice de Preços ao Consumidor</i>				
<i>IPC</i>	<i>FIPE (Consumer Price Index)</i>				
Inflation	<i>Índice de Preços ao Consumidor</i>				
<i>Ampliado</i>	<i>IPCA (Extended Consumer Price)</i>	7.6%	5.7%	3.1%	4.5%
Inflation	<i>Índice Geral de Preços do Mercado</i>				
<i>IGP-M</i>	<i>(General Price Index-Market)</i>	12.4%	1.2%	3.8%	7.7%

---

(1) Tariff increases for each period took effect in August of such year with the exception of 2007, when the increases took effect in September. Sources: Central Bank, *Fundação Getúlio Vargas* and *Fundação Instituto de Pesquisas Econômicas*.

***Effects of Brazilian Economic Conditions***

As a company with all of its operations in Brazil, our results of operations and financial condition are affected by general economic conditions in Brazil, particularly by currency exchange rate movements, inflation rates and interest rate levels. For example, the general performance of the Brazilian economy affects demand for water and sewer services, and inflation affects our costs and our margins. The Brazilian economic environment has been characterized by significant variations in economic growth rates.

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

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

The principal events affecting the Brazilian macroeconomics in 2005 were the corruption allegations against government officials and Brazilian house representatives of the current president's support base, and the Central Bank's efforts to meet the goal of 5.1% annual inflation, which resulted in the maintenance of high levels of interest rates, starting from November, the Central Bank has begun a process of reducing the official interest rate in order to encourage economic growth. As of December 31, 2005, the official interest rate was 18.00%.

In 2006, the appreciation trend continued and the *real* appreciated by 7.5% against the U.S. dollar between December 31, 2005 and 2006. Notwithstanding the *real*'s appreciation, Brazil's trade surplus was US\$46.1 billion. The average unemployment rate increased from 8.3% for the year ended December 31, 2005, to 10.0% for the year ended December 31, 2006, in the principal metropolitan regions of Brazil, according to IBGE estimates.

In 2007, the appreciation trend continued and the *real* appreciated by 20.7% against the U.S. dollar. Notwithstanding the *real*'s appreciation, Brazil's trade surplus was US\$40.0 billion. Brazil finished 2007 with US\$180 billion in currency reserves. The average unemployment rate decreased from 8.4% for the year ended December 31, 2006, to 7.4% for the year ended December 31, 2007, in the principal metropolitan regions of Brazil, according to IBGE estimates. In 2007, the inflation rate, as measured by the IGP-M, was 7.7% as compared to 3.8% in 2006.

***Interest Rates.*** Interest rate levels in Brazil are closely linked to exchange rate movements and inflation rates. High domestic interest rates result in increases in our financial expenses and also negatively affect our ability to obtain financing, on a cost-effective basis, in domestic capital and lending markets. As a result, we may continue to require substantial amounts of foreign currency-denominated debt in order to satisfy our liquidity and capital resource requirements, which increase our exposure to exchange rate movements as discussed below.

The Central Bank increased the official interest rate to 26.3% on February 19, 2003 and decreased it to 15.8% on April 14, 2004. The Central Bank increased the official interest rate to 17.74% on December 15, 2004. During the first four months of 2005, the Central Bank continued to raise the official interest rate, which reached 19.5% on April 20, 2005. However, starting from November of 2005, the Central Bank began a process of reducing the official interest rate. On December 31, 2005, the official interest rate was 18.0%. In 2006, the Central Bank continued to reduce the

official interest rate, reaching 13.19% on December 31, 2006. In 2007, the Central Bank continued to reduce the official interest rate, reaching 11.18% on December 31, 2007. In 2008 the Central Bank began a process of increasing the official interest rate. Since the beginning of 2008, the rate has been increased twice. On June 30, 2008, the official interest rate, was 12.25% . We have not utilized any derivative financial instruments, or any hedging instruments to mitigate interest rate fluctuations. We do, however, continually monitor market interest rates in order to evaluate the possible need to refinance our debt.

Table of Contents

**Inflation.** Inflation affects our financial performance by increasing our costs of services rendered and operating expenses. In addition, all of our *real*-denominated debt is indexed to take into account the effects of inflation. Most of our *real*-denominated debt provides for inflation-based increases in the respective principal amounts of that debt, which increases are determined by reference to the daily government interest rate (*Taxa Referencial-TR*) plus an agreed margin. We cannot assure that we will be able, in future periods, to increase tariffs to offset, in full or in part, the effects of inflation.

The following table shows Brazilian inflation for the periods indicated:

	<b>Year ended December 31,</b>			
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
Inflation Consumer Price Index (IPC-FIPE)	6.6%	4.5%	2.5%	4.4%
Inflation General Price Index-Market (IGP-M)	12.4%	1.2%	3.8%	7.7%

Source: *Fundação Getúlio Vargas*.

**Currency Exchange Rates.** We had total foreign currency-denominated indebtedness of R\$1,242.3 million as of December 31, 2007. In the event of significant devaluations of the *real* in relation to the U.S. dollar or other currencies, the cost of servicing our foreign currency-denominated obligations would increase as measured in *reais*, particularly as our tariff and other revenue are based solely in *reais*. In addition, any significant devaluation of the *real* will increase our financial expenses as a result of foreign exchange losses that we must record. For example, the 34.3% devaluation of the *real* in 2002 increased our financial expenses and negatively affected our overall results of operations for that year. In contrast, in 2003, the *real* appreciated 22.3% against the U.S. dollar, which resulted in a foreign exchange gain of R\$540.6 million. The 8.8% appreciation of the *real* against the U.S. dollar in 2004 led to a foreign exchange gain of R\$179.7 million. The 13.4% appreciation of the *real* against the U.S. dollar in 2005 led to a foreign exchange gain of R\$312.1 million. The 9.5% appreciation of the *real* against the U.S. dollar in 2006 led to a foreign exchange gain of R\$96.1 million. The 20.7% appreciation of the *real* against the U.S. dollar in 2007 led to a foreign exchange gain of R\$188.4 million.

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

	<b>Year ended December 31,</b>			
	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>
Devaluation (appreciation) of the <i>real</i> versus U.S. dollar	(8.8)%	(13.4)%	(9.5)%	(20.7)%
Period-end exchange rate US\$1.00	R\$2.6544	R\$2.3407	R\$2.1380	R\$ 1.7713
Average exchange rate US\$1.00 <sup>(1)</sup>	R\$2.9259	R\$2.4341	R\$2.1771	R\$ 1.9483

(1)Represents the average for period indicated.

Source: The Central Bank.

At times, we enter into forward exchange transactions and financial funding transactions in *reais* to mitigate foreign currency exposure. In addition, we have monitored, overseen and controlled our indebtedness denominated in foreign currency, taking advantage of market opportunities to improve the profile of our indebtedness and reduce our costs. On December 31, 2007 we had no forward exchange transactions.

*Effects of Drought*

Brazil experienced a prolonged and severe drought during 2000 and 2001, although historically droughts have not impacted all of our water supply systems equally. During this period, the São Paulo Metropolitan Region, in particular, faced its worst drought in 65 years. As a result, from mid-June to mid-September in 2000, we rationed water in the south of the São Paulo Metropolitan Region, affecting approximately 3.5 million people, or approximately 20% of the total population of this region. Under this rationing, water was made available to our customers for only two out of every three days. During this rationing period, we also reduced our total water production by approximately 8%. From April 2001 through January 2002, we rationed water in the west of the São Paulo Metropolitan Region, affecting approximately 300,000 people. Under this rationing, water was made available to these 300,000 customers for only 40 out of every 78 hours. Throughout 2003 rain levels were below average resulting in a weak replenishment of our reservoirs, particularly in the Cantareira system, the largest water supply system in the São Paulo Metropolitan Region. From October to December 2003, we rationed water on the western part of the São Paulo Metropolitan Region, served by the Alto Cotia system, affecting approximately 450,000 people, or approximately 2% of the region's population. Under this rationing, water was available to those people for three days, followed by two days of rationing. During this period our total water production volume was reduced by 0.8%. As a result of the drought, our revenue declined as our volume of water billed decreased, and our costs increased because of required expenditures to protect and develop water sources and to preserve water quality. The impact that droughts have may vary across our different systems, which may allow us to mitigate the effects of any particular drought. The effects of the drought continued to affect our systems through 2004. In order to minimize the effects of this drought we implemented a water usage reduction bonus program. Due to this program and the return to normal rainfall levels that occurred throughout 2004 and early 2005, the conditions of our reservoirs have improved. In 2006 the rainfall was sufficient to enable us to maintain our reservoirs at historical levels. In 2007, the rainfall exceeded that of 2006 resulting in an increase in the volume of water held in our reservoirs thereby providing a cushion to meet demand.

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

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

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

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

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

**Critical Accounting Policies, Practices and Estimates**

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

Our management discussion and analysis of financial condition and results of operations are based upon our primary financial statements, which have been prepared in accordance with the Brazilian Corporate Law Method, which differs in significant respects from U.S. GAAP. We have included a discussion on material differences between the Brazilian Corporate Law Method and U.S. GAAP related to each critical accounting policy in our audited financial statements.

***Allowance for Doubtful Accounts***

We record allowance for doubtful accounts in an amount that our management considers sufficient to cover probable losses, based on an analysis of customer accounts receivable. We record an allowance for doubtful accounts for balances receivable in excess of R\$5,000 and overdue for more than 360 days, and for balances receivable in excess of R\$30,000 and overdue for more than 360 days as to which we have commenced judicial collection proceedings. The amount is thus calculated and adjusted when it is in excess or insufficient, based on an aging analysis of receipts and on the expected recovery at different categories of customers. Accounts receivable balances under R\$5,000 and overdue for more than 180 days are written off as a direct charge to income.

Provisions for the allowance for doubtful accounts are included in selling expenses, net of recoveries. The net charge to this allowance was R\$255.3 million in 2005, R\$411.9 million in 2006 and R\$323.3 millions in 2007.

Our methodology for determining the allowance for doubtful accounts receivable requires significant estimates, considering a number of factors including historical collection experience, current economic trends, estimates of forecast write-offs, the aging of the accounts receivable portfolio and other factors. While we believe that the estimates we use are reasonable, actual results could differ from those estimates.

In addition, we have substantial assets consisting of amounts owed by the State. These amounts consist primarily of accounts receivable for services, reimbursement for pensions paid. See Item 7.B. Major Shareholders and Related Party Transactions Related Party Transactions . We do not reserve against any of these amounts owed by the State due to the following factors:

- we do not expect to incur losses from these accounts receivable; and
- we entered into agreements in September 1997, December 2001 and March 2004 under which the State has committed to settle the outstanding amounts due to us described in these agreements by applying dividends declared by us to the remaining balance of the accounts receivable owed by the State or its controlled entities. The second amendment signed on December 2007, does not require the application of dividends to offset accounts receivable from the State.

As of December 31, 2007, the amounts owed to us by the State for the provision of water and sewage services included R\$134.9 million which was considered overdue as of February 29, 2004. As of December 31, 2007 the State owed us an additional R\$311.5 million in accounts receivable related to the provision of water and sewage services rendered from February 2004. With respect to reimbursement for pensions paid on behalf of the State, the State owed us R\$879.1 million as of December 31, 2007 (R\$320.6 million of which was acknowledged by the State in an agreement with us subject to a further audit which has not yet occurred). We have not established any provisions for any amounts due to us by the State.

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

***Financial Instruments Fair Value***

In accordance with CVM Instruction No. 235/95, we estimated the fair value of the financial instruments, using available market information and appropriate estimation methodologies (see note 18 to our financial statements).

However, considerable judgment is required to interpret market data and to develop the estimates of fair value. Accordingly, the estimates presented are not necessarily indicative of the amounts that could be realized in a current market exchange. The use of different market assumptions and/or valuation methodologies may have a material effect on the estimated fair values. As of December 31, 2007, the impact disclosed by us related to the fair value of our financial instruments was a loss of R\$17.7 million.

***Indemnities Receivable***

Indemnities receivable is a long-term asset representing amounts receivable from the Municipalities of Diadema and Mauá as indemnification for the unilateral withdrawal by those authorities of our water and sewage service concessions in 1995. As of December 31, 2007 this asset amounted to R\$148.8 million.

Under our concession contracts we invested in the construction of water and sewage systems in these municipalities to meet our concession service commitments. Upon the unilateral termination of the Diadema and Mauá concessions, our assets were impounded by the municipal authorities, which took on the responsibility of providing water and sewage services in these areas. At that time, we reclassified our property, plant and equipment balances relating to the impounded assets to long-term assets (indemnities receivable) and recorded impairment charges to reduce the carrying value of the assets to the estimated recoverable amounts for which we had contractually agreed as fair compensation with the relevant authorities.

Our rights to the recovery of these amounts are being disputed by the municipalities and no amounts have been received to date. Based on the advice of legal counsel, we continue to believe that we have the right to receive such amounts and we continue to monitor the status of the legal proceedings. However, the ultimate amounts to be received, if any, will most likely be subject to a final court decision. As such, actual amounts received could differ from those recorded.

For more information, see note 7 to our financial statements.

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

***Property, Plant and Equipment***

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

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

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

In evaluating impairment of our long-lived assets, we make significant assumptions and estimates regarding matters that are inherently uncertain, including projections of future operating income and cash flows, future growth rates, and the remaining useful lives of the assets, among others. In addition, projections are computed over an extended period of time, which subjects those assumptions and estimates to an even larger degree of uncertainty. While we believe that the estimates we use are reasonable, the use of different assumptions could materially affect our valuations.

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

***Depreciation of Property, Plant and Equipment.*** Depreciation of our property, plant and equipment, primarily buildings, water and sewage service and other assets acquired, is provided using the straight-line method based on the estimated useful lives of the underlying assets.

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

### ***Loss Contingencies***

We are a party to a number of legal proceedings involving significant monetary claims. These legal proceedings include, among others, tax, labor, civil, environmental, condemnation and other proceedings. For a more detailed discussion of these legal proceedings, see note 15 to our financial statements. We accrue for probable losses resulting from these claims and proceedings when we determine that the likelihood that a loss has occurred is probable and the amount of such loss can be reasonably estimated. As such, we are required to make judgments regarding future events for which we often seek the advice of legal counsel. As a result of the significant judgment required in assessing and estimating these loss contingencies, actual losses realized in future periods could differ significantly from our estimates and could exceed the amounts which we have provisioned.

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

### ***Pension Plans***

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

Under the Brazilian Corporate Law Method, prior to January 1, 2002, we recorded pension expense on an accrual basis based on our contributions to the plan. Effective January 1, 2002, in accordance with the issuance of a new accounting standard, we began accounting for our actuarial obligation under Plan G1. As permitted under this standard, we amortized the transition liability related to the actuarial value of our obligation at the date of adoption of the new standard over a period of five years, which was recorded in our statements of operations as an extraordinary item, net of the related tax impacts. For 2005, pension costs charged to income totaled R\$65.7 million, of which R\$53.2 million (net of tax effects, totaling R\$35.1million) was presented as extraordinary item net of income tax and social contribution. The remaining R\$12.5 million was charged to cost of services rendered, general and administrative expenses and selling expenses. For 2006, pension costs charged to income totaled R\$56.0 million, of which R\$53.2 million (net of tax effects totaling R\$35.1 million) was presented as extraordinary item net of income tax and social contribution. The remaining R\$2.8 million was charged to cost of services rendered, general and administrative expenses and selling expenses. For 2007, pension costs charged to income totaled R\$55.9 million, and this amount was charged to cost of services rendered, general and administrative expenses and selling expenses. At December 31, 2007, our obligation under Plan G1 was R\$365.2 million. See note 13 to our financial statements.

Under U.S. GAAP, we had already adopted the provisions of SFAS No. 87, Employers Accounting for Pensions prior to 2002, which requires that we recognize an actuarial liability for pension benefits under Plan G1. While the actuarial assumptions used for U.S. GAAP are the same as those used in determining the actuarial liability under the Brazilian Corporate Law Method, pension costs and obligations under U.S. GAAP and the Brazilian Corporate Law Method are not the same, mainly due to differences related to the first year of application, the amortization of the initial transition obligation, amortization periods for other actuarial gains and losses, and actuarial calculation methods, among others. After the issuance of SFAS 158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R), in September 2006, an employer is required to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multi-employer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. This statement also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. See note 26 to our financial statements.

Table of Contents

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

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

Consistent with the guidance in SEC Staff Accounting Bulletin Topic 5-T ( SAB No. 5-T ), under U.S. GAAP, we recognize the costs and obligations associated with Plan G0 supplemental pension benefits on a push-down basis, as we are the recipients of the benefits of the employee service for which the supplemental pension benefits are made. The Plan G0 benefit obligation and expenses are accounted for in accordance with SFAS No. 87. Eventual amounts received as reimbursement from the State, if any, are treated as additional paid-in-capital. As such, Plan G0 is considered unfunded for purposes of U.S. GAAP. See notes 26 and 27 to our financial statements.

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

The present value of our pension obligations was based on a discount rate of 12.3% for 2005 and 2006, and 10.8% for 2007. Our pension obligation and expense increases as the discount rate is reduced.

Our expected return on assets for Plan G1 is determined by evaluating the asset class return expectations with our advisors, as well as actual, long-term historical results of our asset returns. For 2007, we used an expected rate of return on assets assumption of 10.8% . The expected return on assets assumption is based on a targeted allocation of investments in accordance with the investment strategies of the plans. We believe that this targeted allocation will, on average, approximate actual long-term asset allocation.

***Certain Transactions with Controlling Shareholder***

**Reimbursement Due from the State.** Reimbursement due from the State for pensions paid represent supplementary pensions (Plan G0) that we pay, on behalf of the State, to former employees of the State-owned companies which merged to form a company. These amounts are reimbursed to us by the State, as primary obligor. However, these amounts have been outstanding for a long period. We account for these as long-term assets, and we do not reserve against such accounts receivable as we expect to recover these amounts and loss is not considered probable. On March 26, 2008, the State of São Paulo, through the Treasury Secretariat and the Sanitation and Energy Secretariat, and we entered into a commitment agreement for the settlement of outstanding debts related to the reimbursement of pension benefits. Even though the State acknowledges its debts related to the pension benefits, the State disagrees with the criteria adopted by us to grant and pay the benefits, based on the legal opinions issued by the State Attorney General, which restricts State actions and prevents the voluntary reimbursement of all amounts paid by us. From our standpoint, the criteria adopted in the past to grant and pay pension benefits were correct, as they were based on

Edgar Filing: COMPANHIA DE SANEAMENTO BASICO DO ESTADO DE SAO PAULO-SABESP - Form 20-F  
specific State authorizations or then effective legal opinions. See note 6 to our financial statements.

Table of Contents

**Accounts Receivable from the State for Water and Sewage Service Provided.** Certain of these accounts receivable have been overdue for a long period and we do not reserve against such accounts receivable as we fully expect to recover these amounts and loss is not considered probable. We have entered into agreements with the state with respect to these accounts receivable. For further information on these agreements, see note 6 to our financial statements.

**Use of Certain Assets Owned by the State.** We currently use certain reservoirs in the Alto Tietê System and the Billings and Guarapiranga reservoirs which are owned indirectly by the State. We currently do not pay any fees with respect to the use of these reservoirs. However, we are responsible for maintaining and meeting the operating costs of these reservoirs. If these facilities had not been made available for our use, we would have had to obtain water from more distant sources, which would be more costly. The State does not incur operating costs on our behalf.

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

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

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

## Results of Operations

The following table sets forth, for the periods indicated, certain items in our statement of operations, each expressed as a percentage of net revenue from sales and services:

	<b>Year ended December 31,</b>		
	<b>2005</b>	<b>2006</b>	<b>2007</b>
Net revenue from sales and services	100.0	100.0	100.0
Cost of sales and services	(48.0)	(47.3)	(45.1)
Gross profit	52.0	52.7	54.9
Selling expenses	(10.9)	(13.0)	(10.7)
Administrative expenses	(7.0)	(7.1)	(9.4)
Financial expenses, net	(9.0)	(10.2)	(9.4)
Income from operations	25.1	22.4	25.4

Non-operating expenses, net	(0.5)	(0.9)	(0.6)
Income before taxes on income	24.6	21.5	24.8
Income tax and social contribution	(6.4)	(6.8)	(7.2)
Extraordinary item, net of income tax and social contribution	(0.7)	(0.6)	-
Net income	17.5	14.1	17.6

**Year Ended December 31, 2007 Compared to Year Ended December 31, 2006*****Net Revenue from Sales and Services***

Net revenue from sales and services increased by R\$443.5 million, or 8.0%, to R\$5,970.8 million in 2007, from R\$5,527.3 million in 2006.

Net revenue from sales and services relating to water services in 2007 increased by R\$232.0 million, or 7.3%, to R\$3,409.3 million in 2007, from R\$3,177.3 million in 2006. This increase was principally due to:

- a 2.2% increase in volume of water invoiced in 2007; and
- a tariff readjustment in 2007 of 4.1%.

Net revenue from sales and services relating to sewage services in 2007 increased by R\$211.4 million, or 9.0%, to R\$2,561.5 million in 2007, from R\$2,350.1 million in 2006. Volumes of sewage increased by 4.3%, while tariffs increased by 4.1% .

***Cost of Sales and Services***

The cost of sales and services increased by R\$78.9 million, or 3.0%, to R\$2,695.7 million in 2007, from R\$2,616.8 million in 2006. As a percentage of net revenue from sales and services, cost of sales and services decreased to 45.1% in 2007 from 47.3% in 2006.

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

- an increase of R\$57.7 million, or 17.7%, in services expenses mainly due to: (1) an increase of R\$20.3 million in network maintenance, residential connections of sewage and water and streets pavement related to the losses reduction program; (2) an increase of R\$17.9 million in maintenance of sewage and water systems; (3) an increase of R\$3.5 million in security expenses related to the improvement of the electronic systems monitored by distances; and (4) an increase of R\$2.1 million related to the improvements and maintenance of our Call Centers;
- an increase of R\$25.6 million, or 5.7%, in energy costs, principally as a consequence of (1) an increase in average energy tariffs of 5.7% in the regular energy supply market; and (2) a decrease of 0.8% related to the program of efficient use of energy;
- an increase of R\$7.9 million, or 7.5%, in materials expenses, as a consequence of the presence of algae in the reservoir of Cantareira that demanded an increase in copper sulphate consumption;
- an increase of R\$3.9 million, or 3.4%, in materials, principally due to (1) a R\$4.8 million increase in materials used in the distribution and collections network maintenance; (2) a R\$1.2 million increase in maintenance of electric and mechanical systems of elevation stations and sewage treatment; (3) expenses in the amount of R\$1.1 million related to our obtainment of the International Occupational Health and Safety Management System Specification Certification, the OHSAS 18001 Certification.  
These increases were partially offset by a decrease of R\$3.8 million, in fuel expenses, related to a decrease of 9.4% in the price of Ethanol;
- an increase of R\$3.3 million, or 0.3%, in payroll expenses and related charges, primarily due to (1) annual salary adjustments of 3.37% that came into effect in May 2007; (2) an increase of R\$38.3 in accrual for pension obligations in accordance with the CVM, under CVM Deliberation No. 371/2000, that were offset by a non recurrent provision from 2006 related to bonuses in the amount of R\$21.2 million and an incentivized resignation program in the amount of R\$9.5 million; and

- a decrease of R\$18.2 million, or 2.9%, in depreciation and amortization, principally due to the transfer of assets recorded as construction in progress to operating permanent assets, which resulted in higher depreciation costs during 2006.

***Gross Profit***

As a result of the factors discussed above, gross profit in 2007 increased by R\$364.5 million, or 12.5%, to R\$3,275.1 million in 2007, from R\$2,910.6 million in 2006. As a percentage of net revenue from sales and services, gross profit increased to 54.9% in 2007 from 52.7% in 2006.

***Selling Expenses***

Selling expenses in 2007 decreased by R\$79.6 million, or 11.1%, to R\$639.6 million in 2007, from R\$719.2 million in 2006. As a percentage of net revenue from sales and services, selling expenses decreased to 10.7% in 2007, from 13.0% in 2006.

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

- a decrease of R\$88.5 million, or 21.5%, in bad debt expenses, net of recoveries, to R\$323.4 million in 2007 from R\$411.9 million in 2006, principally due to the adjustment of R\$93.8 million in 2006, which was a result of an analysis and reconciliation procedure related to the accounting balance of our accounts receivable; and
- an increase of R\$8.1 million, or 10.1%, in services expenses, principally due to (1) the expansion of external technical attendance service (TACE), and (2) an improvement of the electronic systems monitored by distances.

***Administrative Expenses***

Administrative expenses for 2007 increased by R\$171.8 million, or 44.3%, to R\$559.2 million in 2007, from R\$387.4 million in 2006. As a percentage of net revenue from sales and services, administrative expenses increased to 9.4% in 2007, from 7.1% in 2006.

The increase in administrative expenses primarily reflected:

- an increase of R\$163.2 million, in provisions for judicial proceedings, resulting from costumers claims as to which losses are probable. This increase is a result of an internal assessment that considered the history of judicial proceedings to calculate the best estimate of our actual potential liabilities; and
- an increase of R\$10.2 million, or 30.5%, in fiscal expenses principally due to the end of our IPTU (urban buildings and territorial tax) exemption in the municipality of São Paulo.

***Financial Expenses, Net***

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

Financial expenses, net in 2007 decreased by R\$2.3 million, or 0.4%, to R\$561.0 million in 2007, from R\$563.3 million in 2006. As a percentage of net revenue from sales and services, financial expenses, net decreased to 9.4% in 2007, from 10.2% in 2006.

Financial expenses increased R\$96.6 million, or 12.3% . This increase in financial expenses was primarily due to:

- an increase of R\$185.7 million related to financial expenses on judicial proceedings mentioned in administrative expenses.

The increase in financial expenses was partially offset by:

- a decrease of R\$70.5 million related to the prepayment of the 1<sup>st</sup> and 2<sup>nd</sup> series of our 5<sup>th</sup> series of our debentures in April 2006 and September 2007, respectively; and
- a decrease of R\$18.3 million related to prepayment of our 2008 Eurobonds in November 2006. The refinancing of the 2008 Eurobonds with the 2016 Eurobonds, has reduced the nominal interest rate from 12.0%p.a. to 7.5%p.a..

Financial income increased by R\$6.5 million, or 5.1%, to R\$132.4 million in 2007, from R\$125.9 million in 2006, which was related to interest income from renegotiated accounts receivable.

The exchange variation gain, increased R\$92.4 million, or 96.7%, to R\$188.0 million in 2007, from R\$95.6 million in 2006, which was related to the *real* appreciation against the U.S. dollar of 20.7% in 2007 compared to 9.5% in 2006.

As of December 31, 2007, 78.1% of our debt was denominated in *reais* and 21.9% was denominated in foreign currency, principally U.S. dollars.

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

As a result of the factors discussed above, income from operations in 2007 increased by R\$274.7 million, or 22.1%, to R\$1,515.4 million in 2007, from R\$1,240.7 million in 2006.

### ***Non-Operating expenses, net***

Non-operating expenses, net 2007 decreased by R\$15.7 million, or 30.9%, to R\$35.2 million, from R\$50.9 million in 2006.

The decrease in non-operating expenses, net was primarily due to:

- an increase of R\$ 22.6 million, or 38.4%, in losses related to the disposal of obsolete assets; and
- a decrease of R\$34.7 million related to the recognition of amounts that are no longer required to be paid back to customers (prescribed).

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

Income tax and social contribution tax (including deferred taxes) in 2007 increased by R\$55.8 million, or 14.8%, to R\$431.6 million from R\$375.8 million in 2006. This was primarily due to the increase in taxable income, which was R\$1,642.6 in 2007, compared to R\$1,283.5 million in 2006. This increase in profits was partially offset by tax benefits resulting from the declaration of interest on shareholders' equity. This benefit amounted to R\$102.3 million in 2007, compared to R\$92.1 million in 2006, over interest on shareholders' equity in the amounts of R\$300.7 million and R\$270.8 million, respectively.

### ***Extraordinary Item***

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

As permitted, the expense was recorded as an extraordinary item of R\$35.1 million, net of income tax, of R\$18.1 million, for each of the five years. The last appropriation related to the actuarial liability mentioned above was made in 2006.

***Net Income***

As a result of the factors discussed above, net income increased by 34.6%, to R\$1,048.7 million in 2007, from R\$778.9 million in 2006. Excluding the effects of the adjustment of R\$93.8 million in 2006, which was a result of an analysis and conciliation procedure related to the accounting balance of our accounts receivable, our net income would have increased by R\$176.0 million. The bulk of this increase derived from profits from operations, which recorded a significant growth of 22.1%, and the 20.7% appreciation of the *real*, compared to U.S. Dollar, contributed to the balance of the increase.

**Year Ended December 31, 2006 Compared to Year Ended December 31, 2005*****Net Revenue from Sales and Services***

Net revenue from sales and services increased by R\$573.9 million, or 11.6%, to R\$5,527.3 million in 2006, from R\$4,953.4 million in 2005.

Net revenue from sales and services relating to water services in 2006 increased by R\$320.8 million, or 11.2%, to R\$3,177.3 million in 2006, from R\$2,856.5 million in 2005. This increase was principally due to:

- a 2.7% increase in volume of water invoiced in 2006; and
- the effect of the tariff readjustment in 2005 of 9.0%, with a 6.6% impact in 2006, and the tariff readjustment in 2006 of 6.7%, with a 1.7% impact in 2006, which altogether had an impact of 8.3%.

Net revenue from sales and services relating to sewage services increased by R\$253.2 million, or 12.1%, to R\$2,350.1 million in 2006, from R\$2,096.9 million in 2005. Volumes of sewage increased by 4.0%, while tariffs increased by 9.0% .

***Cost of Sales and Services***

The cost of sales and services increased by R\$240.4 million, or 10.1%, to R\$2,616.8 million in 2006, from R\$2,376.4 million in 2005. As a percentage of net revenue from sales and services, cost of sales and services decreased to 47.3% in 2006 from 48.0% in 2005.

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

- an increase of R\$115.5 million, or 13.6%, in payroll expenses and related charges, primarily due to annual salary adjustments of 4.63% that came into effect in May 2006. In addition, the increase was due to the non recurrent provision of a performance-related bonus, a profit sharing plan taking into account in 2006 and the charges related to payment of compensation in connection with our incentive resignation program, totaling an aggregate amount of R\$60.2 million. This increase was partially offset by a 2.7% decrease in the number of our employees, or 470 employees, of which 398 employees resigned under the incentive resignation program. While the number of employees covered by this line item decreased to 16,978 in 2006 from 17,448 in 2005, productivity increased on a company-wide basis based on our operating index of the number of water and sewage connections per employee, which indicated 684 connections per employee in 2006 and 651 connections per employee in 2005;
- an increase of R\$49.4 million, or 8.6%, in depreciation and amortization, principally due to the transfer of assets recorded in construction in progress to operating permanent assets, which resulted in higher depreciation costs during 2006. We expect depreciation costs to increase in the next periods in the same proportion of the increase in our assets in operation.

- an increase of R\$29.0 million, or 9.7%, in outsourced services, principally due to a R\$16.2 million increase in preventive and corrective maintenance of water and sewage treatment stations and in fees related to sludge disposal services, a R\$6.8 million in our water loss control program and a R\$6.0 million in costs related to hiring security companies;

Table of Contents

- an increase of R\$25.7 million, or 6.1%, in energy costs, principally as a consequence of (1) an increase in average energy tariffs of 6.7% in the regular energy supply market; the supply of energy from this market represented 84% of energy costs incurred by us in 2006; (2) an increase in energy consumption due to an increase of 2.7% in water production and of 4.0% in collection and treatment of sewage; and (3) a 16.3% increase in average energy tariffs in the free market, which represented 16% of energy costs incurred by us in 2006. The increase in energy costs was partially mitigated by (1) the migration of 43% of our energy requirements to the free market, where we can more efficiently negotiate for the supply of energy, which enabled us to save R\$4.9 million in energy costs in 2006 and also provided us with a R\$24.9 million saving with the supply of energy in connection with the migration of 43% of our energy requirements to the free market in 2006; (2) the renegotiation of energy supply agreements with municipalities of the São Paulo Metropolitan Region, which enabled us to save R\$0.5 million; and (3) the ending of the additional charge for emergency energy capacity in 2005, which enabled us to save R\$7.3 million;
- an increase of R\$12.5 million, or 11.9%, in materials, principally due to a R\$5.6 million increase in materials used in the distribution and collections network maintenance, a R\$4.6 million increase in fuel, expenses in the amount of R\$0.9 million related to our obtainment of the International Occupational Health and Safety Management System Specification Certification, the OHSAS 18001 Certification, which is a non-recurrent expense, and a R\$1.4 million increase in several other types of materials; and
- an increase of R\$5.6 million, or 5.7%, in treatment materials, due to a higher volume of treated water and collected and treated sewage as a result of the increase in consumption and the increase in the price of certain materials. The average increase in prices of treatment materials was 8.3%, but more efficient operating procedures resulted in total costs not increasing to the same extent.

***Gross Profit***

As a result of the factors discussed above, gross profit in 2006 increased by R\$333.5 million, or 12.9%, to R\$2,910.5 million in 2006, from R\$2,577.0 million in 2005. As a percentage of net revenue from sales and services, gross profit increased to 52.7% in 2006 from 52.0% in 2005.

***Selling Expenses***

Selling expenses in 2006 increased by R\$181.4 million, or 33.7%, to R\$719.2 million in 2006, from R\$537.8 million in 2005. As a percentage of net revenue from sales and services, selling expenses increased to 13.0% in 2006, from 10.9% in 2005.

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

- an increase of R\$156.6 million, or 61.3%, in bad debt expenses, net of recoveries, to R\$411.9 million in 2006 from R\$255.3 million in 2005. Excluding the effects of the adjustment of R\$93.8 million, which was a result of an analysis and conciliation procedure related to the accounting balance of our accounts receivable, the increase was mainly due to the increase in receivables following the end of the water usage reduction bonus program in 2004. For further information on our accounts receivable, see note 5 to our financial statements. The increase was also related to the tariff adjustment of 9.0% in August 2005; and
- an increase of R\$16.4 million, or 11.5%, in payroll expenses and related charges, primarily due to annual salary adjustments of 4.63% that came into effect in May 2006. In addition, the increase was due to the non recurrent provision of a performance-related bonus, a profit sharing plan taking into account in 2006 and the charges related to payment of compensation in connection with our incentive resignation program, totaling an aggregate amount of R\$10.4 million.

***Administrative Expenses***

Administrative expenses for 2006 increased by R\$37.8 million, or 10.8%, to R\$387.4 million in 2006, from R\$349.6 million in 2005. As a percentage of net revenue from sales and services, administrative expenses decreased to 7.0% in 2006, from 7.1% in 2005.

The increase in administrative expenses primarily reflected:

- an increase of R\$30.6 million, or 34.8%, in provisions for judicial proceedings, resulting from environmental claims as to which losses are probable;
- an increase of R\$20.1 million, or 17.9%, in payroll expenses and related charges, primarily due to annual salary adjustments of 4.63% that came into effect in May 2006. In addition, the increase was due to the no recurrent provision of a performance-related bonus, a profit sharing plan taking into account in 2006 and the charges related to payment of compensation in connection with our incentive resignation program, totaling an aggregate amount of R\$9.2 million; and
- a decrease of R\$14.8 million, or 15.7%, in outsourced services related to a decrease in fees paid to external advisers with respect to our debt restructuring in the capital markets.

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

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

Financial expenses, net in 2006 increased by R\$116.3 million, or 26.0%, to R\$563.3 million in 2006, from R\$447.0 million in 2005. As a percentage of net revenue from sales and services, financial expenses, net decreased to 10.2% in 2006, from 9.0% in 2005. Financial expenses increased R\$127.1 million, or 22.6% .

The financial expenses decreased R\$89.0 million, or 10.2% . This decrease in financial expenses was primarily due to:

- a decrease of R\$79.2 million for monetary adjustments in provisions for judicial proceedings related to interest expenses, due to the decrease in amounts provisioned with respect to court deposits; and
- a decrease of R\$20.7 million in interest and other charges related to our foreign currency-denominated debt, principally due to (1) a R\$42.5 million decrease in payment of interest on Eurobonds due to the amortization of the notes due 2005 in July 2005 and the prepayment of part of the 12.5% notes due 2008 in November 2006; we made this prepayment with the proceeds from our offering of 7.5% notes due 2016 in the amount of US\$140.0 million in November 2006; (2) a R\$9.4 million in payment of interest on the principal related to the loan agreement entered into with the Inter-American Development Bank and syndicated loans; (3) a R\$31.3 million increase in expenses with the payment of the premium for note holders who tendered their 12.5% notes due 2008, which is a non-recurrent expense.
- a decrease of R\$10.8 million in interest and other charges related to our *real*-denominated debt, principally due to (1) a R\$9.0 million decrease in payment of interest due to the prepayment of debentures with proceeds from our FIDC, which decreased interest rates from 1.1% to 0.7%; (2) new issuances of debentures in the end of 2005 and the decrease in payment of interest was reflected in our results of 2006.

The decrease in financial expenses was partially offset by the increase in the IGPM Index in 2006 (from 1.2% to 3.8%), generating a R\$ 15.6 million monetary variation impact.

Financial income increased by R\$10.4 million, or 9.0%, to R\$125.9 million in 2006, from R\$115.5 million in 2005, which was related to interest income from short-term investments.

The exchange variation gain, decreased R\$215.7 million, or 69.3%, to R\$95.6 million in 2006, from R\$311.3 million in 2005, which was related to the *real* appreciation against the U.S. dollar of 9.5% in 2006 compared to 13.4% in 2005.

As of December 31, 2006, 76.7% of our debt was denominated in *reais* and 23.3% was denominated in U.S. dollars.

***Income from Operations***

As a result of the factors discussed above, income from operations in 2006 decreased by R\$2.0 million, or 0.2%, to R\$1,240.6 million in 2006, from R\$1,242.6 million in 2005.

***Non-Operating Expenses***

Non-operating expenses in 2006 increased by R\$25.5 million, or 100.4%, to R\$50.9 million, from R\$25.4 million in 2005. Losses on the disposal of obsolete assets were R\$47.8 million in 2006, compared to R\$19.1 million in 2005.

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

Income tax and social contribution tax (including deferred taxes) in 2006 increased by R\$59.2 million, or 18.7%, to R\$375.7 million from R\$316.5 million in 2005. This was primarily due to the increase in taxable income, which was R\$1,283.5 in 2006, compared to R\$1,217.2 million in 2005. This increase in profits was partially offset by tax benefits resulting from the declaration of interest on shareholders' equity. This benefit amounted to R\$92.1 million in 2006, compared to R\$118.4 million in 2005, over interest on shareholders' equity in the amounts of R\$270.8 million and R\$348.2 million, respectively.

***Extraordinary Item***

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

As permitted, the expense is recorded as an extraordinary item of R\$35.1 million, net of income tax, of R\$18.1 million, for both 2006 and 2005.

***Net Income***

As a result of the factors discussed above, net income decreased by 10.0%, to R\$778.9 million in 2006, from R\$865.6 million in 2005. Excluding the effects of the adjustment of R\$93.8 million, which was a result of an analysis and conciliation procedure related to the accounting balance of our accounts receivable, our net income would have increased by R\$7.0 million. The bulk of this increase derived from profits from operations, which recorded a significant growth of 40.3%, and the 8.7% appreciation of the *real* contributed to the balance of the increase.

**U.S. GAAP RECONCILIATION**

Our net income in accordance with the Brazilian Corporate Law Method was R\$865.6 million, R\$778.9 million and R\$1,048.7 million in 2005, 2006 and 2007, respectively. Under U.S. GAAP, we would have reported net income of R\$791.2 million, R\$622.5 million and R\$925.4 million in 2005, 2006 and 2007.

Our shareholders' equity in accordance with the Brazilian Corporate Law Method totaled R\$8,482.5 million, R\$9,018.5 million and R\$9,784.0 million as of December 31, 2005, 2006 and 2007, respectively. Under U.S. GAAP, we would have reported shareholders' equity of R\$6,821.4 million, R\$7,298.2 million and R\$7,891.6 million as of December 31, 2005, 2006 and 2007, respectively.

The principal differences between the Brazilian Corporate Law Method and U.S. GAAP that affect our net income in 2005, 2006 and 2007, as well as shareholders' equity as of December 31, 2005, 2006 and 2007, relate to the treatment of the following items:

- additional inflation restatements and related depreciation which would be mandated by U.S. GAAP (but which are not permitted under the Brazilian Corporate Law Method) for 1996 and 1997 in recognition of Brazil's status as a highly inflationary country in those years;

Table of Contents

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

See note 26 to our financial statements for a description of these differences as they relate to us and a reconciliation of net income and total shareholders' equity from the Brazilian Corporate Law Method to U.S. GAAP.

## 5.B. Liquidity and Capital Resources

### *Capital Sources*

In order to satisfy our liquidity and capital requirements, we have primarily relied on cash provided by operating activities, borrowings from Brazilian Federal and State governmental financial institutions, and financing from multilateral organizations and from domestic and international capital markets. As of December 31, 2007, we had R\$465.0 million of cash and cash equivalents. Outstanding short-term debt was R\$742.1 million as of December 31, 2007, of which R\$251.7 million was denominated in foreign currency. Long-term debt was R\$4,943.1 million, of which R\$990.6 million consisted of foreign currency-denominated obligations. We believe that we have sufficient sources of liquidity and capital to meet our liquidity and capital requirements for the next few years, in light of our current financial position and our expected cash generated by operating activities.

***Cash Provided by Operating Activities.*** Cash provided by operating activities is, and we anticipate that it will continue to be, the single largest source of our liquidity and capital resources in future years and financial periods. Our cash generated by operating activities was R\$1,737.6 million, R\$2,020.8 million and R\$2,215.6 million in 2005, 2006 and 2007.

We have overdue accounts receivable from the State and from the municipalities to which we provide water on a wholesale basis. For more information, see *Item 7.B. Major Shareholders and Related Party Transactions - Related Party Transactions.*

***Debt Financing.*** As of December 31, 2007, we had R\$4,943.1 million in long-term debt outstanding (excluding the current portion of long-term debt), of which R\$990.6 million consisted of foreign currency-denominated long-term debt. We had outstanding short-term debt of approximately R\$742.1 million as of December 31, 2007, representing the current portion of our long-term debt.

As of December 31, 2007, approximately R\$251.7 million of this short-term debt was denominated in foreign currencies. Substantially all of our foreign currency-denominated debt of R\$1,242.3 million as of December 31, 2007

Edgar Filing: COMPANHIA DE SANEAMENTO BASICO DO ESTADO DE SAO PAULO-SABESP - Form 20-F  
was denominated in U.S. dollars or in baskets of foreign currencies.

This debt consisted principally of:

(1) R\$765.4 million (US\$432.1 million) in U.S. dollar denominated loans from the Inter-American Development Bank. Under these loans, payments of principal are made in semi-annual installments with final maturity in July 2025. The principal amount is adjusted semi-annually for the variation in a basket of foreign currencies and accrues interest at a rate varying from 3.00% to 5.61% . We have pledged part of our receivables from our sales and services up to the amount due as collateral. For further information on the terms of these loan agreements, see *Item 4.A. History and Development of the Company Capital Expenditure Program Tietê Project*.

(2) R\$173.7 million (US\$98.1 million) in aggregate principal amount of our 12% notes due 2008 sold in the international capital markets in June 2003 and R\$248.0 million (US\$140.0 million) in the aggregate principal amount of our 7.5% notes due 2016 sold to the international capital markets in November 2006.

Our borrowings from multilateral institutions, such as the World Bank and the Inter-American Development Bank, have in the past been, and in the future are likely to be, guaranteed by the Government of the State or the Federal Government. We do not pay fees for these guarantees. Under some of the loan agreements with the Inter-American Development Bank, we have granted a guarantee (*contra garantia*) to the Federal Government.

Our outstanding domestic debt was approximately R\$4,442.9 million as of December 31, 2007 and consisted primarily of *real*-denominated loans from Federal and State-owned banks, in particular, Banco do Brasil S.A., Caixa Econômica Federal and the Brazilian National Bank for Economic and Social Development (*Banco Nacional de Desenvolvimento Econômico e Social*), or BNDES, as well as debentures issued in September 2004 and March and June 2005.

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

(1) In March 1994, we entered into a loan agreement with Banco do Brasil S.A.. Amortizations of principal amount are made in 240 successive monthly installments, with final maturity in 2014. The principal amount accrues interest at the daily government interest rate plus 8.50% per annum and monetary adjustment.

(2) We have entered into several line of credit agreements with Caixa Econômica Federal, pursuant to which amortizations of principal are paid in 120 or 180 months in monthly installments after 30 days following a grace period, which varies from 14 to 36 months from the date of the first draw-down. The final maturity is 2022. The principal amount accrues interest at a rate varying from 5.00% to 9.50% .

(3) In August 2002, we entered into a line of credit agreement with BNDES. The final maturity date will be in February 2013. The principal amount accrues interest at the long-term rate fixed by the Federal Government (*Taxa de Juros de Longo Prazo*), or TJLP, limited to 6.00%, plus 3.00% per annum. If the TJLP exceeds 6.00%, such excess will be added to the principal amount payable at maturity.

In addition, we entered into a credit agreement on August 6, 2004 with the JBIC for the financing of the Environmental Recovery Program for the Santos Metropolitan Region, which was guaranteed by the Federal Government for an aggregate principal amount of ¥21,320 million (R\$337.7 million). The disbursements began in January 2006. As of December 31, 2007, the total amount disbursed was R\$42.0 million. Under this financing agreement, amortizations are made in semi-annual installments in August and February, with final maturity 2029. This obligation is guaranteed by the Federal Government. For further information on the terms and guarantees of this financing agreement, see *Item 7.B. Major Shareholders and Related Party Transactions Related Party Transactions Government Guarantees of Financing* and *Item 4.A. History and Development of the Company Capital Expenditure Program Capital Expenditure Program Environmental Recovery Program for the Baixada Santista*

*Metropolitan Region Programa Onda Limpa .*

In addition, we are currently negotiating with BNDES and Caixa Econômica Federal for additional loans to finance portions of our capital expenditure program.

Table of Contents

With respect to the debentures issued on September 17, 2004, we filed a securities shelf program with the CVM through which we were able to offer non-convertible debentures in the aggregate amount of R\$1.5 billion. We issued the total amount available under this shelf program by July 1995. As part of the program:

(1) We issued R\$600.0 million in aggregate principal amount of debentures in September 2004 (our 6<sup>th</sup> issuance), offered in three separate series. The debentures of the first, second and third series will mature within three, five and six years after issuance, respectively. The debentures of the first series in the amount of R\$231.8 million bear interest at the interbank deposit rate (CDI) plus 1.75% per year, and the debentures of the second series in the amount of R\$188.3 million, and of the third series, in the amount of R\$179.9 million, bear interest at rates of IGP-M index plus 11.0% per year. The first series was totally paid in September, 2007.

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

(3) We also issued R\$700.0 million in aggregate principal amount of debentures in June 2005 (our 8<sup>th</sup> issuance), offered in two series. The debentures of the first and second series will mature within four and six years, respectively, after issuance. The debentures of the first series, in the total amount of R\$350.0 million, bear interest at the interbank deposit rate (CDI) plus 1.5% per year, and the debentures of the second series, in the total amount of R\$350.0 million, bear interest at the rate of IGP-M index plus 10.75% per year.

All of our *real*-denominated debt is indexed to take into account the effects of inflation. Most of our *real*-denominated debt provides for inflation-based increases in their respective principal amounts; the increases are determined by reference to the daily government interest rate (*Taxa Referencial*) plus an agreed margin.

Furthermore, in March 2006, a securitization fund (*Fundo de Direitos Creditórios*) was created having our future account receivables as its underlying assets. On March 23, 2006, the fund issued senior and junior quotas to investors in Brazil with a value per unit of R\$500,000.00. The senior quotas will be amortized in 54 monthly installments. The fund is designed to have a return to investors corresponding to 100% of the interbank deposit rate (CDI) variation, plus a fixed interest rate of 0.7% per annum. We subscribed and paid for and maintain in a deposit account 26 junior, or subordinated, quotas of this fund in the total amount of R\$13.0 million.

In March 2006, the fund advanced to us revenues derived from the provision of water and sewage services in the amount of R\$250.0 million, representing a portion of the payments due under the underlying receivables during a five-year period. We retain the right to receive the balance of additional payments accounting for the remaining portion of the receivables, provided that no event of default under the by-laws of the fund has occurred or is continuing. Once payments to the fund are made in full, which is expected to happen five years after the creation of the fund, we will be entitled to all payments received under the underlying receivables. The fund manager is Caixa Econômica Federal. See note 10 to our financial statements.

Table of Contents

The following table sets forth information on our outstanding debt as of December 31, 2007. See note 10 to our financial statements:

<b>As of December 31, 2007</b>					
Facility	Current	Long Term	Total Aggregate Principal Amount	Final Maturity	Interest Rate <sup>(1)</sup>
<i>(in millions of reais)</i>					
<i>Real-denominated loans and financings:</i>					
Federal Government/Banco do Brasil	238.2	1,642.6	1,880.8	2014	UPR+8.5%
Debentures 6th Issue	-	427.7	427.7	2010	11.00% and IGPM CDI+1.5%
Debentures 7th Issue	-	312.4	312.4	2010	and 10.80% and IGPM CDI+1.5%
Debentures 8th Issue	-	737.4	737.4	2011	and 10.75% and IGPM UPR+5.00%
Caixa Econômica Federal <sup>(2)</sup>	58.3	490.9	549.2	2008/22	to 9.50%
FIDC Sabesp 1	55.5	125.0	180.5	2011	CDI+0.70% TJLP + 3%
Brazilian Economic and Social Development Bank (BNDES)	41.9	165.7	207.6	2013	(limited to 6.00%) 12.00%, CDI and TJLP + 6.00%
Other	3.1	18.8	21.9	2009/11	
Accrued interest and charges	93.4	32.0	125.4		
	490.4	3,952.5	4,442.9		
<i>Foreign currency denominated loans and financings:</i>					
Long-term Notes: US\$238,052 thousand Inter-American Development Bank (IDB): US\$432.099 thousand	173.7	248.0	421.7	2008/16	12.00% and 7.50%
JBIC Yens 2,654,422 thousand	-	42.0	42.0	2029	3.00% and 5.61%
Accrued interest and charges	13.2	-	13.2		1.8% and 2.5%

	251.7	990.6	1,242.3
<b>Total Debt</b>	742.1	4,943.1	5,685.2

(1) UPR stands for Standard Reference Unit (*Unidade Padrão Referência*) and is equal to the daily government interest rate (*Taxa Referencial TR*), which was 0.064% per month as of December 31, 2007; CDI stands for Interbank Deposit Rate (*Certificado de Depósitos Interbancários*), which was 11.82% per annum as of December 31, 2007; IGP-M stands for *Índice Geral de Preços a Mercado*, which was 7.75% per annum as of December 31, 2007; TJLP stands for Long-term Rate Fixed by the Federal Government on a quarterly basis (*Taxa de Juros a Longo Prazo*), which was 6.25% per annum as of December 31, 2007.

(2) Agreements to provide up to approximately R\$404.9 million in financing for our capital expenditure program until final maturity. We have pledged amounts in certain bank accounts as collateral for these loans.

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

With respect to our indebtedness denominated in U.S. dollars or in baskets of foreign currencies, we are subject to financial covenants, including but not limited to those set forth in the loan agreements entered into with the Inter-American Development Bank. Each of these agreements contains, among other provisions, limitations on our ability to incur debt. The indenture relating to the 7.5% notes due 2016 is the most stringent of these debt agreements. This indenture prohibits, subject to some exceptions, the incurrence of additional debt in the event that (1) the ratio of Adjusted Total Debt to Adjusted EBITDA (as defined in the related indenture) is greater than 3.65x or (2) the Debt Service Coverage Ratio (as defined in the indenture) is less than 2.35x. We do not believe that these covenants will impose constraints on our ability to finance our capital expenditure program or, more generally, to develop our business and enhance our financial performance.

In addition, with respect to our outstanding domestic debt, we entered into a financing agreement with the Federal Government and Banco do Brasil S.A. and also into several credit agreements with Caixa Econômica Federal that do not contain material financial covenants. Under our credit agreement with BNDES we are required to keep (1) an EBITDA/net operational income ratio equal to or higher than 38%, (2) an asset/short-term liability (excluding the short term portion of long-term liabilities) ratio higher than 1.0, (3) total connections (water and sewage)/employees ratio equal to or higher than 520, (4) EBITDA/debt service equal to or higher than 1.5 and (v) a shareholders equity/total debt ratio equal to or higher than 0.8.

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

Brazilian regulations provide that a state-owned company, such as us, must use the proceeds of external credit operations (i.e., foreign currency borrowings), subject to some exceptions, exclusively to refinance outstanding financial obligations. The use will be restricted according to the declared use of proceeds, and until so used, these proceeds must be deposited as directed by the Central Bank. The deposit requirement does not apply in the case of import financing and financing transactions involving multilateral and official organizations, such as the JBIC, the World Bank and the Inter-American Development Bank. On December 31, 2007 there was no restricted cash under this regulation.

**Capital Requirements**

We have, and expect to continue to have, substantial liquidity and capital resource requirements. These requirements include debt-service obligations, capital expenditures to maintain, improve and expand our water and sewage systems, payment of pension plan and other employee benefits, including pension plan payments to certain of our former employees on behalf of the State, and dividend payments and other distributions to our shareholders, including the State.

*Debt-Service and Other Contractual Obligations.* Our debt service obligations and other contractual obligations as of December 31, 2007 were as follows:

	2008	2009	2010	2011	2012 and thereafter	Total
	<i>(in millions of reais)</i>					
Outstanding long-term debt due	742.1	1273.1	852.6	897.4	1,920.0	5,685.2
Operational lease	7.8	2.6	0.6	0.3	-	11.3
Pension benefits - SABESPREV <sup>(1)</sup>	-	-	-	-	365.2	365.2
PAES program	43.9	43.9	43.9	43.9	66.0	241.6
Take-or-pay contracts	182.0	128.9	128.2	133.4	133.8	706.3
<b>Total</b>	975.8	1,448.5	1,025.3	1,075.0	2,485.0	7,009.6

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

We believe that we can meet the maturity schedule through a combination of funds generated by operations, the net proceeds of new issuances of debt securities in the Brazilian and international capital markets and additional borrowings from domestic and foreign lenders. Our borrowings are not affected by seasonality. For information concerning the current interest rates borne by our outstanding indebtedness, see note 10 to our financial statements.

*Capital Expenditures.* Historically, our capital expenditures have been significantly financed with resources from international and national multilateral agencies and development banks. We generally include in our capital expenditure program for the following year the amount of investment that was not realized in the previous year. In 2004, our cash disbursements for purchases of property, plant and equipment under our capital expenditure program totaled R\$670.3 million. In 2005, we planned to invest approximately R\$758.0 million under our capital expenditure program, but effectively invested R\$660.4 million. As of December 31, 2006, we had invested R\$904.9 million under our capital expenditure program. We have budgeted investments in the amount of approximately R\$5.87 billion from 2007 through 2010, of which we spent R\$921.1 million in 2007.

*Pension Plan Payments and Employee Benefits.* We have been making State-mandated special retirement and pension payments to certain former employees who were employed by our predecessor entities prior to May 1974. These special payments totaled R\$104.6 million in 2007, R\$101.7 million in 2006 and R\$96.4 million in 2005. The State is required to reimburse us for these amounts, but has not been paying us on a timely basis. The State's obligation to us for these amounts is recorded under receivables from shareholder on the balance sheet and totaled R\$879.1 million as of December 31, 2007. As of December 31, 2005 and 2006 these receivables had reached R\$672.7 million and R\$774.5 million, respectively, and they were classified as non-current assets in our financial statements. The special payments to former employees made by us are not reflected in our statement of operations, but nonetheless represent a

significant component of our liquidity requirements. Although we have had discussions with the State regarding more timely reimbursement for the special payments to former employees, we cannot assure you as to when or whether such payments will be made by the State. We may continue to be held responsible for these special payments to former employees, irrespective of whether the State reimburses us or not. For further information on State-mandated special retirement and pension payments made by us to certain former employees, see *Item 7.B. Major Shareholders and Related Party Transactions* *Related Party Transactions*.

Table of Contents

*Tax Financing Agreements.* We did not make payments in respect of certain Brazilian federal income tax and social contribution liabilities during the period from 1991 to mid-1996 mainly because we were contesting certain assessments by the federal tax authorities and, in the case of 1993 and 1994, because we did not have sufficient funds to meet all of our then existing liquidity and capital resources requirements. Under the *Programa de Recuperação Fiscal REFIS* tax recovery program, we entered into an agreement with the Brazilian tax authorities regarding these tax obligations and have agreed to make payments on them in monthly installments ending in 2005. We were also required to pay interest on the unpaid balance of this tax liability. However, in July 2003, we included the amounts due under the REFIS program in the PAES program, which is an alternative payment plan for taxes owed. In accordance with this settlement agreement, we are paying amounts due, of approximately R\$317.0 million, in 120 monthly installments, from July 2003. See note 12 to our financial statements. Payments in respect of this aggregate tax liability continue to constitute a liquidity and capital resource requirement that must be satisfied.

*Dividend Distributions.* We are required by our by-laws to make dividend distributions, which can be made as payments of interest on shareholders' equity to our shareholders in an amount equal to not less than 25% of the amounts available for distribution. The aggregate amount of distributions we made for 2005, 2006 and 2007 were R\$348.2 million, R\$270.8 million and R\$300.7 million, respectively.

On April 28, 2005, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$38.2 million, to be paid within 60 days after our 2006 shareholders' meeting to shareholders of record as of May 9, 2005. On June 23, 2005, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$66.8 million, to be paid within 60 days after our 2006 shareholders' meeting to shareholders of record as of July 6, 2005. On October 20, 2005, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$85.2 million, to be paid within 60 days after our 2006 shareholders' meeting to shareholders of record as of November 3, 2005. On December 15, 2005, our board of directors approved the payment of dividends in the form of interest on shareholders' equity in the amount of R\$158.1 million, to be paid within 60 days of our 2006 shareholders' meeting to shareholders of record as of December 28, 2005. On April 20 and December 14, 2006, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$129.6 million and R\$141.2 million, respectively. The payments of interest on shareholders' equity declared in 2007 began being made on June 27, 2008.

On October 18, 2007 and February 21, 2008, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$268.8 million and R\$ 31.9 million, respectively. The payments of these dividends began being made in June 27, 2008.

As of December 31, 2007, our dividends payable to the State were in the amount of R\$552.0 million. The dividends due from 2004 to 2006, in the amount of R\$ 400.8 million (R\$408.2 million adjusted until March 2008), have been paid during the first quarter of 2008. We are currently unable to determine the amount, if any, of the remaining portion of these declared dividends that the State will apply to the current and future accounts receivable owed to us by the State or its controlled entities.

### **Interest on Shareholders' Equity**

Brazilian corporations are permitted to distribute dividends in the form of a tax-deductible notional interest expense on shareholders' equity in accordance with Law No. 9,249, dated December 26, 1995, as amended. The rate at which tax-deductible interest may be paid is limited to the product of the average TJLP and shareholders' equity during the relevant period and cannot exceed the greater of:

- 50% of net income (before taking into account the distribution and any deductions for income taxes and after taking into account any deductions for social contributions on net profits) for the period in respect of which

the payment is made; and

- 50% of retained earnings.

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

For tax purposes, payments of interest on shareholders' equity are recognized when the payments are declared, not when they are paid, within 60 days of the following general shareholders' meeting. Interest on shareholders' equity is recorded as part of, but is immediately reversed under, the financial expenses line item in our statement of operations. The tax deduction relating to distributions of interest on shareholders' equity is reflected under the income tax and social contribution line items in our statement of operations. This tax benefit consequently contributes positively to net income in our statement of operations.

### **5.C. Research and Development, Patents and Licenses, Etc.**

Our policy is to invest continually in the modernization of equipment and in the technology needed to identify, evaluate and improve our provision of basic sanitation services while promoting environmental protection and maintaining our competitiveness and profitability. Our research and development function is divided into committees according to strategy and complexity. In 2005, 2006 and 2007, we spent R\$4.7 million, R\$4.9 million and R\$3.4 million, respectively, on research and development. We have also partnered with several research institutions.

#### ***Trademarks***

We have registered our logo and composite trademark at the Brazilian National Institute of Industrial Property (Instituto Nacional da Propriedade Industrial), or INPI, where the following trademarks are also registered: Pura Programa de Uso Racional da Água; Projeto Tietê; Gotucho, Gota Borradeira, Dr. Gastão and Ratantan, (various characters from Clubinho Sabesp, which is a tool for environmental education aimed at children on our website); Revista DAE; Uso racional da água (Rational Use of Water).

The following trademarks are pending a final decision by INPI: Parque da Integração; Programa de Recuperação Ambiental; Programa Córrego Limpo; Programa Onda Limpa; Super H2O (character from Clubinho Sabesp); Signos - Sistema de Informações Geográficas no Saneamento; Hora H Sabesp; Ligação Sabesp; and Scorpion (operating and loss management software).

From the trademarks which are filed, it is worth pointing out two we consider important: Sabesfértil; and Universidade Empresarial Sabesp - UES.

#### ***Patents***

We have the following patents granted by INPI:

- Water consumption measurement unit
- Constructive disposal in building hydraulic simulator for didactical purposes
- Mobile unit for metrological verification of hydrometers in the field
- Equipment for alignment of motor-pump sets
- Anti-fraud device in the hydrometer
- Equipment for washing filters in water treatment stations
- Motorized activation for automatic correction of dosage of chemical products in conventional dosage devices by gravity
- Mobile unit for reinforcement of water network pressure
- System for inspection of sewage network piping
- Differential pressure measurer with digital reading
- Valve position sensor
- Electronic hydrometer
- Flow deflector

- Hydraulic bi-stable buoy cock
- Turbine with evolving profile blade
- Elastic ring reducer for hydrometer
- Simplified gear reducer fro hydrometers
- Turbine with asymmetry in the blades for hydrometer

- Hydrometer plating through superior sow
- Violation protection shield
- Hydrometer with adjustment through variation of turbine height
- Hydrometer with adjustment by additive flow
- Hydrometer with adjustment through counter-flow
- Bi-stable device for closing of buoy cock

### *Software*

To manage our activities, we use software systems which we have acquired from vendors. We have also developed certain computer programs for management and control of water and sewage treatment facilities, as well as for third-party services management, called AQUALOG, SGL, Electronic Price Quotation (*Cotação Eletrônica de Preços*), Eletronic Inverse Auction (Pregão Sabesp Online) and SCORPION. We also have secured registration of these programs at the INPI and the agency of trademarks. AQUALOG is the only Brazilian software designed to monitor water treatment. SGL (Bid Management System) is an electronic price quotation system that allows us to view all bid and acquisitions proceedings in real time. Constantly improved, the SGL is able to determine the appropriate workflow for the different bidding kinds and modes. It also includes a large array of nuances that are inherent to each contract or procurement. One of the greatest advantages of the system is undoubtedly the Eletronic Inverse Auction a current model for e-commerce.

### **5.D. Trend Information**

Not applicable.

### **5.E. Off-Balance Sheet Arrangements**

We had no off-balance sheet obligations as of December 31, 2005, 2006 and 2007.

### **5. F. Tabular disclosure of contractual obligations**

*Debt-Service and Other Contractual Obligations.* Our debt service obligations and other contractual obligations as of December 31, 2007 were as follows:

	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012 and thereafter</b>	<b>Total</b>
			<i>(in millions of reais)</i>			
Outstanding long-term debt due	742.1	1,273.1	852.6	897.4	1,920.0	5,685.2
Operational lease	7.8	2.6	0.6	0.3	-	11.3
Pension benefits - SABESPREV <sup>(1)</sup>	-	-	-	-	365.2	365.2
PAES program <sup>(2)</sup>	43.9	43.9	43.9	43.9	66.0	241.6
Take-or-pay contracts	182.0	128.9	128.2	133.4	133.8	706.3
<b>Total</b>	<b>975.8</b>	<b>1,448.5</b>	<b>1,025.3</b>	<b>1,075.0</b>	<b>2,485.0</b>	<b>7,009.6</b>

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

(2) The Special Program for Payment of Federal and Social Security-Related Taxes in Installments (*Programa de*

*Parcelamento Especial para Impostos Federais e Previdenciários*), or PAES program, as set forth by Law No. 10,684, dated May 30, 2003.

We believe that we can meet the maturity schedule through a combination of funds generated by operations, the net proceeds of new issuances of debt securities in the Brazilian and international capital markets and additional borrowings from domestic and foreign lenders. Our borrowings are not affected by seasonality. For information concerning the current interest rates borne by our outstanding indebtedness, see note 10 to our financial statements.

**ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES****6.A. Directors and Senior Management**

Under our by-laws and Brazilian Corporate Law, we are managed by our board of directors (*Conselho de Administração*), which currently consists of ten directors, and a board of executive officers (*Diretoria*), which currently consists of six executive officers.

As our controlling shareholder, the State has the ability to control the election of the board of directors and, therefore, our direction and future operations. Upon the election of a new Governor and any resulting change in the administration of the State, all or some of the members of the board of directors, including the chairman, have historically been replaced by designees of the new administration. The board of directors may in turn replace some or all of the executive officers.

**Board of Directors**

Our by-laws provide for a minimum of five and a maximum of 11 directors. The members of our board of directors are elected at a general shareholders meeting to serve renewable one-year terms. Each member of our board of directors must be one of our shareholders, under Brazilian Corporate Law, and a resident of Brazil, under our by-laws. Pursuant to our by-laws, our employees have the option to elect one member of our board of directors, who must be an employee with more than two years of service to us. Currently, our employees have not elected a director. In addition, pursuant to Brazilian Corporate Law, at least one member of the board of directors of mixed capital companies, such as us, must be appointed by the minority shareholders. Finally, according to the *Novo Mercado* rules, at least 20% of the board of directors must be comprised of independent members.

The current members of our board of directors were elected in the general shareholders meeting held on April 29, 2008. The tenure of the directors will end upon the election of the new members at the general shareholders meeting to be held in April 2009. Currently, we have three directors considered independent under the *Novo Mercado* rules.

Our board of directors ordinarily meets once a month or when called by a majority of the directors or the chairman. Its responsibilities include the establishment of policy and general orientation of our business and the appointment and supervision of our executive officers.

The following are the names, ages, position and brief biographical descriptions of the current members of our board of directors:

<b>Director</b>	<b>Age</b>	<b>Position</b>	<b>Date Elected</b>
Dilma Seli Pena	58	Chairman	April 29, 2008
Humberto Rodrigues da Silva	51	Vice-Chairman	April 29, 2008
Alexander Bialer	61	Independent Director*	April 29, 2008
Reinaldo Guerreiro	55	Independent Director*	April 29, 2008
Roberto Yoshikazu Yamazaki	52	Director	April 29, 2008
Manuelito Pereira Magalhães Júnior	40	Director	April 29, 2008
Francisco Vidal Luna	62	Director	April 29, 2008

Mario Engler Pinto Junior	52	Director	April 29, 2008
Antero Paes de Barros Neto	55	Director	April 29, 2008
Jeronimo Antunes	52	Independent Director*	April 29, 2008

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

*Dilma Seli Pena.* Mrs. Pena has been the chairman of the board of directors since January 2007. She holds a master's degree in public administration from Escola de Administração de Empresas de São Paulo - Fundação Getúlio Vargas and a degree in geography from Universidade de Brasília. She was director of the Sanitation of the Urban Policy Office, director of strategic investments of the Ministry of Planning and director of the National Water Agency of the Brazilian government. She was deputy secretary for the Economics and Planning Secretariat of the government of the State of São Paulo. Mrs. Pena was a regular member of the Environmental Board of the State of São Paulo Industry Association (FIESP). Until December 2006, she was a member of our fiscal council. Currently, she is responsible for the State Secretariat of Sanitation and Energy and manages the board of directors of the following São Paulo state-owned companies: Sabesp, Empresa Metropolitana de Águas e Energia S.A., or Emae, Cia Energética de São Paulo, or CESP and Companhia Paulista de Obras e Serviços, or CPOS. She has published a number of articles, texts and books in the areas of sanitation, water resources and planning.

Table of Contents

*Humberto Rodrigues da Silva.* Mr. Silva has been the vice-chairman of the board of directors since January 2007. He holds a post-graduate degree in methodology and projects of municipal and urban development from Escola Nacional de Serviços Urbanos ENSUR and a post-graduate degree in hospital management from Universidade Federal da Bahia. He also holds a degree in public administration from Escola de Administração de Empresas de São Paulo Fundação Getúlio Vargas. Currently, he is the deputy secretary of the Political Affairs Department of the government of the State of São Paulo. He was the chief of the Secretariat of the City of São Paulo, of the Secretariat of Science, Technology and Economic Development of the State of São Paulo and also of the Companhia Metropolitana de Habitação de São Paulo - COHAB. From 1999 to 2004, he was a consultant and the director of planning and projects of the São Paulo Development Corporation. He was a member of the board of directors of the Fundação Paula Souza, of the Instituto de Pesquisa Tecnológica de São Paulo and of the São Paulo Turismo S.A., or SPTURIS. He worked for the government of the State of Bahia and for the municipality of Camaçari.

*Alexander Bialer.* Mr. Bialer has been a member of our board of directors since April 2003. He holds a degree in mechanical engineering from Instituto Tecnológico da Aeronáutica ITA and a specialization degree in systems administration from the Escola de Administração de Empresas de São Paulo - Fundação Getúlio Vargas. He is also the chairman of the board of directors of GE Hydro Inepar, a member of the board of directors of AVIANCA and Romi and the chairman of the executive board of the Synergy Group. Additionally, Mr. Bialer is a member of the advisory councils of GE Previdência, GE Celma, Associação Brasileira de Infraestrutura e Indústrias de Base - ABDIB and Instituto UNIEMP (Fórum Permanente das Relações Universidade Empresa).

*Reinaldo Guerreiro.* Mr. Guerreiro has been a member of our board of directors since January 2007. He holds a Ph.D in accounting and controllership, a master's degree in accounting and controllership and a bachelor's degree in accounting sciences, all of them from Faculdade de Economia, Administração e Contabilidade da Universidade de São Paulo FEA-USP, where he is the vice-director of the Economy, Business and Accounting College, He also headed the Department of Accounting and Actuarial Sciences at FEA-USP for many years. He was a corporate consultant/cooperator for some international consultancy offices such as Roberto Dreyfuss Consultores, Klynveld Main Goerdeler Auditores S/C, SBS Sérgio Bio, Splendore & Associados S/C Ltda. Consultores em Administração, Artur Young Consultores, Biedermann, Bordasch, Ernest & Whinney, Directa and BDO Consultores. He is also a consultant specialized in economic management. He has worked in many projects in the areas of economic management, costs, budgeting and information systems in several companies such as Grupo Zillo Lorenzetti, Grupo Feital, Construtora Mendes Junior, Starret Ind. e Com., CMTC, FEPASA, COSIPA, MAFERSA, Usina Santa Elisa, Gillete do Brasil, Hansen Máquinas e Equipamentos, CIPLA Indústria do Lar, Metalúrgica Matarazzo, Elebra Informática, NEC do Brasil, CEF, Banco do Brasil.

*Roberto Yoshikazu Yamazaki.* Mr. Yamazaki has been a member of our board of directors since January 2007. He holds a degree in business administration. He currently acts as technical advisor of the Treasury Secretariat of the State of São Paulo. From 2006 to January 2007, he was deputy secretary of the Treasury Secretariat of the State. From 2003 to 2006, he was coordinator of the Financial Administration of the State. From 1997 to 2003, he was technical director of the State Treasury Department. From 1995 to 1997, he acted as technical assistant of the State Coordination of Financial Administration. From 1993 to 1994, he was advisor of the Secretariat of Education of the State of São Paulo. From 1992 to 1993, he was technical advisor of the Administrative and Financial Board of Executive Officers at Companhia de Entrepósitos e Armazéns Gerais de São Paulo, or CEAGESP. From 1976 to 1992, he was administrative and financial manager of TERRAFOTO S/A Atividades de Aerolevantamentos.

*Manuelito Pereira Magalhães Júnior.* Mr. Magalhães has been a member of the board of directors since January 2007. He is a candidate for a master's degree in economic sciences from the Instituto de Economia, Universidade Estadual de Campinas UNICAMP. He holds a degree in economic sciences from the Instituto de Economia UNICAMP. He was a member of the board of directors of the Companhia de Engenharia de Tráfego de São Paulo (CET-SP), of the Companhia Metropolitana de Habitação de São Paulo - COHAB and, of the Empresa de Tecnologia

de Informação e Comunicação de São Paulo - PRODAM-SP. He was the parliamentary advisor in the Federal Senate. From 1998 to 2002, he was the special advisor of the Minister of Health. From 2005 to 2006 he was the ombudsman of the National Supplementary Health Agency, or ANS. From 2005 to 2006, he was the deputy secretary of the Planning Secretariat and the secretary of Planning of the Municipality of São Paulo. He was also the technical advisor, the secretary of finance and the director of the Department of Advisory, Planning and Management in the municipality of Campinas, State of São Paulo.

Table of Contents

*Francisco Vidal Luna.* Mr. Luna has been a member of our Board of Directors since July 2007. He holds a doctoral degree in Economics from Faculdade de Economia e Administração da Universidade de São Paulo – USP. He was a researcher and professor at the Institute for International Economic Research (IPE) and at the Foundation Institute of Economic Research (Fipe) until his retirement in 1996. In the public sector, he acted as Secretary of Planning and Budget of the Municipality of the State of São Paulo, and worked at the Treasury Secretariat of the State of São Paulo and at the Ministry of Planning in the Sarney administration, among others. In the private sector, he was vice chairman and chairman of Banco Inter American Express S.A. He also acted as member of the Advisory Council of Sudene; member of the Board of Directors of Banco Nacional de Desenvolvimento Econômico e Social (BNDES); superintendent of the Institute of Planning, Iplan/Ipea, of the Federal Planning Secretariat; Special Economic Affairs Secretary of the Federal Planning Secretariat, in the João Sayad administration; Head of the Economic Affairs Advisory Board of the Treasury Secretariat of the State of São Paulo, and Executive Secretary of the Financial Coordination Board of São Paulo State in Franco Montoro administration.

*Mário Engler Pinto Junior.* Mr. Engler has been a member of our board of directors since March 2006. He holds a law degree from the Faculdade de Direito da Universidade de São Paulo, where he is currently a Commercial Law Ph.D. student. Mr. Engler has been a public attorney for the State of São Paulo Public Attorney's Office since 1984, having been the adjunct general public attorney from 2000 to 2003. As an attorney of the State of São Paulo, Mr. Engler rendered legal advice to the State Privatization Program (Programa Estadual de Desestatização – PED) and to the Public-Private Partnership Program of the State of São Paulo (Programa Estadual de Parcerias Público-Privadas). Mr. Engler was the Chief Executive Officer for Companhia Paulista de Parcerias (CPP) from 2004 to 2006. Mr. Engler has been a member of the board of directors of the Conselho de Defesa dos Capitais do Estado – CODEC (an institution responsible for the control and supervision of state-owned companies) since 2002. Mr. Engler is also a member of the board of directors of Companhia Paulista de Parcerias – CPP. As the public attorney for the State of São Paulo Public Attorney's Office, Mr. Engler is currently responsible for the legal advisory department for the Secretariat of Treasury.

*Antero Paes de Barros Neto.* Mr. Barros Neto has been member of the board of directors since May 2007. He is a journalist and broadcaster. He holds an undergraduate law degree from UPIS – União Pioneira de Integração Social, currently pursuing a graduate degree in constitutional law at IDP in Cuiabá, State of Mato Grosso. He was a council member of the municipality of Cuiabá from 1982 to 1986. He was a congressman from 1986 to 1990. He was the State Chief of Staff and Communications Secretary of Mato Grosso during the administration of Dante de Oliveira, Senator of the Republic from 1999 to January 2003, where he held the position of second vice-president and second Secretary. He was the chairman of the parliamentary inquiry commission, or CPMI, on Banestado. He was an editor of the Diário de Cuiabá, Equipe, Diário de Mato Grosso newspapers. He was the executive officer and editor of Jornal do Dia newspaper, Artistic Director of Real FM and Real AM radio stations, and also editor and reporter of A Voz do Oeste, Cultura and Difusora radio stations, and Artistic Director of Gazeta television broadcast. He worked as a reporter and broadcaster of Centro América television (Globo Network) and Brasil Oeste television (Bandeirantes Network).

*Jerônimo Antunes.* Mr. Antunes has been a member of our Board of Directors since April 2008. He holds a Master's and PhD degree in controllership and accounting from the Universidade de São Paulo (Sao Paulo University) and holds a degree in Business Administration and Accounting. He is an associate of Antunes Auditores Associados since September 2002. He has been a certified Public Accounting and Controllership Independent Consultant since 1977. He has been a professor at School of Business Administration and Accountancy of Sao Paulo University – FEA-USP since 1999, a MBA Capital Market professor of FIPECAFI/FEA/USP since 2000, a MBA Internal Audit Professor since 2005, an MBA Internal Controls professor since 2007. He was a MBA Corporate Governance professor of Banco do Brasil – FIPECAFI/FEA/USP from 2004 to 2005 and a professor of Universidade Federal do Ceará from 2000 to 2005. He was a director of IPECAFI from 2000 to 2007. He was a board member and director of IBRACON from 1998 to 2006. He was a director of ANEFAC from 1994 to 2000.



**Board of Executive Officers**

Our executive officers are responsible for all matters concerning our day-to-day management and operations. Members of our board of executive officers have individual responsibilities established by our board of directors and our by-laws.

The following are the names, ages, position and brief biographical descriptions of our board of executive officers:

<b>Executive Officer</b>	<b>Age</b>	<b>Position</b>	<b>Date Elected</b>
Gesner José de Oliveira Filho	52	Chief Executive Officer	June 26, 2007
Marcio Saba Abud	51	Corporate Management Officer Chief Financial Officer and	June 26, 2007
Rui de Britto Álvares Affonso	50	Investor Relations Officer	June 26, 2007
Paulo Massato Yoshimoto	55	Metropolitan Officer	June 26, 2007
Umberto Cidade Semeghini	58	Regional Systems Officer	June 26, 2007
Marcelo Salles Holanda de Freitas	52	Planning and Technology Officer	June 26, 2007

*Gesner José de Oliveira Filho.* Mr. Oliveira Filho has been our chief executive officer since January 2007. He holds a Ph.D degree in economics from the University of California, Berkeley, a master's degree in economics from the Instituto de Economia da UNICAMP, a bachelor's degree in economics from the Faculdade de Economia e Administração da Universidade de São Paulo - USP. From 1996 to 2000, he was the chairman of the Administrative Council of Economic Protection, (*Conselho Administrativo de Defesa Econômica*), or CADE. From 1993 to 1995, he was the deputy secretary of the Secretariat of the Economic Policy of the Ministry of Finance. In 1995, he was the interim secretary of the Economic Monitoring of the Ministry of Finance. He was also the chairman of the Instituto Tendências de Direito e Economia, the managing partner of Tendências Consultoria Integrada, a consultant and an arbitrator in the areas of regulation of infrastructure and defense of competition. Additionally, Mr. Oliveira Filho was a professor in the Economics Department at Fundação Getúlio Vargas and Visiting Professor of the Center for Brazilian Studies of Columbia University (USA).

*Marcio Saba Abud.* Mr. Abud has been our corporate management officer since January 2007. He holds a degree in Economic Sciences from Faculdade de Economia e Administração da Universidade de São Paulo - FEA/USP. He has broad experience in the financial area and in various segments of the domestic and international markets, such as treasury, capital markets, domestic and international structured operations and management of international securities and note issue programs. He also has experience in foreign trade financing, investment fund creation and management, corporate customer service, and establishment and management of credit lines. He worked at Unibanco from March 1980 to August 1984, Banco Boavista from March 1985 to October 1986, and at Banco Westlb do Brasil S/A from April 1987 to January 2007.

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

*Paulo Massato Yoshimoto.* Mr. Massato has been our metropolitan officer since February 2004. He holds a degree in civil engineering from Escola de Engenharia de Lins. Mr. Yoshimoto has been working at Sabesp since 1983, and has held the following positions: executive assistant to the operations office and head of the water production, maintenance, technical and management of water losses, and metropolitan planning and development departments. Mr. Yoshimoto has also held a number of different positions at the Empresa Metropolitana de Planejamento EMPLASA, from 1975 to 1983.

*Umberto Cidade Semeghini.* Mr. Semeghini has been our regional systems officer since January 2007. He holds a degree in electrical engineering from the Faculdade de Engenharia Industrial FEI. He was secretary of planning of the Ministry of Transport and the executive officer of Gerentec Engenharia. He has experience in the operation of systems, consulting services in the development of studies and projects for water supply and sanitary sewage systems, highway systems and, through partnerships with domestic and foreign companies, development of economic engineering studies (i.e., definition of tariff structures for public services).

*Marcelo Salles Holanda de Freitas.* Mr. Freitas has been our technology and planning officer since January 2007. He holds a degree in civil engineering post-graduation degree in sanitation from the Escola Politécnica da Universidade de São Paulo - USP. He also has a specialization degree in business administration from the IBMEC. He is a regular member of some of the most important institutions and associations of the sanitation and environment market. He was the vice-chairman for the interior and for the metropolitan region at Sabesp. He was the executive officer of projects of the Ondeo Services do Brasil, executive officer of sanitation of Suez Ambiental, CEO of Águas do Amazonas and executive officer of the sanitation services of ETEP.

## **6.B. Compensation**

Pursuant to Brazilian Corporate Law, our shareholders are responsible for establishing the aggregate amount of compensation we pay to the members of our board of directors, members of our fiscal council and our executive officers.

For the year ended December 31, 2007, the aggregate compensation, including benefits in kind granted, that we paid to members of our board of directors and to our executive officers for services in all capacities was approximately R\$2.4 million. An additional amount of R\$0.5 million related to the 2007 bonus, was paid in April, 2008.

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

We have established a pension and benefits fund (*Fundação Sabesp de Seguridade Social*), or SABESPREV, to provide our employees with retirement and pension benefits. This pension plan provides defined-benefit payments to former employees and their families. Both we and our employees make contributions to the pension plan. Our contributions include the responsibility assumed relating to service prior to the constitution of SABESPREV, which is payable up to February 2011. We made contributions to the pension plan totaling R\$11.3 million in 2005, R\$11.4 million in 2006 and R\$ 11.9 million in 2007. Based on independent actuarial reports, as of December 31, 2007, our obligation under this plan was R\$365.2 million. See note 13 to our financial statements.

Since 1996, we have annually negotiated with the unions the profit-sharing plan. We did not pay any profit-sharing amounts to our employees due to State Decree No. 43,794, which prohibited any profit-sharing amounts to be paid in 1999 to employees of State-controlled companies, including us. On April 14, 2000, the State issued Decree No. 44,836 which allows for the payment of profit-sharing amounts on an exceptional basis, provided that specific authorizations are obtained by us from the Wages Policy Commission (*Comissão de Política Salarial*). We have obtained this authorization every year since 2000 and, therefore, paid profit-sharing amounts to our employees during this period.

The goals evaluate the business performance in the economic-financial, operating and administrative aspects. Over the years, the programs have suffered some changes. In 1996 every active employee, who has been working over 6 months for the Company, was entitled to receive profit sharing. As of 1997, every active employee, who has been working over 3 months for the Company, was entitled to receive profit sharing, paid in proportion to the months worked. From 2000 to 2004, the general goals were established to evaluate us as a whole, and other goals were established to evaluate our various business units. As from 2005, all of the goals established evaluate us as a whole. The payments are reduced proportionately if the goals are not fully attained. Up to 2006, the payment was effected in a six-month basis. The program for 2006 was paid on an annual basis.

We recorded profit-sharing expenses of R\$44.3 million in 2005, R\$79.5 million in 2006 and R\$ 51.3 million in 2007. We believe that the profit-sharing plan has, in the past, contributed to increased employee productivity. We do not have a stock-option plan for our employees.



**6.C. Board Practices**

The members of our board of directors are elected at a general shareholders meeting to serve renewable one-year terms. Our board of directors ordinarily meets once a month or when called by a majority of the directors or the chairman. See *Board of Directors*.

Our board of executive officers is composed of six executive officers appointed by our board of directors for renewable two-year terms. Meetings of our board of executive officers are held weekly in the case of ordinary meetings or when called by the chief executive officer in the case of special or extraordinary meetings. See *Board of Executive Officers*.

None of our directors and executive officers is party to an employment contract providing for benefits upon termination of employment, except for those officers who are also our employees, in which case they are granted all benefits regularly applicable.

**Fiscal Council** (*Conselho Fiscal*)

Our *Conselho Fiscal*, which is established on a permanent basis and generally meets once a month, consists of five members and five alternates. The current members of our *Conselho Fiscal* were elected in the shareholders meeting held on April 29, 2008. Their tenure will end in 2009. The primary responsibility of the fiscal council, which is independent from management and from the external auditors appointed by our board of directors, is to review our financial statements and report on them to our shareholders.

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

<b>Fiscal Council Members</b>	<b>Alternates</b>
Sandra Maria Giannella	Vanildo Rolando Neubauer
Jorge Michel Lepeltier	Alexandre Luiz Oliveira de Toledo
Atílio Gerson Bertoldi	Deraldo de Souza Mesquita Junior
Maria de Fátima Alves Ferreira	Tomás Bruginski de Paula
Emília Ticami	Ney Nazareno Sígolo

**Audit Committee**

Our by-laws provide for an audit committee to be comprised of three board members, who shall cumulatively comply with the requirements of (1) independence, (2) technical expertise, and (3) availability. The members may be appointed simultaneously as their appointment to the board of directors, or by later resolution of the board of directors.

The audit committee is responsible for assisting and advising the board of directors in its responsibilities to ensure the quality, transparency and integrity of the Company's published financial information. To this end, the audit committee supervises all matters relating to accounting, internal controls and the internal and independent audit functions. The audit committee and its members have no decision making powers or executive functions.

The minimum availability required from each member of the audit committee is thirty hours per month. Under our bylaws, the members shall exercise their roles for the same period as their corresponding term of office, or until

otherwise resolved by the general shareholders meeting or by resolution of the board of directors.

At a board meeting held on May 8, 2008, the following members of the board of directors were elected to serve on our audit committee:

Director	Position
Jerônimo Antunes	Coordinator and Financial Expert
Reinaldo Guerreiro	Member
Mario Engler Pinto Junior	Member

### Corporate Governance Practices

The significant differences between our corporate governance practices and the New York Stock Exchange standards can be found on our website, [www.sabesp.com.br](http://www.sabesp.com.br). The information found at this website is not incorporated by reference into this document.

### 6.D. Employees

As of December 31, 2007, we had 16,850 full-time employees. In 2007, we had an average of 337 trainees and 528 apprentices (*aprendizes*), as defined by Federal Law No. 10,097 of December 19, 2000.

The following table sets forth the number of our full-time employees by main category of activity and geographic location as of the dates indicated:

	As of December 31,		
	2005	2006	2007
Total number of employees	17,448	16,978	16,850
Number of employees by category of activity:			
Projects and operations	11,450	11,145	11,130
Administration	2,812	2,735	2,794
Finance	614	606	564
Marketing	2,572	2,492	2,362
Number of employees by corporate division:			
Head office	2,029	1,981	1,618
São Paulo Metropolitan Region	8,046	7,732	8,004
Regional Systems	7,373	7,265	7,228

The average tenure of our employees is approximately 17 years. We also outsource certain services such as maintenance, delivery of water and sewage bills, meter reading, catering and security. We believe that our relations with our employees are generally satisfactory.

Approximately 70% of all our employees are members of unions. The four main unions that represent our employees are the *Sindicato dos Trabalhadores em Água, Esgoto e Meio Ambiente de São Paulo* SINTAEMA, *Sindicato dos Trabalhadores da Região Urbana de Santos, São Vicente, Santos Metropolitan Region, Litoral Sul e Vale Ribeira* SINTIUS, the *Sindicato dos Engenheiros do Estado de São Paulo* SEESP and the *Sindicato dos Advogados de São Paulo* SASP. Our most recent collective bargaining agreements, which became effective on May 1, 2007 and expired on April 30, 2008, did not contemplate total job protection for our employees. However, we had a formal understanding with the unions that represent our employees that we would not dismiss more than 2.0% of our current

employees before April 30, 2008. We are negotiating our collective bargaining agreement for 2008-2009. We have offered a 0.5% increase over the inflation index and a 10% readjustment for employee grocery and lunch related benefits. In addition, we have offered that we will not dismiss more than 2% of our employees before April 30, 2009. SINTAEMA and SASP have accepted the offer. The other two unions, SINTIUS and SEESP, current have not accepted the offer regarding wages readjustment. For the employees represented by these two unions (SINTIUS and SEESP), the final decision now depends on a verdict of the Labor Court. We have experienced the following strikes in the last five years, none of which interrupted the essential services that we provide: a two-day strike in May 2003, a two-day strike in May 2004, a two-day strike in June 2005, a one-day strike in May 2006 and any strike in 2007. In June 2008 we experienced a four-day strike. Under Brazilian law, our non-administrative employees are considered essential employees and therefore are limited in their right to strike.

#### **6.E. Share Ownership**

As of May 31, 2008, the members of the board of directors and the executive officers owned an aggregate of 4,807 common shares. The members of our board of directors and our executive officers, on an individual basis and as a group, beneficially own less than 1% of our common shares. See *Item 7A. Major Shareholders and Related Party Transactions Major Shareholder* for more information. As of the same date, none of our directors and executive officers owned any stock option plans.

**ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS****7.A. Major Shareholder**

Our outstanding share capital as of June 30, 2008 consisted of 227,836,623 common shares, without par value. Under our by-laws and the laws of the State of São Paulo, the State is required to own at least one-half plus one of our outstanding common shares. All of our shareholders, including the State, have the same voting rights.

The following table sets forth ownership information for each of our shareholders that beneficially owned 5.0% or more of our common shares and for our officers and directors, individually and as a group, as of June 30, 2008.

	<b>Common shares*</b>	
	<b>Shares</b>	<b>%</b>
State of São Paulo	114,508,087	50.3%
Directors and executive officers of Sabesp <sup>(1)</sup>	4,808	0.0%
Others	113,323,728	49.7%
Total <sup>(2)</sup>	227,836,623	100%

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

<sup>(2)</sup> As of June 30, 2008, 25.85% of our outstanding common shares were held by 2,406 registered shareholders in Brazil.

\* After June 4, 2007 our common shares have been traded considering the reverse stock split. Under U.S. GAAP the SFAS N° 128 requires the retroactive restatement of earnings-per-share computations for stock dividends, stock splits, and reverse splits (see note 26 (r) to our financial statements).

**7.B. Related Party Transactions****Transactions with the State of São Paulo**

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

Many of our transactions with the State of São Paulo reflect policies of the State that depend on decisions of elected officials or public servants and are accordingly subject to change. Among the practices that could change are those described below concerning the provision of State guarantees, and the terms on which we use state-owned reservoir facilities.

**Provision of Services**

We provide water and sewage services to the Federal Government, the State and municipal governments and government entities in the ordinary course of our business. Sales of water and sewage services to the State, including State entities, totaled approximately R\$335.8 million for the year ended December 31, 2007. Our accounts receivable from the State totaled R\$446.4 million as of December 31, 2007. In addition, as required by law, we invest our cash

and cash equivalents with government financial institutions in short-term securities.

**Payment of Pensions**

Pursuant to a law enacted by the State, certain former employees of some state-owned companies which merged to form Sabesp, who provided service to us between our inception and 1974, when the law was prospectively repealed, acquired a legal right to receive supplemental pension benefit payments which rights are referred to as Plan G0. These amounts are paid by us, on behalf of the State, and are claimed by us as reimbursements from the State, as primary obligor. In 2007, we made payments to former employees of R\$104.6 million in respect of Plan G0. The State did not make any reimbursements in this period. See note 6 to our financial statements.

## Agreements with the State

In September 1997, we and the State entered into a memorandum of understanding providing that we would, in effect, apply dividends we declared that were otherwise payable to the State to offset accounts receivable in connection with the provision of water and sewage services to the State and its controlled entities. In 1998, 2000 and 2001, we applied dividends, in the form of interest on shareholders' equity due to the State in respect of its shareholding in us to settle a portion of the unpaid accounts receivable from the State. In 1999, we did not pay dividends or other distributions to our shareholders.

On December 11, 2001, we entered into an agreement with the State and the State Department of Water and Energy. Pursuant to this agreement, the State acknowledged and agreed, subject to an audit by a State-appointed auditor, to pay us amounts it owed to us in respect of:

- water and sewage services we provided to governmental agencies, State-owned autonomous entities and foundations through December 1, 2001; and
- supplemental retirement and pension benefits we paid from March 1986 to November 2001 on behalf of the State to former employees of the State-owned companies which merged to form Sabesp; as we did not reach an agreement regarding these amounts, a joint inquiry has commenced in order to ensure agreement between us and the State.

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

The agreement provided that the State Department of Water and Energy would transfer to us ownership of the Taiapuê, Jundiá, Biritiba, Paraitinga and Ponte Nova reservoirs, which make up the Alto Tietê system, and that the fair value of these assets would reduce the amounts owed to us by the State.

Under the December 2001 agreement, in July and August 2002, a State-owned construction company (*Companhia Paulista de Obras e Serviços*), or CPOS, on behalf of the State, and an independent appraisal firm (*Engenharia de Avaliações*), or ENGEVAL, on our behalf, presented their valuation reports relating to the reservoirs. Under the agreement, the arithmetic average of these appraisals is deemed the fair value of the reservoirs. The appraisals contained in these reports were in the amounts of R\$335.8 million and R\$341.2 million, respectively. Because we had already made investments in these reservoirs by then, the arithmetic average of the appraisals submitted to our board of directors by August 2002, R\$300.9 million, was net of a percentage corresponding to these investments. Our board of directors approved the valuation reports.

Under the December 2001 agreement, for amounts due in excess of the fair value of the reservoirs, the State is to make payments in 114 consecutive monthly installments. The nominal amount owed by the State would not be indexed to inflation or earn interest if there was a delay in concluding the appraisal of fair value. The installments will be indexed on a monthly basis by the IGP-M index, plus 6.0% per year, starting on the date the first installment becomes due.

On October 29, 2003, the Public Prosecution Office of the State of São Paulo (*Ministério Público do Estado de São Paulo*), on behalf of the people of the State, brought a civil public action in a Trial Court of the State of São Paulo (*12a Vara da Fazenda Pública do Estado de São Paulo*) alleging that a transfer to us of ownership of the Alto Tietê system reservoirs from the State Department of Water and Energy would be illegal. An injunction against the transfer of ownership of such reservoirs was granted but was later reversed. However, in October 2004, the court ruled in favor of the Public Prosecution Office of the State of São Paulo, which ruling we believe relates only to the illegality of the

transfer of the reservoirs. In response, we filed an appeal which is pending final decision and the State successfully filed an action suspending the lower court's decision until final judgment is reached by the Court of Justice of the State of São Paulo. We are unable to predict whether we will succeed in appealing such decision. However, we currently do not expect that an eventual unfavorable decision would have a material adverse effect on our business and financial condition.

Table of Contents

The December 2001 agreement also provided that the legal advisors of the State would carry out specific analyses, which have commenced, to ensure agreement among the parties as to the methodology employed in determining the amount of reimbursement for pension benefits owed to us by the State. The commencement of payments with respect to pension amounts owed to us by the State has been postponed until these analyses are completed, the appraisal report is approved and the credit assignments relating to the transfer of the reservoirs described above are formalized. In addition, the transfer of these reservoirs is currently being disputed and we are not certain whether such transfer will be legally allowed. Under the December 2001 agreement, the original first payment was to be made in July 2002. On March 22, 2004, we and the State executed the first amendment to the December 2001 agreement. Under this amendment, the State acknowledged a debt owed to us of R\$581.8 million, related to unpaid accounts receivable from the State until February 29, 2004, and we acknowledged the aggregate amount of R\$518.7 million due to the State as dividends in the form of interest on shareholders' equity. Accordingly, we and the State agreed to set-off each other's credit up to the limit of R\$404.9 million (value adjusted up to February 2004). The remaining amount of R\$176.9 million as of February 29, 2004 of the State's consolidated debt will be paid in monthly consecutive installments from May 2005 until April 2009. These installments will be indexed according to the IPCA index, plus an interest rate of 0.5% per month. With the execution of the March 2004 agreement, we were able to reconcile the compensation of part of the values owed to us by the State for the use of water and sewage services until February 2004 with values owed to the State by us as interest on shareholders' equity. The remaining amount of interest on shareholders' equity owed by us to the State, of R\$113.8 million was netted against accounts overdue after February 2004.

On December 28, 2007, we and the State Government, through the Treasury Secretariat, signed the second amendment to the terms of the original Gesp Agreement, (1) agreeing upon the payment in installments of the remaining balance of the First Amendment, amounting to R\$133.7 million (on November 30, 2007), to be paid in 60 monthly and consecutive installments of the same amount, the first of which fell due on January 2, 2008. The amount of the installments will be monetarily restated in accordance with the variation of the IPCA-IBGE, plus interest of 0.5% per month. (2) with respect to the accounts past due and unpaid in the period between March 2004 and October 2007, arising from the provision of water supply and sewage collection services in the amount of R\$256.6 million. (3) The interest on capital due from us to the State, related to the period between March 2004 and December 2006, in the amount of R\$400.8 million, restated between June 2007 and November 2007, based on the Selic (central Bank overnight rate), was paid in the period between January and March 2008. (4) The State and we agreed on immediately resuming the compliance with the mutual obligations under the following new assumptions: (a) implementation of an electronic account management system to facilitate and speed up the monitoring of payment processes and budget management procedures; (b) structuring of the Rational Water Use Program (PURA) to rationalize the consumption of water and the amount of the water and sewage bills under the responsibility of the State; (c) establishment, by the State, of criteria for budgeting so as to avoid the reallocation of amounts to a specific water and sewage accounts as of 2008; (d) possibility of registering state bodies and entities in a delinquency system or reference file; and (e) possibility of interrupting water supply to state bodies and entities in the case of nonpayment of water and sewage bills. We have not established any provisions for any amounts due to us by the State, because we expect to recover these amounts and net losses are not considered probable.

In 2007, we received payment installments from the State in the amount of R\$326.0 million. As of December 31, 2007, our dividends payable to the State, due from 2004 through 2007, were in the amount of R\$552.0 million. We are currently unable to determine the amount, if any, of the portion of these declared dividends that the State will apply to the current and future accounts receivable owed to us by the State or its controlled entities. The second amendment signed in 2007, with the State of São Paulo no longer requires the application of dividends to offset accounts receivable from the State.

On March 26, 2008, the State of São Paulo, through the Treasury Secretariat and the State Secretariat for Sanitation and Energy, and we entered into a Commitment Agreement for the settlement of outstanding debts related to the reimbursement of pension benefits. Even though the State acknowledges its debts related to the pension benefits, the

State disagrees with the criteria adopted by us to grant and pay the benefits, based on the legal opinions issued by the State Attorney General, which restrict State actions and prevent the voluntary reimbursement of all amounts paid by us.

From our standpoint, the criteria adopted in the past to grant and pay pension benefits were correct, as they were based on specific State authorizations or then effective legal opinions. The prolongation of the disputes between the State and us is the main reason why the parties did not manage until now to fully implement the provisions of the São Paulo State Government Agreement, described in note 6 (iii) to our financial statements.

Based on preliminary information gathered, under the calculation and eligibility criteria agreed by the State, we estimate an Indisputable Reimbursement of approximately R\$936 million, which is comprised of monetary adjustments based on the IPCA (Extended Consumer Price Index) (R\$605.3 in notional amount). The amount paid by us was R\$1,422.8 million, adjusted based on the IPCA (R\$879.0 in notional amount).

The parties agree that this discrepancy should not represent an obstacle to the implementation of the commitments made in the São Paulo State Government Agreement. See note 6 (iii) to our financial statements regarding the Indisputable Reimbursement.

Fipecafi (Fundação Instituto de Pesquisas Contábeis e, Atuariais e Financeiras) is validating the Indisputable Reimbursement and the Controversial Amount, estimated by us. In addition, Fipecafi, in addition to other independent consulting firm is performing a new evaluation of the Reservoirs that might be transferred to us as amortization of the reimbursement payable by the State to us. The amount of the Indisputable Reimbursement will be modified pursuant to the monthly variation of the IPCA from the month of each disbursement made by us to the month that the work will be completed.

Once the amount of the Indisputable Reimbursement is determined and validated by the parties, and the new evaluation of the reservoirs is concluded, the State will begin a 30-day period for payment of the Indisputable Reimbursement, as provided for by the São Paulo State Government Agreement, in 114 monthly, consecutive installments, including the annual IPCA variation, plus interest of 6% per year.

## **Dividends**

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

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

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

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

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



Table of Contents

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

On April 20, and December 14, 2006, our board of directors approved the payment of dividends, in the form of interest on shareholders equity, in the amount of R\$129.6 million, and R\$141.2 million, respectively, to be paid within 60 days after our 2007 shareholders meeting to shareholders of record as of May 3, 2006. The amount related to the dividends approved in 2006 for the controlling shareholder, the State of São Paulo, was R\$136.1 million. The payments of interest on shareholders equity declared in 2005 began being made on June 27, 2006. The payments of interest on shareholders equity declared in 2006 began being made on June 29, 2007.

On October 18, 2007 and February 21, 2008, our board of directors approved the payment of dividends, in the form of interest on shareholders equity, in the amount of R\$268.8 million and R\$ 31.9 million, respectively. The payments of these dividends began being made in June 27, 2008.

**Investment of Liquid Assets**

Our cash and cash equivalents invested with State financial institutions in short-term securities amounted to R\$421.6 million as of December 31, 2007.

**Government Guarantees of Financing**

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

On December 17, 1992, the State entered into a loan agreement with the World Bank in the amount of US\$119.0 million. This loan was guaranteed by the Federal Government and its proceeds were designated to finance the environmental clean-up of the Guarapiranga basin. Pursuant to this agreement, we would receive a loan from the State to be used in the expansion of the wastewater collection network and sewage treatment facilities in the Guarapiranga reservoir. As a result, on March 12, 1993, we entered into an agreement with the State pursuant to which the State transferred to us US\$37.0 million of this loan, which loan amount was increased to US\$42.5 million pursuant to an amendment entered into between the State and us in September of 1999. We pledged three of our properties as collateral for this financing in the amount of R\$60.5 million, according to a valuation of the properties carried out in November 2005. The last installment of this financing was paid in April, 2007, but so far the Federal Government has not released the properties.

The State has also guaranteed a portion of our repayment obligations under loan agreements that we entered into with the Federal Government in 1994 through its financial agent, Banco do Brasil S.A. which totaled R\$1,880.8 million as of December 31, 2007. The Federal Government has guaranteed, and the State has provided a counter-guarantee, in respect of the financial agreement we entered into with the Inter-American Development Bank in 2000 for the total aggregate amount of US\$200 million related to the financing of the Tietê River recovery project to reduce pollution.

On August 6, 2004, we entered into a credit agreement with the JBIC for the financing of the Environmental Recovery Program for the Santos Metropolitan Region, which was guaranteed by the Federal Government, with counter-guarantee from the State of São Paulo, for an aggregate principal amount of R\$337.7 million. We are currently also negotiating with BNDES and Caixa Econômica Federal for additional loans to finance portions of our capital expenditure program.

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

We currently use the Guarapiranga and Billings reservoirs and a portion of some of the reservoirs of the Alto Tietê system, which are owned by another company controlled by the State. We do not pay any fees with respect to the use of these reservoirs. We are, however, responsible for maintaining them and funding their operating costs. The State incurs no operating costs on our behalf. If these facilities were not available for our use, we would have to obtain water from more distant sources, which would be more costly.

Table of Contents

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

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

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

**Water Use Incentive Agreements**

We have entered into agreements with public entities, including State entities and municipalities, that manage approximately 7,000 properties under which we provide these entities with a 25.0% tariff reduction for the water and sewage services we provide if such entities implement our program for the rational use of water, which includes a reduction of at least 10.0% in water consumption. These agreements are valid for a period of 12 months with automatic renewal for equal periods. Pursuant to the terms of these agreements, if these entities fail to make any payment on a timely basis to us, we have the right to cancel the agreement, thereby revoking the 25.0% tariff reduction.

**Transactions with SABESPREV Pension Fund**

SABESPREV is the funded pension plan that we established to provide our employees with retirement and pension benefits. The assets of SABESPREV are independently held, but we nominate 50% of the directors of SABESPREV, including the Chairman of the Board, who has the deciding vote in accordance with the applicable legislation. Both we and our employees make contributions to the pension plan. We contributed R\$11.3 million, R\$11.4 million and R\$11.9 million in 2005, 2006 and 2007. On May 29, 2001, a Federal law was enacted which, among other things, limits the amount mixed capital companies, like us, may contribute to their pension plans. Specifically, the ordinary contributions made by us to our pension plans may not exceed the contributions made by the beneficiaries of these plans. Studies have been undertaken in order to cure the deficit with respect to the current plan and transform it into a defined contribution plan.

## ITEM 8. FINANCIAL INFORMATION

### 8.A. Consolidated statements and other financial information

See *Item 3.A. Key Information Selected Financial Data* and *Item 18. Financial Statements* .

#### Legal Proceedings

In the ordinary course of our business, we are a party to judicial and administrative proceedings relating to civil, environmental, labor and tax matters. As of December 31, 2007, we estimated that these legal proceedings totaled approximately R\$2,888.4 million (excluding the amount of R\$29.8 million related to court deposits). This amount was based on probable and possible losses and on the value attributed to the lawsuit by the plaintiffs in some cases and on the economic value of the lawsuits in others. Out of this total amount of contingencies, approximately R\$1,235.3 million relate to tariff-related legal proceedings and consumers claims, approximately R\$428.7 million relate to contractors claims, approximately R\$234.4 million relate to tax proceedings, approximately R\$132.1 million relate to labor proceedings, approximately R\$564.5 million relate to civil public actions related to environmental matters and R\$323.2 million relate to other civil matters. On the same date, the provisions for legal contingencies totaled R\$945.3 million (excluding the amount of R\$29.8 million related to court deposits), of which approximately R\$526.3 million relate to tariff-related legal proceedings and consumers claims, approximately R\$174.6 million relate to contractors claims, approximately R\$34.5 million relate to tax proceedings, approximately R\$61.7 million relate to labor proceedings, approximately R\$50.1 million relate to civil public actions related to environmental matters and approximately R\$127.9 million relate to other civil matters.

The difference between the provisioned amount and the total amount of the contingencies derives from the methodology for establishing our provisions. This methodology takes into account: (1) the probability of loss of each lawsuit, based on the alleged facts, the claim based on the factual circumstances vis-à-vis the law, as well as prevailing precedents in similar cases; and (2) the calculation of the provisioned amounts, which requires significant judgment and in certain circumstances, given the nature of the claim, we are unable to estimate with accuracy its exposure. In these cases, we have taken into account the value attributed to the lawsuits by the plaintiff and legal opinions of counsel in charge of each lawsuit. Once the methodology is applied, as a general rule, we make the provisions only for the lawsuits that are considered as probable loss.

We cannot give any assurances either as to the sufficiency of the provisioned amount to cover the contingencies or as to the total amount of potential liabilities that we may incur or penalties that may be imposed. We may not obtain a favorable outcome in the administrative or court proceedings to which we are a party. In addition, the total amount of the contingencies, based on the value attributed to the lawsuit by the plaintiff, may not correspond to the economic value of the lawsuits, which may be substantially higher than the total amount of contingencies. If the economic outcome of these lawsuits is higher than the amount attributed to the lawsuit by the plaintiff or, in the event the total amount of our provisions does not suffice to pay the contingencies due, we could incur greater costs than those that were originally foreseen. If these costs are significant, our results of operations and financial condition could be negatively affected.

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

We are a party to civil public actions brought by municipalities that seek cessation of the collection of fees relating to sewage services, alleging that we do not treat the sewage in these municipalities and that we failed to make certain investments in sewage treatment facilities as provided in the relevant concession contracts.

Additionally, several environmental public civil actions have been brought against us by the São Paulo State Public Attorney's Office, certain municipalities and certain non-governmental organizations seeking the following: (1) to forbid the dumping of raw sewage into certain local watercourses; (2) in some cases seeking remedies for environmental damages, which have not yet been specified and evaluated by technical experts of the courts; and (3) aiming to require us to install and operate sewage treatment facilities in those locations. In each case, we are subject to daily fines for noncompliance therewith. In our response to these lawsuits we emphasize that the installation and operation of sewage treatment facilities in those locations is included in our business plan and that the immediate cessation of the release of raw sewage into the relevant local water courses would hinder us from collecting sewage a primary necessity in those locations, causing even more damages against the environment and public health. There have already been some unfavorable rulings against us. However, we cannot foresee the final result of all the lawsuits and we believe that an unfavorable result could have a substantially adverse effect. The public civil actions to which we are party include the following:

Table of Contents

(1) The Public Prosecutor's Office of the São Bernardo do Campo judicial district has brought a public civil action requesting remedies due to environmental damage caused by the release of sludge from our water treatment facility into certain receiving waters; seeking the immediate cessation of this activity and the implementation of an environmental recovery project. The lower court ruled in our favor and there was a subsequent appeal against this ruling. The appellate court ruled against us and ordered that the dumping of residue cease within a year from the final ruling. The court also determined that environmental recovery must be carried out within two years of the date mentioned above, under the penalty of a daily fine of R\$10.0 thousand and conversion into compensation for environmental damages. Our legal counsel assessed the risk of loss as probable and the reserve recognized, as of December 31, 2007, represents the adjusted amount of R\$163 thousand, which reflects the amount attributed to this lawsuit;

(2) Public civil action filed by the Public Attorney's Office against us and the Cotia Mayor's Office seeking individual and joint adverse judgments of the defendants in relation to: (a) the permanent cessation of releasing untreated water effluents into the Cotia River or its tributaries, subject to a daily fine in the case of noncompliance; (b) the treatment of sewage prior to releasing it into the Cotia River, under the penalty of a daily fine, in the event of non-compliance; (c) the full restoration of soil, of surface and underground water bodies and of vegetation to their original condition, under the penalty of a daily fine, in the event of non-compliance and (d) the payment of compensation for environmental damages caused to soil, to water sources and to underground and surface water bodies that cannot be recovered. The appellate court rendered favorable decisions to us with respect to items (a), (c) and (d) mentioned above. According to evaluations by the court's technical expert, compensation for environmental damages was R\$5.8 million as of October 17, 2006. This amount is still under discussion and its approval is subject to a final decision by the court. Our in-house counsel has considered it as a probable loss. In December 2007, we recorded the total provision in the amount of R\$ 6.9 million.

(3) On February 25, 2003, an environmental public civil action was filed by the Public Attorney's Office against Sabesp with a view to sentencing us for failure to cease releasing raw sewage without proper treatment into the Boa Esperança stream and other water bodies in the municipality of Lutécia, as well as the requirement of investing in a sewage and water treatment facility in the municipality of Lutécia and provide the payment to remedy environmental damages. The expert's report estimated damages to the amount of R\$82.8 million, on July 13, 2004. This sum is definitive as a ruling has not yet been rendered.

(4) Public civil action filed by the São Paulo State Public Attorney's Office against us seeking to sentence it for the non-cessation of releasing raw sewage without proper treatment into the Borá stream and other water bodies in the municipality of Borá, as well as our obligation to invest in a water and sewage treatment facility in the municipality, carrying out the works necessary for the proper sewage treatment. The expert report estimated environmental damages to the amount of R\$41.0 million on November 29, 2005. However, this sum is not yet definitive as a ruling has not been rendered yet.

Lawsuits 3 and 4 mentioned above are currently under negotiation with the State Public Attorney's Office. Provisions have been made for the expected amount of disbursement. For the municipality of Lutécia we have estimated the amount of R\$3.9 million for the following works: reforestation; the implementation of the Urban Drainage Director Plan, of the Lutécia Sewerage System and of the Recyclable Materials Collection Center. The sum of R\$744.4 thousand has been provisioned for the municipality of Borá for the following works: reforestation, Urban Drainage Direction Plan and recovery and adaptation of the bathing area.

(5) A public civil action filed by the Piracicaba Civil Entities Coordination Board against us and the National Water Agency seeking remedy for damages caused by the use of the Piracicaba, Jundiá and Capivari rivers' basin to supply the São Paulo Metropolitan Region through the Cantareira Water System for nearly 30 years. The value attributed to the claim is R\$11.4 billion on December 10, 2003 updated to R\$ 15.1 billion on December 31, 2007. This lawsuit is in

its initial stage and is pending judgement from the lower court. So far no value has been set for the damages alleged. Our in-house counsel has evaluated the case as a remote loss and therefore, no provisions have been made referring to this lawsuit.

Table of Contents

(6) The São Paulo State Public Attorney's Office has filed a public civil action against us, AES Eletropaulo, Daece, Cetesb and Fazenda do Estado de São Paulo seeking a joint condemnation for alleged environmental damages caused by the reversal of the Pinheiros River into the Billings Dam. A lower court decision was issued based on an expert's report which estimated the damages at R\$284.5 million, jointly sentencing the parties to pay the amount restated between June 2000 and December 2007, in the amount of R\$491.6 million. We, Daece, AES Eletropaulo, Cetesb and State Treasury Department have appealed against the ruling at the appellate court claiming that the decision has no factual basis and are awaiting a decision. There is no guarantee that the joint sentence will hold up in court. This lawsuit had previously been evaluated by our in-house counsel as a remote loss, but in view of the recent decision, it is now considered as a possible loss and therefore still no provisions have been made for this lawsuit.

We are currently involved in other environmental lawsuits against the release of sewage without treatment in the municipalities where we operate, which have been evaluated as probable and possible losses by our counsels. The amounts provisioned not always represent the final amount to be paid as compensation for the alleged damages in view of the current status of the lawsuits and since the Management is precluded from reasonably estimating the amounts of future disbursements. As of December 31, 2007, the total amount provisioned was R\$50.1 million, including the provisions described in items (1), (2), (3) and (4) above.

***Labor Proceedings***

On October 6, 1989, SINTAEMA (Union of Water, Sewage, and Environmental Workers of São Paulo) filed a lawsuit against us seeking the payment of wage differences related to additional payment for health hazard allowances due to harmful working conditions in the period between September 1987 and February 1991. On December 19, 1997, the Higher Labor Court rendered an unfavorable decision against us. We appealed against the decision, which was upheld by the Higher Labor Court. SINTAEMA has started to execute the decision. The court's technical expert report was presented on February 21, 2007, with the a restated sum of R\$28.3 million, which was updated on December 31, 2007 to R\$30.7 million. Our expectations of a probable loss and a provision to that effect was made on December 31, 2007. As of March 2008 we are party to approximately 2,939 labor proceedings and one public civil action filed by some of our current and former employees. These lawsuits seek to negotiate certain benefits granted by Law 4,819, as of August 26, 1958. Approximately 40 plaintiffs are claiming the same benefits in the civil court and in these cases, we allege that the São Paulo State government, and not us, should be responsible for the payments due to the plaintiffs. In the public civil action filed against us and the State Treasury, an injunction was granted in the lower court requiring us to pay the benefits foreseen in Law 4,819/58 to all the plaintiffs. A lower court decision was rendered on April 5, 2005, granting relief to such proceeding and confirming the injunction granted to the effect that we are to continue to pay the benefits. We have appealed at the Regional Labor Court. There are currently other pending individual lawsuits discussing the same claims, and up to the date of this report neither Sabesp nor the São Paulo State Government had reached an agreement as to the indemnification amounts related to these proceedings.

As of December 31, 2007, the total amounts involved related to labor proceedings were R\$132.1 million for risks considered as probable and possible losses. We had established a provision totaling R\$61.7 million with respect to potential damages in lawsuits and administrative proceedings involving present and former employees, including the lawsuits described in the preceding paragraphs, based on calculations made by our legal and human resources departments.

***Tax Proceedings***

In July 1999, we took legal action against the São Paulo city government against the levy of a new charge for the use of public areas for the installation of water and sewage mains for the provision of public sanitation services. Based on our in-house counsel's opinion, we believe that this charge is illegal as it was levied through a municipal decree and not through a municipal law. Therefore, we are challenging this charge and any related charges. On May 11, 2000, the

São Paulo State's 12th Treasury District Court ruled in favor of this municipal charge and we subsequently appealed the decision at the appellate court of the State of São Paulo. A recently approved law has legalized a charge on the use of public areas in São Paulo city. In April 2004, our request for an injunction suspending the levy of this charge was granted by the aforementioned District Court and subsequently upheld in the decision issued by the related courts.

Table of Contents

The lawsuit is awaiting decision of appeals filed by us against the charge enacted by municipal decree. The São Paulo city government (PMSP) subsequently enacted a law imposing a charge for the use of public areas. We filed a proceeding and the injunction was granted and subsequently confirmed by means of decision rendered. The PMSP appealed this decision at the State of São Paulo appellate court and the decision is still pending. The proceeding is awaiting decision at the appellate court. We cannot estimate the potential increase to our expenses should we have to pay this tax for the use of municipal soil or should any future levy of this tax date back to 1999. Until present, no provision for any type of potential expense deriving from this municipal tax had been recorded.

We filed an Injunction to challenge the revocation of ISS (Brazilian Service Tax) exemption in the City of São Paulo, which was established by a Municipal Law enacted in 2002. In April 2003, a preliminary injunction was granted, suspending the taxation. In May 2005, the State Court pronounced a judgment overruling the injunction. In July 2005, we filed an appeal aiming at the maintenance of the restraining order previously granted. The final decision has not been issued yet, but the expectation for a favorable decision is deemed as possible. Concomitantly, the Treasury Secretariat of the City of São Paulo drew up assessment notices on September 18, 2006, against which an administrative objection was timely filed and thereafter dismissed in the lower court. The amount involved is estimated in R\$70.0 million (R\$120 million amount restated as of December 31, 2007).

In November 2004, we took legal action against the municipality of Bragança Paulista against the imposition of a new charge for the use of public areas for the installation of water and sewage mains for the provision of public sanitation services. On February 16, 2005, we were granted an injunction suspending the imposition of this charge and preventing the municipality from collecting any current or future amounts due in respect of this charge until there is a final decision on the merits. The municipality appealed the decision, but the appellate court upheld the injunction granted. In June 2005, the preliminary injunction was considered to be valid. In July 2005, the municipality of Bragança filed an appeal which is currently awaiting court decision. We have not made any provisions for this proceeding.

In 2006, the Federal Revenue Service by means of a lawsuit verified the compliance of our fiscal obligations related to income and social contribution taxes for 2001, calculating a fiscal credit to the Federal Revenue Service in the amount of R\$277.0 million and updated to R\$ 298.0 million on December 31, 2007. We filed a response in a timely manner contesting this amount and will appeal against the administrative decision by means of an administrative proceeding and a lawsuit. Based on the opinion of our internal legal counsel, approximately 90% of this amount is considered as a remote loss and the remaining 10% as a possible loss.

We cannot predict the outcome of any of these lawsuits nor can we assure you that, in the event of an adverse decision, we will be able to pass on to our customers any increase in our deductions from gross revenue, operating expenses or other expenses.

We are party to several actions filed by the municipality of Ferraz de Vasconcelos seeking the payment of owed fines for alleged damages caused by us during construction works in the municipality. Many of these actions have been refused by lower courts, but are still subject to appeal. After revising these proceedings, we have estimated the sum of R\$51 million, for which no provision has been made.

***Condemnation Proceedings***

We are party to a significant number of condemnation proceedings arising from the partial or total expropriation or use of private property for water mains, sewer lines and facilities. Under Brazilian law, the State or the relevant municipality is entitled to condemn private property to the extent required for the construction, development or improvement of parts of water and sewage systems operated by us. However, we are required to provide compensation to affected property owners based upon appraised fair market values. Although we generally provide

compensation to property owners on the basis of negotiated settlements, we are a party to many lawsuits related to compensation awards.

On December 31, 2007, the future disbursement was estimated at R\$472.4 million as to all proceedings of expropriation and servitude. These payments are made over the year, according to each lawsuit decision and amicable settlement. After making said payment, we will own the real properties which will be recorded as assets belonging to us after being expropriated. Accordingly, the disbursement will take place throughout the years due to the aforementioned reasons. We have not provisioned any amounts with regards to these proceedings.

***Concession-Related Legal Proceedings***

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

In December 1997, the municipality of Santos enacted a law expropriating our water and sewerage mains in Santos. We requested an injunction against the expropriation which was denied by the lower court. This decision was subsequently reversed by the State of São Paulo appellate court, which then issued an injunction suspending the law. On August 2, 2002, a decision was issued in our favor by the lower and appellate courts, but this lawsuit is still subject to an extraordinary appeal. On March 25, 2004, the Public Attorney's Office filed a civil action against the municipality of Itapira, its mayor, the Municipal House of Representatives and us, claiming that Municipal Law No. 3,593/04 is unconstitutional and seeking termination of the concession contract we entered into with the municipality of Itapira. Although an injunction was granted, the Court of Justice of the State of São Paulo has stayed the injunction. On March 23, 2005, the House of Representatives of Itapira approved a decree revoking the concession contract. In addition, Municipal Law No. 3,730/05 was enacted revoking an earlier law which authorized the municipality to enter into the concession contract with us. The municipality of Itapira has further filed an action against us seeking to repossess the assets related to its water and sewage services and has obtained an injunction which was later confirmed by a court decision. We appealed the decision, but have been unable to revoke its effects until the final trial. In view of the compensation lawsuit filed by the Company against the aforementioned municipality, we have waived the appeal in view of its harmful potential. As of the date of this annual report, a trial decision on this litigation was pending. We have not made any provisions for this proceeding.

The municipality of Sandovalina has brought a legal action against us seeking to (1) obtain the termination of the concession entered into with us and (2) obtain remedies for environmental damage and alleged losses caused to the municipality due to our failure to provide sewage treatment, as well as other damage caused to public property. We are also seeking the payment of a contractual indemnification based on the early termination of the contract. We are currently operating the water and sewage treatment facility of Sandovalina, and the lawsuit is still in the fact-finding phase. We have not made any provisions for this proceeding. The lawsuit is currently suspended while the parties discuss the procedures. No provisions have been made for this proceeding.

The municipality of Tuiuti has brought a declaratory action seeking to recognize the inexistence of any judicial or legal grounds to justify our permanence as the provider of water and sewage collection services in the municipality of Tuiuti, and the subsequent taking over of these services by the municipality. We have responded with a counterclaim against the municipality seeking a statement corroborating the existence of a legal relationship between the two parties for subsequent compensation for investments made. The lawsuit is in the discovery phase and undergoing an expert examination, and a hearing has been scheduled.

The municipality of Cajobi has filed a Repossession Action. This seeks the retaking of water and sewage collection services in view of the termination of the concession entered into with us on November 13, 2006, and the return to the Granting Authority of all the reversible assets, rights and privileges transferred. The action also seeks to require us to pay for losses and damages for amounts received as water and sewage tariffs not received in view of utilities explored since the enactment of Municipal Decree 767, of November 13, 2006 (which foresees the retaking of service granted), and for the use of assets related to the concession. The lawsuit is in the discovery phase.

The municipality of Monte Alto has brought a cumulative Repossession Action for losses and damages stating the termination of the concession contract entered into with us and seeking the retaking of water supply and sewage collection services following the termination of the concession on October 23, 2006. The action also seeks a reversal to the Granting Authority of all the reversible assets and of the administration of the services foreseen in the concession contract. The injunction was granted by the Fourth Public Law Chamber of the appellate court under an interlocutory appeal filed by the municipality and executed on November 17, 2006. The lawsuit is in discovery phase, although the parties have been negotiating a program contract.

Table of Contents

The municipality of Araçoiaba da Serra has brought a Repossession Action seeking an authorization to enter into the installations included in the concession contract, including all property and assets connected to the water supply and sewage treatment services. In addition to this, the municipality seeks to take over the administration, operation and exploration of these services in view of the expiration of the concession contract, scheduled for September 23, 2006. The municipality also claims the definitive restoring of the service's ownership, including due reversal of all assets, rights and privileges previously transferred to us. The request for an injunction seeking to keep the municipality in charge of the services was granted by the appellate court and by the Superior Courts. We have subsequently filed a writ of prevention for the early production of evidence. The lawsuit is in discovery phase.

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

Approximately 1,170 lawsuits were filed by commercial customers, which claim that their tariffs should be equal to the tariffs of another consumer category, and therefore claim the refund of amounts collected by SABESP from such customers. We were granted both favorable and unfavorable final decisions at several courts, and recognized a provision when the likelihood of loss is considered probable. In 2007, the volume of lawsuit decisions allowed our management to evaluate the contingency process and based on this evaluation, we quantified the lawsuits involving customers, considering the most recent history of favorable and unfavorable court decisions to improve our estimate of liability. The result of this process evidenced the need to increase the provision by approximately R\$253 million, net of exclusions.

The Association of Distinguished Bars and Restaurants (*Associação de Bares e Restaurantes Diferenciados* - ABREDI), has initiated several lawsuits to challenge the 10.0% penalty fee we charge on late water and sewage payments. In several of these cases, lower courts have dismissed the lawsuits based on the lack of standing by the plaintiff to initiate such a lawsuit. In other cases, the lawsuits were dismissed because a civil public action with respect to the same matter was already being heard at the civil courts of the State of São Paulo. In this civil public action, a decision was granted against us and we appealed against this decision and a final decision is still pending. Notwithstanding these legal proceedings, we have reduced to 2.0% the penalty fee we charge on late bill payments by all of our customers.

***Contractors Claims***

Certain contractors have filed claims against us alleging underpayment of inflation indexation adjustments and monetary losses incurred in connection with introduction of the real. Based on advice from our legal counsel, as of December 31, 2007, we established a provision for these claims in the amount of R\$174.6 million to meet probable losses arising from unfavorable decisions in these actions.

***Other Legal Proceedings***

We are a party to several civil lawsuits related to indemnities for property damage, pain and suffering, and loss of profits allegedly caused to third parties. As of December 31, 2007, we recognized provisions of R\$127,890 (R\$76,909 in 2006) for claims whose likelihood of loss is considered probable. There was an increase both in lawsuits with probable and possible risk of loss, arising from the increase in lawsuits and the review of the expected outcomes, comprising monetary adjustment, interest and fees for the year. The São Paulo State Public Attorney's Office has filed a public civil action against Sabesp, seeking to ensure a water supply in the municipality of Guarujá within accepted levels of potability and in accordance with current legislation. The lawsuit also seeks the company be sentenced to start building ETA (Water Treatment Station), restore fees charged to consumers and pay compensation for moral and property damages caused by allegedly improper water consumption. An injunction was granted and we appealed against such decision. However, the appellate court rejected the appeal. Sabesp has offered a defense and the lawsuit is currently in discovery phase. We have not estimated the disbursement yet for there are no sufficient data to estimate the amounts. We evaluated this demand as a possible loss.



Table of Contents

On October 29, 2003, the Public Prosecution Office of the State of São Paulo on behalf of the people of the State of São Paulo, brought a civil public action in a trial court of the State of São Paulo (*12a. Vara da Fazenda Pública do Estado de São Paulo*) alleging that a transfer to us of ownership of the Alto Tietê System reservoirs from the State Department of Water and Energy would be illegal. In October 2004, the court ruled in favor of the Public Prosecution Office of the State of São Paulo, with respect to the illegality of the transfer of the reservoirs. In response, we filed an appeal which is pending final decision.

In December 1996, we filed a claim to collect payment due from the municipality of Diadema. In December 2005, the Court of Justice of the State of São Paulo ruled in our favor. This legal proceeding was followed by several other related legal proceedings, some of which are currently pending. A civil public action and an annulment action have been decided in our favor. On October 11, 2006, the municipality of Diadema appealed against the decision and on November 21, 2006 a decision was published allowing us to present our response to the appeal. We filed our response on December 6, 2006.

We entered into a settlement agreement with the municipality of Mauá at the time the concession was terminated in which Mauá agreed to make the payments owed to us in connection with the return of water and sewage treatment facilities. However, to date Mauá has not yet made any payments to us under the settlement agreement. We filed a claim against Mauá in December 1996 and a decision was issued in February 2005 by the lower court requiring Mauá to pay us the amount of R\$153.2 million. The municipality of Mauá and SAMA Saneamento Básico do Município de Mauá appealed this decision. The appeal is pending final decision by the Court of Justice of the State of São Paulo. On July 4, 2006 the judgment was converted into investigation to clarify the amount related to the indemnity. On February 20, 2008, the municipality of Mauá provided its opinion about the investigation and the case is now with the judge. On April 7, 2008, Sabesp responded to the plaintiffs' charges and now we are awaiting decision on the municipality and SAMA's appeals. Based on our internal legal counsel opinion, our management still believes that we have the legal right to receive the amount related to the indemnity and we continue to monitor the status of these legal proceedings. The updated amount related to the indemnity estimated according to legal official adjustment index is R\$551 million.

We are a party to a substantial number of other legal proceedings, in addition to the lawsuits and administrative proceedings discussed above, in the normal course of our business. These legal proceedings include personal injury and property damage cases, environmental proceedings, challenges to our ability to cease rendering water and sewage services upon default by our customers and a range of other matters. We have not established provisions with respect to these other legal proceedings.

**Dividends and Dividend Policy*****Amounts Available for Distribution***

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

- the legal reserve; and
- retained earnings for investment reserve.

We are required to maintain a legal reserve, to which we must allocate 5% of net profits for each fiscal year until the amount for such reserve equals 20% of our paid-in capital. However, we are not required to make any allocations to our legal reserve in respect of any fiscal year in which the aggregate amount of the legal reserve plus our other established capital reserves exceeds 30% of our capital. Net losses, if any, may be charged against the legal reserve. On December 31, 2007, the balance of our legal reserve was R\$306.7 million, which was equal to 9.0% of our paid-in capital.

Table of Contents

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

Under Brazilian Corporate Law, any company may, as a term in its by-laws, create a discretionary reserve. By-laws which authorize the allocation of a percentage of a company's net income to the discretionary reserve must also indicate the purpose, criteria for allocation and maximum amount of the reserve. We may also allocate a portion of our net profits for discretionary appropriations for plan expansion and other capital investment projects, the amount of which would be based on a capital budget previously presented by management and approved by shareholders. Under Law No. 10,313 of October 3, 2001, capital budgets for more than one year must be revised at each annual shareholders' meeting. After completion of the relevant capital projects, we may retain the appropriation until the shareholders vote to transfer all or a portion of the reserve to capital or retained earnings. At December 31, 2007, we had an investment reserve of R\$3,609.6 million.

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

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

**Mandatory Distribution**

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

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

**Payment of Dividends**

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

Table of Contents

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

In general, shareholders who are not residents of Brazil must register with the Central Bank to have dividends, sales proceeds or other amounts with respect to their shares eligible to be remitted outside of Brazil. The common shares underlying our ADSs are held in Brazil by *Banco Itaú S.A.*, also known as the custodian, as agent for the depositary, which is the registered owner on the records of their registrar for our common shares. Our current registrar is *Banco Itaú S.A.* The depositary electronically registers the common shares underlying the ADSs with the Central Bank and, therefore, is able to have dividends, sales proceeds or other amounts with respect to these shares eligible to be remitted outside Brazil. See *Item 10.D. Additional Information Exchange Controls*.

Payments of cash dividends and distributions, if any, will be made in Brazilian currency to the custodian on behalf of the depositary, which will then convert such proceeds into U.S. dollars and will cause such U.S. dollars to be delivered to the depositary for distribution to holders of ADSs. See *Item 10.D. Additional Information Exchange Controls*. Under current Brazilian law, dividends paid to shareholders who are not Brazilian residents, including holders of ADSs, will not be subject to Brazilian withholding income tax, except for dividends declared based on profits generated prior to December 31, 1995. See *Item 10.E. Additional Information Taxation*.

### **Record of Dividend Payments and Interest on Shareholders' Equity**

Brazilian corporations are permitted to distribute dividends in the form of a tax-deductible notional interest expense on shareholders' equity in accordance with Law No. 9,249, dated December 26, 1995, as amended. The rate at which tax-deductible interest may be paid is limited to the product of the average *Taxa de Juros de Longo Prazo* (TJLP (a long-term interest rate published by the Brazilian government) and shareholders' equity during the relevant period and cannot exceed the greater of:

- 50% of net income (before taking into account such distribution and any deductions for income taxes and after taking into account any deductions for social contributions on net profits) for the period in respect of which the payment is made; and
- 50% of retained earnings. Any payment of interest on shareholders' equity to holders of ADSs or common shares, whether or not they are Brazilian residents, is subject to Brazilian withholding income tax at the rate of 15% or 25% if the beneficiary is resident in a tax haven. See *Item 10.E. Additional Information Taxation*. The amount paid to shareholders as interest on shareholders' equity, net of any withholding tax, may be included as part of any mandatory distributable amount. Under Brazilian law, we are obligated to distribute to shareholders an amount sufficient to ensure that the net amount received by them, after payment by us of applicable Brazilian withholding taxes in respect of the distribution of interest on shareholders' equity, is at least equal to the mandatory distributable amount. When we distribute interest on shareholders' equity, and that distribution is not accounted for as part of the mandatory distribution, Brazilian withholding tax will apply. All payments to date were accounted for as part of the mandatory distribution.

The following table sets forth the distributions out of net income that we made or will make to our shareholders in respect of our 2005, 2006 and 2007 net income. All these amounts distributed or to be distributed were or will be in the form of interest on shareholders' equity.

### **Distributions out of net income**

<b>Net</b>	<b>Payment</b>	<b>Payment</b>	<b>Aggregate amount</b>	<b>Pay-out</b>
------------	----------------	----------------	-------------------------	----------------

<b>Year ended December 31,</b>	<b>income<sup>(1)</sup></b>	<b>Dates</b>	<b>per 1,000 shares<sup>(6)</sup></b>	<b>per ADS</b>	<b>distributed<sup>(1)</sup></b>	<b>ratio<sup>(2)</sup></b>
	<b>R\$</b>		<b>R\$</b>	<b>R\$</b>	<b>R\$</b>	<b>%</b>
2005	865.6	(3)	12.23	3.06	348.2	40.2
2006	778.9	(4)	9.51	2.38	270.8	34.8
2007	1,048.7	(5)	1.32	2.64	300.7	28.7

(1) In millions of *reais*.

(2) Represents distributions divided by net income.

(3) June 26, 2006.

(4) June 29, 2007

(5) June 27, 2008.

(6) After the reverse split from 2007 the company started to calculate the dividends payments per shares. After June 4, 2007 our common shares have been traded considering a reverse stock split, of 125 common shares into one common share. To convert from *Reais* per 1,000 common shares to *Reais* per share, for 2003, 2004, 2005 and 2006, the price per common share must be divided by 1,000 and multiplied by 125.

On April 28, June 23, October 20 and December 15, 2005, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$38.2 million, R\$66.8 million, R\$85.2 million and R\$158.1 million respectively, to be paid within 60 days after our 2006 shareholders' meeting. On April 20 and December 14, 2006, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$129.6 million and R\$141.2 million, respectively. The payments of interest on shareholders' equity declared in 2006 began being made on June 29, 2007. On October 18, 2007 and February 21, 2008, our board of directors approved the payment of dividends, in the form of interest on shareholders' equity, in the amount of R\$268.8 million and R\$ 31.9 million, respectively. The payments of these dividends began being made on June 27, 2008.

### **Dividend Policy**

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

### **8.B. Significant Changes**

We are not aware of any significant changes bearing upon our financial condition since the date of the consolidated financial statements included in this annual report.

## **ITEM 9. THE OFFER AND LISTING**

### **9.A. Offer and Listing Details**

#### *Market Price of Common Shares*

Our common shares are traded on the São Paulo Stock Exchange under the symbol *SBSP3*. As of December 31, 2007, we had 2,659 registered holders of common shares.

On April 30, 2007, our shareholders approved a reverse stock split of 125 common shares into one common share. Under U.S. GAAP the SFAS N°128 requires the retroactive restatement of earnings-per-share computations for stock dividends, stock splits, and reverse splits (see note 26 (r) to our financial statements).

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

Table of Contents

	<b>Reais per 1,000 common shares</b>		<b>U.S. dollar equivalent per ADS</b>		<b>Average daily trading volume (in lots of 1,000 common shares)</b>
	<b>Low</b>	<b>High</b>	<b>Low</b>	<b>High</b>	
<b>2003:</b>	74.60	168.00	5.21	14.29	50,002
<b>2004:</b>	115.82	182.00	10.10	16.24	51,359
<b>2005:</b>	121.41	163.90	11.60	15.39	54,203
<b>2006:</b>					
First quarter	154.80	191.00	17.10	21.98	54,056
Second quarter	174.00	219.02	19.04	26.53	62,225
Third quarter	196.00	259.98	22.14	29.89	54,545
Fourth quarter	250.01	308.49	29.24	35.94	38,664
<b>2007:</b>					
First quarter	258.99	302.00	30.04	36.19	49,874
	<b>Reais per common shares</b>		<b>U.S. dollar equivalent per ADS</b>		<b>Average daily trading volume</b>
	<b>Low</b>	<b>High</b>	<b>Low</b>	<b>High</b>	
Second quarter	33.75	40.88	32.96	41.99	43,775
Third quarter	41.50	49.10	39.29	53.10	384,527
Fourth quarter	39.31	47.86	43.38	52.86	363,180
<b>2008:</b>					
January	34.29	43.00	37.47	48.61	324,629
February	36.71	41.00	42.37	49.03	272,563
March	37.60	40.60	43.16	47.75	283,075
April	38.65	42.99	44.09	51.52	339,748
May	43.59	46.50	52.49	56.02	304,315
June	39.50	43.95	49.53	54.05	350,348

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

***Market Price of ADSs***

Our American Depositary Shares, or ADSs, each of which represent 2 of our common shares, as of the date of the filing of this annual report, are listed on the New York Stock Exchange under the symbol `SBS` . Prior to June 8, 2007, each ADS represented 250 of our common shares. Our ADSs began trading on the New York Stock Exchange on May 10, 2002 in connection with the initial offering of our equity securities in the United States. We did not receive any of the proceeds from this sale.

Table of Contents

The table below sets forth, for the periods indicated, the reported high and low closing prices for our ADSs on the New York Stock Exchange.

	Price in U.S. dollars per ADS		Average daily trading volume
	Low	High	
<b>2002:</b>			
Second quarter (commencing May 10)	8.60	11.80	186,311
Third quarter	4.75	8.80	42,784
Fourth quarter	4.65	6.45	25,098
<b>2003:</b>			
First quarter	5.29	7.80	17,014
Second quarter	6.33	10.05	30,020
Third quarter	8.20	11.90	83,056
Fourth quarter	10.92	14.47	69,912
<b>2004:</b>			
First quarter	11.21	16.07	116,077
Second quarter	9.24	13.45	73,830
Third quarter	10.55	12.35	45,982
Fourth quarter	10.00	14.97	271,470
<b>2005:</b>			
First quarter	11.73	15.10	235,987
Second quarter	11.76	15.99	142,430
Third quarter	13.60	17.44	260,919
Fourth quarter	15.65	17.32	201,740
<b>2006:</b>			
First quarter	17.21	22.01	419,783
Second quarter	18.96	26.63	345,676
Third quarter	22.04	30.10	265,682
Fourth quarter	29.19	35.35	254,846
<b>2007:</b>			
First quarter	29.15	36.11	343,761
Second quarter	32.99	46.26	312,806
Third quarter	39.84	53.49	384,570
Fourth quarter	44.00	53.57	248,851
<b>2008:</b>			
January	40.92	49.19	341,353
February	42.44	48.95	226,402
March	44.09	48.62	311,841
April	44.56	50.91	269,251
May	52.69	56.35	313,860
June	49.12	53.60	351,383

**9.B. Plan of Distribution**

Not applicable.

## 9.C. Markets

### *Trading on the Brazilian Stock Exchanges*

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

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

The São Paulo Stock Exchange has an electronic trading system that conducts trading from 10:00 a.m. to 5:00 p.m.. The São Paulo Stock Exchange also permits trading from 5:30 p.m. to 7:00 p.m., on a differentiated trading time called the after market . Trading on the aftermarket is subject to regulatory limits on price volatility and on the volume of shares transacted through internet brokers. There are no specialists or officially recognized market makers for our shares.

In order to better control volatility, the São Paulo Stock Exchange adopted a circuit breaker pursuant to which trading sessions may be suspended for a period of 30 minutes or one hour whenever its main index (the Index of the São Paulo Stock Exchange or Bovespa ) fall below the limits of 10% or 15%, respectively, in relation to the index registered in the previous trading session.

Table of Contents

The São Paulo Stock Exchange is less liquid than the New York Stock Exchange or other major exchanges in the world. As of December 31, 2007, the aggregate market capitalization of the 404 companies listed on the São Paulo Stock Exchange was equivalent to approximately US\$1,398.72 billion and the 10 largest companies listed on the São Paulo Stock Exchange represented approximately 54.7% of the total market capitalization of all listed companies. Although any of the outstanding shares of a listed company may trade on a Brazilian stock exchange, in most cases fewer than half of the listed shares are actually available for trading by the public, the remainder being held by small groups of controlling persons, by governmental entities or by one principal shareholder. As of December 31, 2007, we accounted for approximately 0.4% of the market capitalization of all listed companies on the São Paulo Stock Exchange.

Trading on Brazilian stock exchanges by a holder not deemed to be domiciled in Brazil for Brazilian tax and regulatory purposes (a non-Brazilian holder) is subject to certain limitations under Brazilian foreign investment legislation. With limited exceptions, non-Brazilian holders may only trade on Brazilian stock exchanges in accordance with the requirements of Resolution No. 2,689, of January 26, 2000, of the National Monetary Council. Resolution No. 2,689 requires that securities held by non-Brazilian holders be maintained in the custody of, or in deposit accounts with, financial institutions duly authorized by the Central Bank and the Brazilian securities commission. In addition, Resolution No. 2,689 requires non-Brazilian holders to restrict their securities trading to transactions on Brazilian stock exchanges or qualified over-the-counter markets. With limited exceptions, non-Brazilian holders may not transfer the ownership of investments made under Resolution No. 2,689 to other non-Brazilian holders through a private transaction. See *Item 10.E Additional Information Taxation Brazilian Tax Considerations Taxation of Gains* for a description of certain tax benefits extended to non-Brazilian holders who qualify under Resolution No. 2,689.

***Novo Mercado***

Since April 24, 2002, our shares have been listed on the *Novo Mercado*. The *Novo Mercado* is a listing segment under the São Paulo Stock Exchange designed for the trading of shares issued by companies that voluntarily undertake to abide by some additional corporate governance practices and disclosure requirements in addition to those already imposed by Brazilian law. A company in the *Novo Mercado* must follow a series of corporate rules known as "good practices of corporate governance". These rules generally increase shareholders' rights and enhance the quality of information provided to shareholders. On April 18, 2002 and on June 19, 2006, our shareholders approved changes to our by-laws to comply with the *Novo Mercado* requirements. In addition, the *Novo Mercado* provides for the creation of a Market Arbitration Chamber for conflicts resolution between investors and companies listed in the *Novo Mercado*.

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

- issue only voting shares;
- hold public offerings of shares in a manner favoring diversification of the company's shareholder base and broader retail access;
- maintain a minimum free float equal to 25% of the outstanding share capital of the company;
- grant tag along rights for all shareholders in connection with a transfer of control of the company;
- limit the term of all members of the board of directors to two years;

- at least 20% of the members of the board of directors must be independent, as defined under the *Novo Mercado* regulation;
- prepare annual and quarterly financial statements, including cash flow statements, in accordance with U.S. GAAP or International Accounting Standards;
- disclose information on a quarterly basis, including insider share ownership and amount of free float of shares;
- if it elects to delist from the *Novo Mercado*, hold a tender offer by the company's controlling shareholder (the minimum price of the shares to be offered will be determined by an appraisal process); and
- make greater disclosure of related party transactions.

## **Regulation of Brazilian Securities Markets**

The Brazilian securities markets are principally governed by Law No. 6,385, of December 7, 1976, and Brazilian Corporate Law, each as amended and supplemented, and by regulations issued by the Brazilian securities commission, which has regulatory authority over the stock exchanges and securities markets generally, the National Monetary Council, and by the Central Bank, which has licensing authority over brokerage firms and regulates foreign investment and foreign exchange transactions. These laws and regulations, among others, provide for disclosure requirements applicable to issuers of traded securities, protection of minority shareholders and criminal penalties for insider trading and price manipulation. They also provide for licensing and oversight of brokerage firms and governance of the Brazilian stock exchanges. Nevertheless, the Brazilian securities markets are not as highly regulated and supervised as the U.S. securities markets.

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

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

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

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

Trading on the São Paulo Stock Exchange by non-residents of Brazil is subject to limitations under Brazilian foreign investment and tax legislation. The Brazilian custodian for the common shares underlying the ADSs must, on behalf of the depositary for our ADSs, obtain registration from the Central Bank to remit U.S. dollars abroad for payments of dividends, any other cash distributions, or upon the disposition of the shares and sales proceeds thereto. In the event that a holder of ADSs exchanges ADSs for common shares, the holder will be entitled to continue to rely on the custodian's registration for five business days after the exchange. Thereafter, the holder may not be able to obtain and remit U.S. dollars abroad upon the disposition of our common shares, or distributions relating to our common shares, unless the holder obtains a new registration. See *Item 10.D Additional Information Exchange Controls*.

### **9.D. Selling Shareholders**

Not applicable.

### **9.E. Dilution**

Not applicable.

**9.F. Expenses of the Issue**

Not applicable.

**ITEM 10. ADDITIONAL INFORMATION****10.A. Share Capital**

Not applicable.

**10.B. Memorandum and Articles of Association**

The following is a summary of the material terms of our common shares, including related provisions of our by-laws and Brazilian Corporate Law. This description is qualified by reference to our by-laws and to Brazilian law.

**Corporate Purposes**

Companhia de Saneamento Básico do Estado de São Paulo-SABESP is a *sociedade de economia mista*, a mixed capital company, incorporated on November 1, 1973, with limited liability of unlimited duration, duly organized and operating under Brazilian Corporate Law. As set forth in Article 2 of our by-laws, our corporate purpose is to plan, provide and operate basic sanitation services throughout the territory of the State of São Paulo, and sell these services and the related benefits that directly or indirectly arise in connection with these services. Under Article 63 of Supplementary Law 1,025 of December 7, 2007, we were permitted to expand our operational scope geographically and to add new types of services related to environmental sanitation and energy.

**Description of Common Shares*****General***

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

Under Brazilian Corporate Law, our common shares are entitled to dividends or other distributions made in respect of our common shares in proportion to their share of the amount available for the dividend or distribution. See *Item 8.A Financial Information Consolidated Statements and Other Financial Information Dividends and Dividend Policy* for a more complete description of payment of dividends and other distributions on our common shares. In addition, upon any liquidation of Sabesp, our common shares are entitled to return of capital in proportion to their share of our net worth.

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

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

- the right to participate in the distribution of profits;

Table of Contents

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

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

Neither Brazilian Corporate Law nor our by-laws expressly addresses:

- staggered terms for directors;
- cumulative voting, except as described below; or
- measures that could prevent a takeover attempt.

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

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

### **Preemptive Rights**

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

In the event of a capital increase by means of the issuance of new shares, holders of ADSs, or of common shares, would, except under circumstances described above, have preemptive rights to subscribe for any class of our newly issued shares. However, an ADS 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 Securities Act is effective with respect to those rights or an exemption from the registration requirements of the Securities Act is available. See *Item 3.D. Key Information Risk Factors Risks Relating to Our Common Shares and ADSs* A holder might be unable to exercise preemptive rights and tag-along rights with respect to the common shares.



## Redemption and Rights of Withdrawal

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

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

The right of withdrawal lapses 30 days after publication of the minutes of the shareholders' meeting that approved the corporate actions described above. We would be entitled to reconsider any action giving rise to withdrawal rights within 10 days following the expiration of such rights if the withdrawal of shares of dissenting shareholders would jeopardize our financial stability. Brazilian Corporate Law allows companies to redeem their shares at their economic value, subject to the provisions of their by-laws and certain other requirements. Our by-laws currently do not provide that our capital stock will be redeemable at its economic value and, consequently, any redemption pursuant to Brazilian Corporate Law would be made based on the book value per share, determined on the basis of the last balance sheet approved by the shareholders. However, if a shareholders' meeting giving rise to redemption rights occurred more than 60 days after the date of the last approved balance sheet, a shareholder would be entitled to demand that his or her shares be valued on the basis of a new balance sheet dated within 60 days of such shareholders meeting.

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

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

## **Reserves**

### **General**

The Brazilian Corporate Law provides that all discretionary allocations of adjusted income are subject to shareholder approval and may be added to capital or distributed as dividends in subsequent years. In the case of Tax Incentive Reserve and the Legal Reserve, they are also subject to shareholder approval; however, the use of their respective balances is restricted to being added to capital or the absorption of losses. They cannot be used as a source for income distribution to shareholders.

**Capital Reserve**

Our Capital Reserve is comprised of tax incentives and donations from government agencies and private entities, which amounted to R\$17.6 million during 2007 (R\$27.9 million in 2006). At December 31, 2007, we had a Capital Reserve of R\$124.3 million.

**Tax Incentive Reserve**

Our Tax Incentive Reserve results from an option to invest in the capital stock of companies undertaking specified government-approved projects. In lieu of paying part of the income tax due, the amount is credited to income tax and subsequently appropriated from retained earnings to this reserve.

**Donations Reserve**

Our Donations Reserve reflects the value of assets received from government entities, principally enabling the us to provide service access to properties. No shares are issued in exchange nor other remuneration provided in connection with assets received. These donations are recorded as a direct benefit to shareholders' equity.

**Investment Reserve**

Our Investment Reserve is comprised specifically of internal funds for expansion of water supply and sewage service systems.

At our Shareholders' Meeting held on April 29, 2008, Management proposed the transfer of the retained earnings balance of R\$783.2 million to the Investment Reserve account, to cover the needs of investments with own funds, as planned in the Capital Budget. At December 31, 2007, we had an Investment Reserve of R\$3,609.6 million.

**Legal Reserve**

Under Brazilian Corporate Law, we are required to record a Legal Reserve to which we must allocate 5% of the adjusted net income each year until the amount of the reserve equals 20% of paid-in capital. Any accumulated deficit may be charged against the Legal Reserve. On December 31, 2007, the balance of our Legal Reserve.

**Arbitration**

In connection with our listing with the *Novo Mercado*, we, our controlling shareholders, directors and officers have undertaken to refer to arbitration any and all disputes or controversies arising out of the *Novo Mercado* rules or any other corporate matters. See *Item 9.C. Markets*. 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, the application of the rules and regulations regarding Brazilian capital markets, will be resolved by arbitration conducted pursuant to the Bovespa Arbitration Rules in the Bovespa Arbitration Chamber. Any disputes among shareholders, including holders of ADSs, and disputes between us and shareholders, including holders of ADSs, will also be submitted to arbitration.

**Options**

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

**Directors' Powers**

Although our by-laws contain no specific provisions regarding a director or executive officer's power to vote on a proposal, arrangement or contract in which that director has a material interest, under Brazilian Corporate Law, a director or an executive officer is prohibited from voting in any meeting or with respect to any transaction in which that director or executive officer has a conflict of interest with the company and must disclose the nature and extent of the conflicting interest for transcription in the minutes of the meeting. In any case, a director or an executive officer may not transact any business with the company, including any borrowing, except on reasonable or fair terms and conditions that are identical to the terms and conditions prevailing in the market or offered by third parties.

Under our by-laws our shareholders are responsible for establishing the compensation we pay to the members of our board of directors and the executive officers.

Pursuant to Brazilian Corporate Law, each member of our board of directors must be a shareholder of Sabesp and, pursuant to our by-laws, a resident of Brazil. Our by-laws do not establish any mandatory retirement age limits.

See also *Item 6.A. Directors and Senior Management*.

### **Sabesp's Corporate Governance Practice and NYSE Guidelines**

On November 4, 2003, the Securities and Exchange Commission ( SEC ) approved the final corporate governance rules of the NYSE. According to such rules, foreign private issuers are subject to a more limited set of requirements regarding corporate governance than those imposed on U.S. domestic issuers. As a foreign private issuer, we must comply with three rules imposed by the NYSE:

- (1) the requirements set forth by the SEC concerning audit committees;
- (2) our CEO must promptly notify the SEC in writing after any executive officer becomes aware of any material non-compliance with any of the applicable NYSE corporate governance rules; and
- (3) we shall provide a brief description disclosing any significant ways in which our corporate governance practices differ from those followed by U.S. companies under NYSE listing standards.

#### Introduction

As a Brazilian company listed on the São Paulo Stock Exchange, or Bovespa, we are obliged to comply with the corporate governance standards set forth in Corporate Law No. 6,404 of December 15, 1976, as amended (the Brazilian Corporate Law ) and the rules of the Comissão de Valores Mobiliários (the Brazilian securities and exchange commission, or CVM ). In addition to these rules, because we are listed on the Novo Mercado listing segment of Bovespa (the New Market ), we are also required to comply with its regulations (the New Market Regulations ), which includes more stringent standards regarding corporate governance practices than those required by Brazilian Corporate Law.

The New Market Regulations apply to board practices, transparency and minority shareholders protection, among others. For example, we (i) can issue only ordinary voting shares, (ii) must maintain a minimum free float equal to 25% of our outstanding share capital; (iii) must make available our annual financial statements in the English language and such financial statements must be based upon internationally accepted accounting principles or upon the Brazilian Corporate Law method with a reconciliation to internationally accepted account principles; (iv) the term of all members of the board of directors must be limited to two years; (v) our Board of Directors must be composed of, at least, five directors, elected by the general meeting, out of which, in compliance with the specific rules concerning this matter, at least 20% must be Independent Members, as defined in the New Market Listing Regulations; and (vi) must disclose additional and detailed information on our quarterly reports, including insider share ownership and the amount of free float of shares.

The chart below provides a brief description of the significant differences between our corporate governance practices and those followed by U.S. companies under NYSE listing standards.

Table of Contents

303A.00 Corporate Governance Standards for domestic issuers	Sabesp Corporate Governance practices
303A.01 Listed companies must have a majority of independent directors.	Our Board of Directors must have a minimum of five members and 20% of the board (even if the board consists of greater than five members) must meet the definition of Independent Board Member. Currently, three of our ten directors are independent, pursuant to the New Market Listing Regulations. Additionally, both the Brazilian Corporate Law and CVM have established rules in relation to certain qualification requirements and restrictions, investiture, compensation, duties and responsibilities of the companies' executives and directors. We believe these rules provide adequate assurances that our directors are independent; however, they do not require that we have a majority of independent directors as is required by the NYSE.
303A.03 Executive Sessions	According to Brazilian Corporate Law, up to one-third of the members of the Board of Directors are permitted to consist of directors who do not meet the NYSE's definition of non-management directors. Additionally, non-management directors are not required to meet regularly without management. Nevertheless, currently, our Board of Directors consists entirely of members who meet the NYSE's definition of non-management directors. The directors do not have regularly scheduled executive sessions without the presence of the CEO.
303A.04 Nominating/Corporate Governance Committee	We are not required under applicable Brazilian Corporate Law to have, and currently we do not have, a nominating or corporate governance committee.
303A.05 Compensation Committee	Currently we do not have a compensation committee. Pursuant to our by-laws our directors are elected by our shareholders at a general shareholders meeting. Compensation for our directors and executive officers is based on criteria established by our controlling shareholder and is subject to approval by our shareholders at the annual shareholders meeting.
303A.06 Audit Committee	Our Audit Committee is composed of three Independent board members, as defined in the concept of Independent Board Members of Rule 10A-3 of
303A.07 Audit Committee Additional Requirements	the Securities and Exchange Commission-SEC, and one of them is an expert in finances and, also, Coordinator of the Committee.  The Committee has a formal written charter which provides for procedures required for its operation, comprising its purpose, basic principles, authority, organization, meetings, functions, responsibilities, compensation and budget. The

Committee main focus is the follow-up of the presentation process of financial reports to ensure quality, transparency and integrity of the financial information published, the efficiency of internal controls, of the risk management system and of the Internal Audit function, the Independent Audit work, monitoring of the compliance with the laws and regulations affecting the presentation of the financial reports and the monitoring of the compliance with the Code of Ethics and Conduct, concerning issues related to accounting, internal controls and audit.

Brazilian Corporate Law also requires us to have a fiscal board which is composed of three to five members which are elected at the general shareholders meeting. The fiscal board is intended to operate independently from our management and our external auditors. Its main function is to examine the financial statements of each fiscal year and provide a formal report to our shareholders. Our fiscal council consists of five members and five alternates and the members meet once a month.

Table of Contents

303A.08 Shareholder Approval of Equity Compensation Plans	Currently we do not have any equity compensation plans. If such a plan were to be implemented, there is no requirement under Brazilian Corporate Law for the approval of the plan by our shareholders. However, if the issuance of new shares in connection with any equity compensation plan exceeded the authorized capital under our by-laws, the increase in capital would require a shareholder vote.
303A.09 Corporate Governance Guidelines	<p>We are in compliance with the adoption of corporate governance guidelines required under the New Market Regulations. Additionally, under the CVM's guidelines, we have created, adopted and observe (i) the Policy of Publicizing Acts or Relevant Facts and the Preservation of Confidentiality which requires us to publicly disclose all relevant information and (ii) the Securities Negotiation Policy which requires management to inform the CVM and Bovespa of any purchases or sales of Sabesp's securities. We believe the corporate governance guidelines applicable to us under the New Market Regulations, as well as the CVM, do not conflict with the guidelines established by the NYSE.</p> <p>Our corporate governance guidelines and practices are available in our website at <a href="http://www.sabesp.com.br">www.sabesp.com.br</a> and in our annual management report.</p>
303A.10 Code of Business Conduct and Ethics	We have decided to adopt and disclose a code of ethics and conduct applicable to all our officers, directors and employees. The adoption and disclosure of a formal code is in addition to the ethical obligations of the Company under the Brazilian Corporate Law. We believe our formal code addresses the matters required to be addressed by the applicable NYSE and SEC rules.
303A.12(b) and (c) Certification Requirements	Our CEO shall promptly notify the NYSE in writing after any executive officer become aware of any material non-compliance with any applicable provision of the NYSE corporate governance rules. Moreover, we must submit an executed Witten Affirmation annually, and an interim Written Affirmation each time a change occurs to the board or to the Audit Committee.

### **10.C. Material Contracts**

For a description of the material contracts entered into by Sabesp and the State, see *Item 7. Major Shareholders and Related Party Transactions* *Related Party Transactions* *Transactions with the State of São Paulo* *Agreements with the State*.

### **10.D. Exchange Controls**

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

Pursuant to Brazilian law, investors may invest in common shares under Resolution 2,689, of January 26, 2000, of the National Monetary Council.

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

Pursuant to Resolution 2,689, a foreign investor must: (1) appoint at least one representative in Brazil with powers to perform actions relating to the foreign investment; (2) complete the appropriate foreign investor registration form; (3) register as a foreign investor with the Brazilian securities commission; and (4) register the foreign investment with the Central Bank.

Securities and other financial assets held by foreign investors pursuant to Resolution 2,689 must be registered or maintained in deposit accounts or under the custody of an entity duly licensed by the Central Bank or the Brazilian securities commission. In addition, securities trading is restricted to transactions carried out in the stock exchanges or organized over-the-counter markets licensed by the Brazilian securities commission, except for transfers resulting from a corporate reorganization, occurring upon the death of an investor by operation of law or will or as a consequence of the de-listing of the relevant shares from a stock exchange and the cancellation of the registration with the Brazilian securities commission.

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

Table of Contents

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

Following the closing of the sale of our ADSs in May 2002, an electronic certificate of registration was made in the name of The Bank of New York, as the depositary, with respect to such ADSs and will be maintained by the Brazilian custodian for our common shares on behalf of the depositary. This electronic registration is carried on through the Central Bank Information System. Pursuant to the registration, the custodian and the depositary are able to convert dividends and other distributions with respect to the common shares represented by ADSs into foreign currency and remit the proceeds outside Brazil. In the event that a holder of ADSs exchanges such ADSs for common shares, the holder will be entitled to continue to rely on such electronic registration for five business days after the exchange. Thereafter, unless our common shares are held pursuant to Resolution No. 2,689 by a duly registered investor, or, if not a registered investor under Resolution No. 2,689, a holder of common shares applies for and obtains a new certificate of registration from the Central Bank, the holder may not be able to convert into foreign currency and remit outside Brazil the proceeds from the disposition of, or distributions with respect to, our common shares, and the holder, if not registered under Resolution No. 2,689, will be subject to less favorable Brazilian tax treatment than a holder of ADSs. In addition, if the foreign investor resides in a tax haven jurisdiction, the investor will be also subject to less favorable tax treatment.

See *Item 3.D. Key Information Risk Factors Risks Relating to Our Common Shares and ADSs Investors who exchange ADSs for common shares may lose their ability to remit foreign currency abroad and to obtain Brazilian tax advantages* and *Item 10.E. Taxation Brazilian Tax Considerations*.

### **10.E. Taxation**

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

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

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

The withholding tax applicable to Interest on Shareholders Equity is retained and collected by us, and the shareholders are not grossed-up, although it is ultimately their responsibility to pay withholding taxes.

#### ***Brazilian Tax Considerations***

The following discussion summarizes the principal Brazilian tax consequences of the acquisition, ownership and disposition of common shares or ADSs by a holder that is not domiciled in Brazil for purposes of Brazilian taxation (a non-Brazilian holder). It is based on Brazilian law as currently in effect, and, therefore, any change in such law may change the consequences described below. Each non-Brazilian holder should consult his or her own tax adviser concerning the Brazilian tax consequences of an investment in common shares or ADSs.

A non-Brazilian holder of ADSs may withdraw them in exchange for common shares in Brazil. Pursuant to Brazilian law, the non-Brazilian holder may invest in the common shares under Resolution 2,689, of January 26, 2000, of the National Monetary Council ( 2,689 holder ).

*Taxation of Dividends*

As a result of the tax legislation adopted on December 26, 1995, dividends based on profits generated after January 1, 1996, including dividends paid in kind, payable by us in respect of common shares or ADSs, are exempt from withholding income tax. Dividends relating to profits generated prior to January 1, 1996 may be subject to Brazilian withholding income tax at varying rates, depending on the year the profits were generated.

*Taxation of Gains*

Gains realized outside Brazil by a non-Brazilian holder on the disposition of ADSs to another non-Brazilian holder are not currently subject to Brazilian tax. However, according to Law No. 10,833 of December 2003, or Law No. 10,833, the disposition of assets located in Brazil by a non-Brazilian holder, whether to other non-Brazilian holder or Brazilian holders, may become subject to taxation in Brazil. Although we believe that the ADSs do not fall within the definition of assets located in Brazil for the purposes of Law No. 10,833, considering the general and unclear scope of it and the lack of judicial court ruling in respect thereto, we are unable to predict whether such understanding will ultimately prevail in the courts of Brazil.

Thus, the gain on disposition of ADSs by a non-Brazilian holder to a resident in Brazil (or even to a non Brazilian resident in case the argument above does not prevail) may be subject to income tax in Brazil according to the rules described below for ADSs or the tax rules applicable to common shares, as applicable.

The withdrawal of ADSs in exchange for common shares is not subject to Brazilian income tax provided that the regulatory rules are appropriately observed in respect to the registration of the investment before the Central Bank of Brazil. The deposit of common shares in exchange for ADSs may be subject to Brazilian capital income tax at the rate of 15% or 25%, in case the non-Brazilian holder is located in a tax haven, i.e. considered to be places which do not impose any income tax at a maximum rate of less than 20% and those where the internal legislation imposes restrictions on disclosure of the shareholding composition or the ownership of the investment ( tax haven holder ), if the acquisition cost of the common shares is lower than (1) the average price per common share on a Brazilian stock exchange on which the greatest number of such shares were sold on the day of deposit, or (2) if no common shares were sold on that day, the average price on the Brazilian stock exchange on which the greatest number of common shares were sold in the fifteen trading sessions immediately preceding such deposit. In this case, the difference between the acquisition cost and the average price of the common shares, calculated as above, shall be considered a capital gain.

Gains realized on disposition of common shares, are subject to income tax in Brazil, regardless of whether the sale or the disposition is made by the non-Brazilian holder to a resident or person domiciled in Brazil or not, based on the fact that the common shares could be considered as assets located in Brazil for purposes of Law No. 10,833.

Thus, for purposes of taxation of gains earned in a sale or disposition of common shares carried out on the Brazilian stock exchange (which includes the transactions carried out on the organized over-the-counter market):

- are exempt from income tax when assessed by a 2,689 holder and is not a tax haven holder; and
- are subject to income tax at a rate of 15% in any other case, including gains assessed by a non- Brazilian holder that (1) is not a 2,689 holder, or (2) is a 2,689 holder but is a tax haven holder. In these cases, a withholding income tax of 0.005% shall be applicable and can be offset with the eventual income tax due on the capital gain.

Any other gains assessed on the disposition of the common shares that are not carried out on the Brazilian stock exchange are subject to income tax a rate of 15%, except for tax haven holder which, in this case, is subject to income tax at a rate of 25%. In case these gains are related to transactions conducted on the Brazilian non-organized over-the-counter market with intermediation, the withholding income tax of 0,005% shall also be applicable and can be offset with the eventual income tax due on the capital gain.

In the case of redemption of securities or capital reduction by a Brazilian corporation, such as ourselves, the positive difference between the amount effectively received by the non-Brazilian holder and the corresponding acquisition cost is treated, for tax purposes, as capital gain derived from disposition of common shares not carried out on a Brazilian stock exchange market, and is therefore subject to income tax at the rate of 15% or 25%, as the case may be.

Table of Contents

Any exercise of preemptive rights relating to the common shares will not be subject to Brazilian income tax. Any gain on the sale or assignment of preemptive rights relating to the common shares by a non-Brazilian holder of common shares or ADSs will be subject to Brazilian taxation at the same rate applicable to the sale or disposition of common shares.

There is no assurance that the current preferential treatment for holders of ADSs and non-Brazilian holders of common shares under Resolution 2,689 will continue in the future or that it will not be changed in the future. Reductions in the rate of tax provided for by Brazil's tax treaties do not apply to the tax on gains realized on sales or exchange of common shares.

*Interest Attributed to Shareholders' Equity*

Distribution of an interest on equity charge attributed to shareholders' equity in respect of the common shares or ADSs as an alternative form of payment to shareholders, including non-Brazilian holders of common shares or ADSs, is subject to Brazilian withholding income tax at the rate of 15% or 25%, in case of a tax-haven holder. Such payments, subject to certain limitations and requirements, are deductible for Brazilian income tax purposes.

*Other Brazilian Taxes*

There are no Brazilian inheritance, gift or succession taxes applicable to the ownership, transfer or disposition of common shares or ADSs by a non-Brazilian holder, except for gift and inheritance taxes, which are levied by some states of Brazil on gifts made or inheritances bestowed by a non-Brazilian holder to individuals or entities resident or domiciled within such states in Brazil. There are no Brazilian stamp, issue, registration, or similar taxes or duties payable by a non-Brazilian holder of common shares or ADSs.

*Tax on Bank Account Transaction, or CPMF*

Until December 31, 2007, any transaction carried out by a holder of securities in Brazil that results in the transfer of *reais* from an account maintained by such holder (or its custodian) with a Brazilian financial institution may be subject to the CPMF tax, at the rate of 0.38%. The funds transferred for the acquisition of shares on a Brazilian stock exchange are exempt from the CPMF tax.

As of January 1, 2008, the CPMF tax was abolished, and should not be levied on any debit to bank accounts carried out after that. The Brazilian government may attempt to reestablish the CPMF tax.

*Taxation of Foreign Exchange Transactions, or IOF/Câmbio*

The IOF is a tax on foreign exchange, securities, credit and insurance transactions. The IOF rate may be changed by an Executive Decree (rather than a law). In addition, the IOF rate is not subject to the ex-post-facto principle, which provides that laws increasing the rate of or creating new taxes will only come into effect as of the latter of (i) the first day of the year following their publication, or (ii) ninety days after their publication. A statute increasing the IOF rate will as a result only take effect from its publication date.

Regarding foreign exchange transactions, in spite of the maximum rate of IOF being 25%, the inflow and outflow of funds are generally subject to IOF at a rate of 0.38%; however, the inflow and outflow of funds from portfolio investors located outside Brazil are not taxed. The conversion of Brazilian currency into foreign currency for purposes of paying dividends on preferred shares and ADS is currently not taxed.



*Tax on Bonds and Securities Transactions, or IOF/Títulos*

The IOF/Títulos may be imposed on any transactions involving bonds and securities, including those carried out on Brazilian futures and commodities stock exchanges. As a general rule, the rate of this tax for transactions involving common shares or ADSs is currently zero, although the executive branch may increase such rate up to 1.5% per day, but only with respect to future transactions.

*United States Tax Considerations*

The summary discussion below is applicable to you only if you are a U.S. holder that is not domiciled in Brazil (or domiciled or resident in a tax haven jurisdiction) for purposes of Brazilian taxation and, in the case of a holder of common shares, that has registered its investment in common shares with the Central Bank as a U.S. dollar investment. A U.S. holder is a beneficial owner of a common share or ADS that, for U.S. federal income tax purposes, is:

- a citizen or resident of the United States;
- a corporation created or organized in or under the laws of the United States or any political subdivision of the United States;
- an estate the income of which is subject to United States federal income taxation regardless of its source; or
- a trust if it (1) is subject to the primary supervision of a court within the United States and one or more United States persons have the authority to control all substantial decisions of the trust or (2) has a valid election in effect under applicable United States Treasury regulations to be treated as a United States person.

Except where noted, this summary deals only with common shares or ADSs held as capital assets and does not deal with special situations, such as those of banks, dealers in securities or currencies, traders in securities that elect to use a mark-to-market method of accounting for their securities holdings, financial institutions, tax-exempt entities, insurance companies, real estate investment trusts, regulated investment companies, persons holding common shares or ADSs as part of a hedging, integrated, conversion or constructive sale transaction or a straddle, persons liable for alternative minimum tax, pass-through entities and investors in a pass-through entity, persons owning 10% or more of our voting stock, or persons whose functional currency is not the U.S. dollar. Furthermore, this discussion set forth under United States Taxation is based upon the provisions of the Internal Revenue Code of 1986, as amended, or the Code, and regulations, rulings and judicial decisions thereunder as of the date hereof, and such authorities may be repealed, revoked or modified so as to result in United States federal income tax consequences different from those discussed below possibly with retroactive effect. In addition, such summary is based, in part, upon representations made by the Depositary to us and assumes that the deposit agreement, and all other related agreements, will be performed in accordance with their terms.

If a partnership holds common shares or ADSs, the tax treatment of a partner will generally depend upon the status of the partner and the activities of the partnership. If you are a partner of a partnership holding common shares or ADSs, you should consult your tax advisors.

*ADSs*

In general, for United States federal income tax purposes, U.S. holders of ADSs will be treated as the owners of the underlying common shares that are represented by such ADSs. Deposits or withdrawals of common shares by U.S. holders for ADSs will not be subject to United States federal income tax. However, the United States Treasury has

expressed concerns that parties involved in transactions wherein depository shares are pre-released may be taking actions that are inconsistent with the claiming of foreign tax credits by the holders of ADSs. Accordingly, the analysis of the creditability of Brazilian taxes described herein could be affected by future actions that may be taken by the United States Treasury.

*Taxation of Dividends*

The gross amount of distributions paid to you (including amounts withheld by the Brazilian taxing authority, if any, and any payments of interest on shareholders' equity, as described above under *Brazilian Tax Considerations*) will be treated as dividend income to the extent paid out of our current or accumulated earnings and profits, as determined under United States federal income tax principles. Such income may be included in your gross income as ordinary income when actually or constructively received by you, in the case of common shares, or when actually or constructively received by the Depositary, in the case of ADSs. Such dividends will not be eligible for the dividends received deduction allowed to corporations under the Code. To the extent that the amount of any distribution exceeds our current and accumulated earnings and profits for a taxable year, the distribution will first be treated as a tax-free return of capital to the extent of the U.S. holders tax basis in the common shares or ADS, causing a reduction in the adjusted basis of our common shares or ADSs (thereby increasing the amount of gain, or decreasing the amount of loss, to be recognized on a subsequent disposition of our common shares or ADSs), and thereafter, as capital gain recognized on a sale or exchange.

The amount of any dividend paid in *reais* will equal the U.S. dollar value of the *reais* received calculated by reference to the exchange rate in effect on the date the dividend is received by you, in the case of common shares, or by the Depositary, in the case of ADSs, regardless of whether the *reais* are converted into U.S. dollars. If the *reais* received as a dividend are not converted into U.S. dollars on the date of receipt, you will have a basis in the *reais* equal to their U.S. dollar value on the date of receipt. Any gain or loss realized on a subsequent conversion or other disposition of the *reais* will be treated as United States source ordinary income or loss.

Certain dividends received by certain non-corporate U.S. Holders through taxable years beginning on or before 31 December 2010 are subject to a reduced maximum tax rate of 15% so long as (1) specified holding period requirements are met, (2) the U.S. Holder is not under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property, (3) the company paying the dividend is a qualified foreign corporation and (4) the company is not a passive foreign investment company for U.S. federal income tax purposes (a PFIC) in the year of distribution or the prior year. We do not believe that we were classified as a PFIC for our prior taxable year nor do we expect to be classified as a PFIC. We generally will be treated as a qualified foreign corporation with respect to our ADSs so long as the ADS remain listed on the New York Stock Exchange. Based on existing guidance, it is not entirely clear whether dividends received with respect to the common shares (to the extent not represented by ADSs) will be treated as qualified dividend income, because the common shares are not themselves listed on a U.S. exchange. You should consult your own advisor about the application of this rate to dividends paid directly on common shares.

Subject to certain limitations, Brazilian withholding taxes on dividends, if any, may be treated as foreign taxes eligible for credit against a U.S. holder's United States federal income tax liability. Alternatively, at a U.S. holder's election if it does not elect to claim a foreign tax credit for any foreign taxes paid during the taxable year, all foreign income taxes paid may instead be deducted in computing such U.S. holder's taxable income. For purposes of calculating the foreign tax credit, dividends paid on our common shares will be treated as income from sources outside the United States. The limitation on foreign taxes eligible for credit is calculated separately with respect to specific classes of income. Special rules apply to certain individuals whose foreign source income during the taxable year consists entirely of qualified passive income and whose creditable foreign taxes paid or accrued during the taxable year do not exceed US\$300 (US\$600 in the case of a joint return). Further, a U.S. holder that (q) has held common shares or ADSs for less than a specific minimum period during which it is not protected from risk of loss or (2) is obligated to make payments related to the dividends will not be allowed a foreign tax credit for foreign taxes imposed on dividends paid on common shares or ADSs. In addition, a U.S. holder that holds the shares in certain arrangements in which the U.S. holder's expected economic profits are insubstantial may not be allowed a foreign tax credit for such foreign taxes. The rules governing the foreign tax credit are complex. You should consult your tax advisors regarding the availability of

the foreign tax credit under your particular circumstances.

*Taxation of Capital Gains*

For United States federal income tax purposes, you generally will recognize taxable gain or loss on any sale, exchange or other disposition of a common share or ADS in an amount equal to the difference between the U.S. dollar value of the amount realized for the common share or ADS and your adjusted tax basis in the common share or ADS, determined in U.S. dollars. Such gain or loss will be capital gain or loss. The capital gain or loss will be long-term capital gain or loss if at the time of sale, exchange or other disposition you have held our common shares or ADSs for more than one year. Capital gains of individuals derived with respect to capital assets held for more than one year are eligible for reduced rates of taxation. The deductibility of capital losses is subject to limitations. Any gain or loss recognized by you will generally be treated as United States source gain or loss. Consequently, a U.S. holder may not be able to use the foreign tax credit arising from Brazilian tax imposed, if any, on the disposition of a common share or ADS unless such credit can be applied (subject to applicable limitations) against tax due on other income treated as derived from foreign sources.

*Passive Foreign Investment Company Rules*

Based upon our current and projected income, assets and activities, we do not expect the common shares or ADSs to be considered shares of a PFIC for our current fiscal year or for future fiscal years. However, because the determination of whether the common shares or ADSs constitute shares of a PFIC will be based upon the composition of our income and assets, and entities in which we hold at least a 25% interest, from time to time, and because there are uncertainties in the application of the relevant rules, there can be no assurance that the common shares or ADSs will not be considered shares of a PFIC for any fiscal year. If the common shares or ADSs were shares of a PFIC for any fiscal year, U.S. holders (including certain indirect U.S. holders) may be subject to adverse tax consequences, including the possible imposition of an interest charge on gains or excess distributions allocable to prior years in the U.S. holder's holding period during which we were determined to be a PFIC. If we are deemed to be a PFIC for a taxable year, dividends on our ADSs would not be qualified dividend income subject to preferential rates of U.S. federal income taxation. U.S. holders should consult their own tax advisors regarding the application of the PFIC rules to the common shares or ADSs.

*Information Reporting and Backup Withholding*

In general, information reporting requirements will apply to dividends in respect of our common shares or ADSs or the proceeds received on the sale, exchange, or redemption of our ADSs, in each case to the extent treated as being paid within the United States (and in certain cases, outside of the United States) to you unless you establish you are an exempt recipient (such as a corporation), and backup withholding may apply to such amounts if you do not establish you are an exempt recipient and you fail to provide a correct taxpayer identification number. The amount of any backup withholding from a payment to you will be allowed as a refund or credit against your United States federal income tax liability provided you timely furnish the required information to the Internal Revenue Service.

**10.F. Dividends and Payments Agents**

Not applicable.

**10.G. Statements by Experts**

Not applicable.

**10.H. Documents on Display**

We are subject to the periodic reporting and other informational requirements of the U.S. Securities Exchange Act of 1934, as amended. Accordingly, we are required to file reports and other information with the U.S. Securities and Exchange Commission. You may inspect and copy reports and other information filed by us at the public reference facilities maintained by the Commission at 450 Fifth Street, N.W, Washington D.C. 20549. You may obtain copies of these materials upon written request from the Public Reference Section of the Commission at 450 Fifth Street, N.W, Washington D.C. 20549 at prescribed rates. You may also inspect this material at the offices of the New York Stock Exchange, Inc., 20 Broad Street, New York, New York 10005. In addition to the public reference facilities maintained by the Commission and the New York Stock Exchange, you may obtain a copy of the annual report, upon written request from the depository for our ADSs at its corporate trust office located at 101 Barclay Street, New York, New York 10286.

We also furnish to the depository annual reports in English including audited annual financial statements and unaudited quarterly financial statements in English for each of the first three quarters of the fiscal year. We also furnish to the depository English translations or summaries of all notices of shareholders' meetings and other reports

Edgar Filing: COMPANHIA DE SANEAMENTO BASICO DO ESTADO DE SAO PAULO-SABESP - Form 20-F  
and communications that are made generally available to holders of common shares.

**ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to various market risks in particular, foreign currency exchange rate risk and interest rate risk. We are exposed to exchange rate risk because a substantial portion of our financial expenses are denominated in foreign currencies (primarily the U.S. dollar), while we generate all of our net operating revenues in *reais*. Similarly, we are subject to interest rate risk based upon changes in interest rates, which affect our net financial expenses. For further information on how exposures are managed, see *Item 5 Operating and Financial Review and Prospects*.

**Exchange Rate Risk**

As of December 31, 2007 and 2006, approximately R\$1,242.3 million and R\$1,472.8 million, or 21.9% and 23.3%, respectively, of our debt obligations were denominated in foreign currencies (including debt pegged to baskets of foreign currencies). The basket of foreign currency-pegged debt consists primarily of our debt with the Inter-American Development Bank. As a result, we are exposed to exchange rate risks that may adversely affect our financial condition and results of operations, as well as our ability to meet debt service obligations.

**Exchange Rate Sensitivity**

We estimate that the potential loss to us in connection with U.S. dollar-denominated debt that would have resulted as of December 31, 2007 and 2006 from each hypothetical instantaneous and unfavorable 1% change in the U.S. dollar against the *real* would have been approximately R\$12.4 million and R\$14.7 million, respectively. Consistent with these estimates, a hypothetical instantaneous and unfavorable 10% change in this exchange rate would have resulted in losses of approximately R\$124.2 million and R\$147.3 million as of December 31, 2007 and 2006, respectively. These estimates do not take into account that the changes in exchange rates comprising the baskets of foreign currencies often present variations different from the devaluation of the *real* in relation to the U.S. dollar.

The devaluation of the *real* in relation to the U.S. dollar and with the Inter-American Development Bank and World Bank basket of currencies, for the year ended December 31, 2007 were as follows:

	<b>Year ended December 31,</b>	
	<b>2007</b>	<b>2006</b>
Devaluation (appreciation) of <i>real</i> in relation to:	<i>(in percentages)</i>	
U.S. dollar	(20.7)	(9.5)
World Bank basket of currencies	NA	3.42
Inter-American Development Bank basket of currencies	4.0	2.1

We have not utilized derivative financial instruments, although at times, we enter into forward exchange transactions and financial funding transactions in *reais* to mitigate foreign currency exposure. On December 31, 2007 we had no forward exchange transactions.

As of December 31, 2007 and 2006, we had no short-term debt outstanding, other than the current portion of long-term debt.

**Interest Rate Risk**

As of December 31, 2007 and 2006, approximately R\$2,431.2 million, or 54.7%, and R\$2,598.8 million, or 53.3%, respectively, of our total debt outstanding balance denominated in *reais*, was based on variable rates of interest based on the *Unidade Padrão de Referência UPR* (Reference Standard Unit), which is equal to the Taxa Referencial TR (daily government interest rate). In addition, on December 31, 2007 and 2006, approximately R\$750.5 million, or 16.9%, and R\$1,041.4 million, or 21.5%, respectively, of our total debt denominated in *reais* was subject to interest rates based on the *Certificado de Depósito Interbancário*, or CDI, rate (benchmark interest rate set by the Brazilian interbank market on a daily basis). As of December 31, 2007 and 2006, R\$721.1 million and R\$849.4 million, respectively, of our foreign-currency denominated debt was based on the Inter-American Development Bank and the World Bank variable rates of interest, which are determined based on the cost of funding of these multilateral organizations in each period.

Table of Contents

As of December 31, 2007 and 2006, we did not have any derivative contracts outstanding which limited exposure to changes in the UPR or the CDI or in the Inter-American Development Bank or World Bank variable rates. However, we are obliged by law to invest our excess cash with financial institutions controlled by the Brazilian government. We invest these excess funds, which totaled R\$392.2 million on December 31, 2007 and R\$248.1 million on December 31, 2006, mainly in short-term instruments. As a result, our exposure to Brazilian interest rate risk is partially limited by our *real*-denominated floating interest time deposits investments, which generally earn the CDI rate. In addition to our exposure with respect to existing indebtedness, we may become exposed to interest rate volatility with respect to indebtedness incurred in the future.

We estimate that we would have suffered a loss over periods of one year, respectively, of up to R\$7.5 million and R\$10.5 million if a hypothetical instantaneous and unfavorable change of 100 basis points in the interest rates applicable to financial liabilities on December 31, 2007 and 2006, respectively, had occurred. Consistent with these estimates, a hypothetical instantaneous and unfavorable 10%, or 1000 basis point, change in these interest rates would have resulted in losses of approximately R\$75.1 million and R\$104.1 million as of December 31, 2007 and 2006, respectively. This sensitivity analysis is based on the assumption of an unfavorable 100 basis point movement of the interest rates applicable to each homogeneous category of financial liabilities and sustained over a period of one year and that such movement may or may not affect interest rates applicable to any other homogenous category of financial liabilities. A homogeneous category is defined according to the currency in which financial liabilities are denominated and assumes the same interest rate movement within each homogeneous category (e.g., U.S. dollars). As a result, our interest rate risk sensitivity model may overstate the effect of interest rate fluctuation on these financial instruments, as consistently unfavorable movements of all interest rates are unlikely.

The tables below provide information about our interest rate-sensitive instruments. For variable interest rate debt, the rate presented is the weighted average rate calculated as of December 31, 2007. For the foreign currency denominated obligations these amounts have been converted at the selling rates as of December 31, 2007, and do not represent amounts which may actually be payable with respect to such obligations on the dates indicated.

**As of December 31, 2007****Expected maturity date**

	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>After2012</b>	<b>Total</b>	<b>Average annual interest rate</b>
<i>(in millions, except percentages)</i>							
<b>Assets:</b>							
Time deposits denominated in <i>reais</i>	392.2	-	-	-	-	392.2	
<b>Total assets</b>	392.2	-	-	-	-	392.2	
<b>Liabilities:</b>							
<b>Long-term debt:</b>							
Floating rate, denominated in <i>reais</i> indexed by TR or UPR	312.6	321.5	348.7	379.0	1,084.7	2,446.5	9.76%
Floating rate, denominated in <i>reais</i> indexed by TJLP	43.1	42.2	41.9	41.9	40.0	209.1	2.40%

Floating rate, denominated in <i>reais</i> indexed by IGPM	47.8	218.7	321.3	387.5	-	975.3	19.46%
Floating rate, denominated in <i>reais</i> indexed by CDI	86.9	626.0	76.0	23.1	-	812.0	12.53%
Floating rate, denominated in U.S. dollars	68.6	59.8	59.8	59.8	481.8	729.8	4.86%
Fixed rate, denominated in U.S. dollars	183.1	4.9	4.9	6.1	313.5	512.5	8.23%
<b>Total long-term debt</b>	<b>742.1</b>	<b>1,273.1</b>	<b>852.6</b>	<b>897.4</b>	<b>1,920.0</b>	<b>5,685.2</b>	

124

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

	<b>On December 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>Floating rate debt:</b>		
Denominated in U.S. dollars	12.84%	13.56%
Denominated in Euro	0.00%	0.00%
Denominated in <i>reais</i>	78.15%	76.72%
<b>Fixed rate debt:</b>		
Denominated in U.S. dollars	9.01%	9.72%
<b>Total</b>	<b>100.00%</b>	<b>100.00%</b>

## ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES

### 12.A. Debt Securities

Not applicable.

### 12.B. Warrants and Rights

Not applicable.

### 12.C. Other Securities

Not applicable.

### 12.D. American Depositary Shares

Not applicable.

## PART II

## ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

Not applicable.

## ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

Not applicable.

## ITEM 15. CONTROLS AND PROCEDURES

*a) Disclosure Controls and Procedures.*

We maintain disclosure controls and procedures (as defined in the U.S. Securities Exchange Act of 1934 under Rule 13a-15(e)) that are designed to ensure that information required to be disclosed by us in the reports that we file and submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer and Investor Relations Officer, to allow timely decisions regarding required disclosures. Our management, under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer and Investor Relations Officer, has evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2007, the end of the period covered by this annual report. Based on this evaluation, our management, including our Chief Executive Officer and our Chief Financial Officer and Investor Relations Officer, has concluded that as of December 31, 2007, our disclosure controls and procedures were effective at the reasonable assurance level.

*b) Management's Report on Internal Control over Financial Reporting*

The management of Companhia de Saneamento Básico do Estado de São Paulo - SABESP (the Company) is responsible for establishing and maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting as defined in Rules 13a-15(f) under the U.S. Securities Exchange Act of 1934.

The Company's internal control over financial reporting is a process designed by, or under the supervision of, the Company's Chief Executive Officer and Chief Financial Officer and Investor Relations Officer and effected by the Company's board of directors, Audit Committee, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. The Company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect material misstatements on a timely basis. Therefore even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2007, based on the criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission - COSO. Based on that assessment, management has concluded that as of December 31, 2007, the Company's internal control over financial reporting is effective.

The Company's independent registered public accounting firm, Deloitte Touche Tohmatsu Auditores Independentes, have audited the Company's internal control over financial reporting, and the report of the auditors is included in Part II, Item 15 (c).

/s/GESNER JOSÉ DE OLIVEIRA FILHO

Gesner José de Oliveira Filho

Chief Executive Officer

July 10, 2008

/s/RUI DE BRITTO ÁLVARES AFFONSO

Rui de Britto Álvares Affonso

Chief Financial Officer and Investor Relations Officer

July 10, 2008

*c) Attestation Report of Independent Registered Public Accounting Firm*

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of  
Companhia de Saneamento Básico do Estado de São Paulo - SABESP

We have audited the internal control over financial reporting of Companhia de Saneamento Básico do Estado de São Paulo - SABESP (the Company) as of December 31, 2007, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the financial statements as of and for the year ended December 31, 2007 of the Company and our report dated July 10, 2008 expressed an unqualified opinion on those financial statements, containing explanatory paragraphs

concerning (1) the Company's negotiations with the São Paulo State Government regarding the reimbursement of the amounts for supplementary retirement and pension paid by the Company; (2) the Company's agreement with the São Paulo Municipal Government, seeking stability in the provision of services in the municipality of São Paulo and establishment of sanitation and environmental actions supplementary to the actions taken by the Municipality; (3) how the Company's application of accounting practices adopted in Brazil vary in certain respects from accounting principles generally accepted in the United States of America; and (4) the presentation of the statements of cash flows.

/s/ Deloitte Touche Tohmatsu  
Auditores Independentes

July 10, 2008  
São Paulo, Brazil.

*d) Changes in internal control over financial reporting*

There have been improvements in our internal control over financial reporting as of December 31, 2007. Our management adjusted the current controls and implemented other controls that reinforced our internal control structure and guaranteed a substantial improvement in the effectiveness of the financial statements such as the updating of the Procedure for the Segregation of Duties.

Management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer and Investor Relations Officer, has been actively engaged in the implementation of remediation efforts to address the material weaknesses that was in existence as of December 31, 2006 and previously disclosed in our 2006 Annual Report on Form 20-F.

The following describes the major controls that have been implemented to remediate the material weaknesses that existed as of December 31, 2006:

1. implemented more stringent policies and procedures for our processes over accounting reconciliation;
2. performed an extensive study and a reconciliation of the balance of the Unidentified Collections (Unapplied Cash Receipts) account, included as part of Customer Accounts Receivable;
3. introduced a review by an independent department to ensure the timely and accurate transfer of amounts from the construction-in-progress account to the corresponding accounts for property, plant and equipment;
4. automated certain controls that were performed manually;
5. performed a month-end review and closing processes as well as provided additional oversight and supervision within the accounting department;
6. promoted programs that provide ongoing training and professional education as well as development plans for the accounting department and to improve internal communications procedures throughout the Company.

All of this work was conducted by a group designed specifically to address the internal control issues related to the reconciliation of the balance of the Unidentified Collections account and the timely and accurate transfer of amounts from the construction-in-progress account to the corresponding accounts for property, plant and equipment.

As of December 31, 2007, the group specifically designated to address the internal control issues completed the above remediation efforts. As a result of this work, we have concluded that the previous material weaknesses as disclosed in our 2006 Annual Report on Form 20-F have been remediated as of December 31, 2007.

**ITEM 16****16.A. AUDIT COMMITTEE FINANCIAL EXPERT**

At a board meeting held on June 26, 2006, we established an audit committee, as defined under section 3(a)(58) of the Exchange Act. Our board of directors has determined that Jerônimo Antunes qualifies as an audit committee financial expert as defined for the purposes of this Item 16A in Item 16A of Form 20-F. Jerônimo Antunes is an independent director within the meaning of the SEC rules.

**16.B. CODE OF ETHICS**

We have adopted a code of business conduct and ethics, as defined in Item 16B of Form 20-F under the Securities Exchange Act of 1934, as amended. Our code of business conduct and ethics, called Code of Ethics and Conduct, applies to all employees of Sabesp, including directors, principal executive officer, principal financial officer and principal accounting officer. Our Code of Ethics and Conduct is available on our web site at <http://www.sabesp.com.br> under Corporate Governance . If we amend the provisions of our Code of Ethics and Conduct, or if we grant any waiver of such provisions, we will disclose the amendment or waiver on our web site at the same address.

**16.C. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Deloitte Touche Tohmatsu Auditores Independentes served as our independent registered public accounting firm for the years ended December 31, 2005, 2006 and 2007 appearing in this annual report on Form 20-F.

The following table presents the aggregate fees for professional services and other services rendered to us by Deloitte Touche Tohmatsu Auditores Independentes in 2005, 2006 and 2007.

	<b>2005</b> <b>(in thousands of</b> <b>R\$)</b>	<b>2006</b> <b>(in thousands of</b> <b>R\$)</b>	<b>2007</b> <b>(in thousands of</b> <b>R\$)</b>
Audit Fees <sup>(1)</sup>	370	1,548	1,923
Audit-related Fees <sup>(2)</sup>			
Tax Fees			
All Other Fees			
<b>Total</b>	<b>370</b>	<b>1,548</b>	<b>1,923</b>

(1) Audit Fees are the fees billed by Deloitte Touche Tohmatsu Auditores Independentes for the fiscal years fo 2005, 2006 and 2007 for the audit of our annual financial statements, reviews of interim financial statements and attestation services that are provided in connection with statutory and regulatory filings or engagements.

**Pre-approval policies and procedures**

Pursuant to Brazilian law, our board of directors is responsible, among other matters, for the selection, dismissal and oversight of the external auditor. Our management is required to obtain the board of directors approval before engaging independent auditors to provide any audit or permitted non-audit services to us. The Brazilian Federal and State Public Bidding Laws also apply to us with respect to obtaining services from third parties for our business, including the services provided by our independent external auditor. As part of the bidding process, the external independent auditing firms are required to submit proposals, and are then selected by us based on certain criteria including technical expertise and cost.

During 2005, 2006 and 2007, Deloitte Touche Tohmatsu Auditores Independentes did not provide non-audit services to us.

**16.D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES**

We are in full compliance with the listing standards for audit committee pursuant to Exchange Act Rule 10A-3. For a further discussion of our fiscal council and the audit committee exemption, see *Item 6.C. Directors, Senior Management and Employees Board Practices*.

**16.E. PURCHASES OF EQUITY SECURITIES BY ISSUER AND AFFILIATED PURCHASERS**

Not Applicable.

**PART III****ITEM 17. FINANCIAL STATEMENTS**

We have responded to Item 18 in lieu of responding to this Item.

**ITEM 18. FINANCIAL STATEMENTS**

The following financial statements, together with the Report of Independent Registered Public Accounting Firms, are filed as part of this annual report:

## Index to Financial Statements

Report of Independent Registered Public Accounting Firm from Deloitte Touche Tohmatsu Auditores Independentes	F-3
Balance Sheets as of December 31, 2007 and 2006	F-4
Statements of Income for the years ended December 31, 2007, 2006 and 2005	F-6
Statements of Changes in Shareholders' Equity for the years ended December 31, 2007, 2006 and 2005	F-7
Statements of Changes in Financial Position for the years ended December 31, 2007, 2006 and 2005	F-8
Notes to Financial Statements as of and for the years ended December 31, 2006, 2005 and 2004	F-10

**ITEM 19. EXHIBITS****Item Description**

- 1.1 By-laws of the Registrant (English translation) (incorporated by reference to the June 23, 2008 Form 6-K).
- 4.1 Agreement between the Registrant and the State Department of Water and Energy (*Departamento de Águas e Energia Elétrica DAEE*), dated April 24, 1997 (English translation) (incorporated by reference to Exhibit 10.1 to the Registrant's Registration Statement on Form F-1 filed on April 8, 2002 (the April 8, 2002 Form F-1)).
- 4.2 Protocol of Understanding between the Registrant and the State of São Paulo, dated September 30, 1997 (English translation) (incorporated by reference to Exhibit 10.2 to the April 8, 2002 Form F-1).
- 4.3 Agreement between the Registrant and the State of São Paulo, through the Secretariat of Finance, dated September 10, 2001 (English translation) (incorporated by reference to Exhibit 10.3 to the April 8, 2002 Form F-1).
- 4.4 Agreement between the Registrant and the State of São Paulo, through the Secretariat of the Treasury, dated December 11, 2001 (English translation) (incorporated by reference to Exhibit 10.4 to the April 8, 2002 Form F-1).
- 4.5 Amendment to the Agreement, dated April 24, 1997, between the Registrant and the State Department of Water and Energy, dated March 16, 2000 (English translation) (incorporated by reference to Exhibit 10.5 to the April 8, 2002 Form F-1).
- 4.6 Amendment to the Agreement, dated April 24, 1997, between the Registrant and the State Department of Water and Energy, dated November 21, 2001 (English translation) (incorporated by reference to Exhibit 10.6 to the April 8, 2002 Form F-1).
- 4.7

First Amendment to the Agreement, dated December 11, 2001, between the Registrant and the State of São Paulo, dated March 22, 2004. (English Translation) (incorporated by reference to Exhibit 4.7 to the June 28, 2004 Form 20-F).

- 4.8 Second Amendment to the Agreement, dated December 11, 2001, between the Registrant and the State of São Paulo, dated December 28, 2007. (English Translation) (incorporated by reference to the February 25, 2008 Form 6-K).

**Item Description**

- 4.9 Commitment Agreement, between the Registrant and the State of São Paulo, dated March 26, 2008. (English Translation) (incorporated by reference to the April 28, 2008 Form 6-K).
- 4.10 Agreement Executed between the Registrant and the São Paulo City Government, dated November 14, 2007 (English Translation) (incorporated by reference to the March 12, 2008 Form 6-k).
- 4.11 Amendment to the Agreement Executed between the Registrant and the São Paulo City Government, dated February 10, 2008 (English Translation) (incorporated by reference to the May 12, 2008 Form 6-k).
- 4.12 Code of Ethics and Conduct dated January 26, 2006 (English Translation) (incorporated by reference to the July 7, 2008 Form 6-k).
- 4.13 The Audit Committee Charter dated August 9, 2007 (English Translation) (incorporated by reference to the July 7, 2008 Form 6-k).
- 12.1 Certification of Gesner José de Oliveira Filho, Chief Executive Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 12.2 Certification of Rui de Britto Álvares Affonso, Chief Financial Officer and Investor Relations Officer, pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 13.1 Certification of Gesner José de Oliveira Filho, Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 13.2 Certification of Rui de Britto Álvares Affonso, Chief Financial Officer and Investor Relations Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 15.1 Management's report dated July 10, 2008, on the effectiveness of our internal control over financial reporting as of December 31, 2007.

**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

**COMPANHIA DE SANEAMENTO BÁSICO DO  
ESTADO DE SÃO PAULO-SABESP**

By: /s/GESNER JOSÉ DE OLIVEIRA FILHO

Name: Gesner José de Oliveira Filho

Title: Chief Executive Officer

By: /s/RUI DE BRITTO ÁLVARES AFFONSO

Name: Rui de Britto Álvares Affonso

Title: Chief Financial Officer and  
Investor Relations Officer

Date: July 10, 2008

**INDEX TO FINANCIAL STATEMENTS**

<u>Report of Independent Registered Public Accounting Firm from Deloitte Touche Tohmatsu Auditores Independentes</u>	<u>F-3</u>
<u>Balance Sheets on December 31, 2007 and 2006</u>	<u>F-4</u>
<u>Statement of Income for the years ended December 31, 2007, 2006 and 2005</u>	<u>F-6</u>
<u>Statements of Changes in Shareholders' Equity for the years ended December 31, 2007, 2006 and 2005</u>	<u>F-7</u>
<u>Statement of Changes in Financial Position for the years ended December 31, 2007, 2006 and 2005</u>	<u>F-8</u>
<u>Notes to Financial Statements for the years ended December 31, 2007, 2006 and 2005</u>	<u>F-10</u>

Companhia de Saneamento

Básico do Estado de São Paulo

SABESP

F-2

---

## **Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Shareholders of  
Companhia de Saneamento Básico do Estado de São Paulo - SABESP

We have audited the accompanying balance sheets of Companhia de Saneamento Básico do Estado de São Paulo SABESP (the Company) as of December 31, 2007 and 2006, and the related statements of operations, changes in shareholders' equity and changes in financial position for each of the three years in the period ended December 31, 2007. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2007 and 2006, and the results of its operations, the changes in shareholders' equity and the changes in its financial position for each of the three years in the period ended December 31, 2007, in conformity with accounting practices adopted in Brazil.

Accounting practices adopted in Brazil vary in certain respects from accounting principles generally accepted in the United States of America. The application of the latter would have affected results of operations for each of the three years in the period ended December 31, 2007 and the determination of shareholders' equity as of December 31, 2007 and 2006, to the extent summarized in Note 26 to the financial statements.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The statements of cash flows for each of the three years in the period ended December 31, 2007 are presented for purposes of additional analysis and is not a required part of the basic financial statements prepared in accordance with accounting practices adopted in Brazil. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

As mentioned in Notes 6 to the financial statements, the Company is negotiating with the São Paulo State Government the reimbursement of the amounts for supplementary retirement and pension paid by the Company.

As mentioned in Note 23 to the financial statements, on November 14, 2007, the Company entered into an agreement with the São Paulo Municipal Government, seeking stability in the provision of services in the municipality of São Paulo and establishment of sanitation and environmental actions supplementary to the actions taken by the Municipality.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2007 based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated July 10, 2008 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ Deloitte Touche Tohmatsu  
Auditores Independentes

July 10, 2008  
São Paulo, Brazil.

F-3

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****BALANCE SHEETS AS OF DECEMBER 31, 2007 AND 2006**

(In thousands of Brazilian reais R\$)

<b>Assets</b>	<b>2007</b>	<b>2006</b>
<b>Current assets</b>		
Cash and cash equivalents (note 4)	464,997	328,206
Customer accounts receivable, net (note 5)	1,207,885	1,111,289
Receivable from shareholder, net (note 6)	338,506	367,864
Inventories	53,141	48,889
Taxes Recoverable	9,414	31,582
Other current assets	41,782	24,124
Deferred taxes (note 11)	108,792	7,078
Total current assets	2,224,517	1,919,032
<b>Non current assets</b>		
<b>Long-term assets</b>		
Customer accounts receivable, net (note 5)	278,787	296,562
Receivable from shareholder, net (note 6)	986,988	863,467
Indemnities receivable (note 7)	148,794	148,794
Escrow deposits	19,806	33,835
Other assets	75,202	52,238
Deferred taxes (note 11)	357,226	342,654
Investments	720	720
Property, plant and equipment, net (note 8)	14,060,073	13,837,498
Intangible assets (note 9)	507,789	495,118
Deferred charges	3,474	10,035
Total non current assets	16,438,859	16,080,921
<b>Total Assets</b>	<b>18,663,376</b>	<b>17,999,953</b>

The accompanying notes are an integral part of these financial statements.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****BALANCE SHEETS AS OF DECEMBER 31, 2007 AND 2006**

(In thousands of Brazilian reais R\$)

<b>Liabilities and Shareholders Equity</b>	<b>2007</b>	<b>2006</b>
<b>Current liabilities</b>		
Accounts payable to suppliers and contractors	165,267	144,167
Loans and financing (note 10)	742,114	852,475
Accrued payroll and related charges	166,797	177,705
Taxes payable (note 12)	127,735	105,552
Deferred taxes (note 11)	75,249	76,359
Interest on shareholders equity (16 (d))	680,339	511,519
Provisions for contingencies (note 15)	290,172	2,294
Services Received	156,987	152,953
Other current liabilities	50,077	78,912
	2,454,737	2,101,936
<b>Non Current</b>		
<b>Long-term liabilities</b>		
Loans and financing (note 10)	4,943,121	5,474,254
Taxes payable (note 12)	197,635	230,440
Deferred taxes (note 11)	159,865	146,901
Provisions for contingencies (note 15)	655,084	655,258
Accrued pension obligation (note 13)	365,234	321,212
Other liabilities	103,694	51,470
	6,424,633	6,879,535
<b>Shareholders equity (note 16)</b>		
Paid-in capital	3,403,688	3,403,688
Capital reserve	124,255	106,690
Revaluation reserve	2,339,829	2,427,499
Profit reserves	3,916,234	3,080,605
	9,784,006	9,018,482
<b>Total Liabilities &amp; Shareholders Equity</b>	<b>18,663,376</b>	<b>17,999,953</b>

The accompanying notes are an integral part of these financial statements.



**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****STATEMENTS OF INCOME**

FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(In thousands of Brazilian reais R\$, except for earnings per share)

	<b>2007</b>	<b>2006</b>	<b>2005</b>
<b>GROSS REVENUE FROM SALES AND SERVICES</b>			
<b>(Note 19)</b>	6,448,211	5,984,012	5,356,326
Gross Revenue Deductions	(477,369)	(456,679)	(402,963)
Net revenue from sales and services	5,970,842	5,527,333	4,953,363
Cost of sales and services (note 20)	(2,695,696)	(2,616,764)	(2,376,375)
<b>GROSS PROFIT</b>	3,275,146	2,910,569	2,576,988
<b>OPERATING EXPENSES (Note 20)</b>			
Selling expenses	(639,552)	(719,185)	(537,831)
Administrative expenses	(559,190)	(387,407)	(349,584)
<b>OPERATING INCOME BEFORE FINANCIAL AND FOREIGN EXCHANGE RESULTS, NET</b>	2,076,404	1,803,977	1,689,573
Financial expenses, net (note 20)	(748,995)	(658,863)	(758,275)
Foreign Exchange Result, net (note 20)	188,038	95,598	311,271
<b>OPERATING PROFIT</b>	1,515,447	1,240,712	1,242,569
<b>NON OPERATING INCOME (EXPENSES)</b>			
Income	46,115	7,810	9,456
Expenses	(81,291)	(58,717)	(34,877)
	(35,176)	(50,907)	(25,421)
<b>INCOME BEFORE TAXES ON INCOME</b>	1,480,271	1,189,805	1,217,148
Income and social contribution taxes (note 11)			
Current	(543,345)	(383,123)	(343,426)
Deferred	111,777	7,345	27,047

<b>INCOME BEFORE EXTRAORDINARY ITEM</b>	1,048,703	814,027	900,769
Extraordinary item, net of income and social contribution taxes (note 13(b))	-	(35,122)	(35,122)
<b>NET INCOME</b>	<b>1,048,703</b>	<b>778,905</b>	<b>865,647</b>
Earnings per share R\$(per thousand shares in 2006 and 2005)	4.60	27.35	30.40

The accompanying notes are an integral part of these financial statements.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY**

FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(In thousands of Brazilian reais R\$)

	Paid in	Capital	Revaluation	Profit reserves		Retained	
	capital	reserve	reserve	Legal	Investment	earnings	Total
<b>BALANCES AS OF JANUARY 1, 2005</b>	<b>3,403,688</b>	<b>65,291</b>	<b>2,619,220</b>	<b>171,991</b>	<b>1,691,398</b>	<b>-</b>	<b>7,951,588</b>
Donations (note 16 (e))		13,529					13,529
Realization of revaluation reserve (note 8 (h))			(89,449)			89,449	-
Net income						865,647	865,647
<b>Allocation of income:</b>							
Legal reserve (note 16 (f))				43,282		(43,282)	-
Interest on shareholders equity (note 16 (d))						(348,216)	(348,216)
Investment reserve (note 16 (f(ii)))					563,598	(563,598)	-
<b>BALANCES AS OF DECEMBER 31, 2005</b>	<b>3,403,688</b>	<b>78,820</b>	<b>2,529,771</b>	<b>215,273</b>	<b>2,254,996</b>	<b>-</b>	<b>8,482,548</b>
Donations (note 16 (e))		27,870					27,870
Realization of revaluation reserve (note 8 (h))			(102,272)			102,272	-
Net income						778,905	778,905
<b>Allocation of income:</b>							
Legal reserve (note 16 (f))				38,946		(38,946)	-
Interest on shareholders equity (note 16 (d))						(270,841)	(270,841)
Investment reserve (note							

16 (f(ii)))					571,390	(571,390)	-
<b>BALANCES AS OF DECEMBER 31, 2006</b>	<b>3,403,688</b>	<b>106,690</b>	<b>2,427,499</b>	<b>254,219</b>	<b>2,826,386</b>	<b>-</b>	<b>9,018,482</b>
Donations (note 16 (e))		17,565					17,565
Realization of revaluation reserve (note 8 (h))			(87,670)			87,670	-
Net income						1,048,703	1,048,703
<b>Allocation of income:</b>							
Legal reserve (note 16 (f))				52,435		(52,435)	-
Interest on shareholders equity (note 16 (d))						(300,744)	(300,744)
Investment reserve (note 16 (f(ii)))					783,194	(783,194)	-
<b>BALANCES AS OF DECEMBER 31, 2007</b>	<b>3,403,688</b>	<b>124,255</b>	<b>2,339,829</b>	<b>306,654</b>	<b>3,609,580</b>	<b>-</b>	<b>9,784,006</b>

The accompanying notes are an integral part of these financial statements.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**  
**STATEMENTS OF CHANGES IN FINANCIAL POSITION**

FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(In thousands of Brazilian reais - R\$)

	2007	2006	2005
<b>SOURCES OF FUNDS</b>			
<b>From operations:</b>			
Net income	1,048,703	778,905	865,647
<b>Items not affecting working capital</b>			
Bad debt expense Long term accounts receivable	105,301	102,025	137,639
Depreciation and amortization	622,549	642,171	595,981
Investments write-off	-	20	4,360
Write-off of property, plant and equipment	68,568	54,350	19,051
Write-off of deferred assets	1,276	5,195	6,700
Monetary variations on long-term items	(15,786)	(11,521)	(19,597)
Reversal of provision for losses with escrow deposits, net	-	(4,421)	-
Provisions for contingencies	287,704	75,450	119,577
Other provisions	155	7,504	-
Provision for pension obligation	44,022	44,654	54,382
<b>Interests and monetary and foreign exchange variation on non current liabilities:</b>			
Loans and financing	(46,141)	15,733	(143,210)
Taxes payable	10,197	15,151	21,761
<b>Deferred income and social contribution taxes:</b>			
In long-term assets	(14,572)	(43,834)	(41,549)
In long-term liabilities	12,964	13,458	3,388
<b>Total from operations</b>	<b>2,124,940</b>	<b>1,694,840</b>	<b>1,624,130</b>
<b>From third parties:</b>			
Transfers from non-current assets to current assets	351,944	394,738	328,548
<b>Increase in non current liabilities:</b>			
Loans and financings funding	222,474	706,774	1,153,479
Other increases	52,069	9,306	-
Increase in property, plant and equipment by donations work aid	17,565	27,870	13,529
<b>Total from third parties</b>	<b>644,052</b>	<b>1,138,688</b>	<b>1,495,556</b>
<b>Decrease in working capital</b>	<b>47,316</b>	<b>145,532</b>	<b>-</b>
<b>Total sources</b>	<b>2,816,308</b>	<b>2,979,060</b>	<b>3,119,686</b>
<b>USES OF FUNDS</b>			
Increase in long-term assets	556,140	606,197	504,482
Capitalized amounts property, plant and equipment	27,371	27,902	24,417
Decrease in non current liabilities	-	-	58,028
<b>In non current assets</b>			

Property, plant and equipment	901,598	886,534	673,489
Intangible	32,818	12,630	4,748
Deferred charges	-	2,789	106
<b>In non current liabilities</b>			
Transfers from non current liabilities to current liabilities:			
Loans and financing	666,757	858,532	634,487
Taxes and contributions	43,002	40,824	37,986
Contingencies provision	287,878	-	-
Anticipated settlement of loans and financings	-	272,811	-
Interest on shareholders equity	300,744	270,841	348,216
<b>Increase in working capital</b>	-	-	<b>833,727</b>
<b>Total uses</b>	<b>2,816,308</b>	<b>2,979,060</b>	<b>3,119,686</b>
<b>Current assets</b>			
At end of year	2,224,517	1,919,032	1,725,386
At beginning of year	1,919,032	1,725,386	1,229,790
<b>Variation in current assets</b>	<b>305,485</b>	<b>193,646</b>	<b>495,596</b>
<b>Current liabilities</b>			
At end of year	2,454,737	2,101,936	1,762,758
At beginning of year	2,101,936	1,762,758	2,100,889
<b>Variation in current liabilities</b>	<b>352,801</b>	<b>339,178</b>	<b>(338,131)</b>
<b>Increase (decrease) in working capital</b>	<b>(47,316)</b>	<b>(145,532)</b>	<b>833,727</b>

The accompanying notes are an integral part of these financial statements.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO SABESP****STATEMENTS OF CHANGES IN FINANCIAL POSITION**

FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(In thousands of Brazilian reais - R\$)

	2007	2006	2005
<b>SUMMARY</b>			
<b>SOURCES</b>			
From operations	2,124,940	1,694,840	1,624,130
From third parties	644,052	1,138,688	1,495,556
Decrease in working capital	47,316	145,532	-
<b>Total sources</b>	<b>2,816,308</b>	<b>2,979,060</b>	<b>3,119,686</b>
<b>USES</b>			
Increase in non current assets	556,140	606,197	504,482
Capitalized amounts property, plant and equipment	27,371	27,902	24,417
Decrease in non current liabilities	-	-	58,028
In property, plant and equipment, deferred assets and intangible	934,416	901,953	678,343
Transfers from non current liabilities to current liabilities	997,637	899,356	672,473
Anticipated settlement of loans and financings	-	272,811	-
Shareholders - Interests on shareholders equity	300,744	270,841	348,216
Increase in working capital	-	-	833,727
<b>TOTAL USES</b>	<b>2,816,308</b>	<b>2,979,060</b>	<b>3,119,686</b>

The accompanying notes are an integral part of these financial statements.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

**1. OPERATIONS**

The Company is a mixed-capital company headquartered in São Paulo, controlled by the São Paulo State Government. The Company is engaged in the provision of basic and environmental sanitation services, and supplies treated water on a wholesale basis and provides sewage treatment services to other six municipalities of the Greater São Paulo Metropolitan Area.

In addition to providing basic sanitation services in the State of São Paulo, SABESP may perform these activities in other states and countries, and can operate in drainage, urban cleaning, solid waste handling and energy markets. The company intends to expand its basic operations and, at the same time, become an environmental solutions company.

At the end of 2007, the company operates water and sewage services to 366 municipalities, although, due to judicial orders, we had temporarily stopped operating three of them (Araçoiaba da Serra, Cajobi e Monte Alto). We have recently resumed providing service to Monte Alto. As for the other two municipalities (Araçoiaba da Serra and Cajobi) we are still in litigation. Even if we cannot resume providing services to these municipalities, there will be no major impact on us as: i) revenue from these operations account for less than 0,2% of our total revenues, and ii) we will continue to be entitled to indemnities related to the assets invested in the municipalities and not yet amortized. Of the 174 municipalities whose concessions have expired, 124 approved a municipal law that authorizes the signature of a program contract with SABESP. One hundred and six of these municipalities have already signed the program contracts (for the definition see note 24) and the remainder is in the final stage for formalizing the program contracts procedure.

In December 2008, 104 concession contracts will be expired or be under negotiation with the respective municipalities. Between 2009 and 2034, 117 concession contracts will expire in addition to the remaining concession contracts with legal relationships with indefinite term for which Law 11445, which regulated the sanitation services in Brazil, determines that the parties can sign an agreement by 2010. Management believes that all these legal situations will result in new contracts or extensions, and does not consider the risk related to the discontinuity in the provision of municipal water and sewage services. As of December 31, 2007, the book value of property, plant and equipment of the concessions in final stage of formalization or terminating in 2008 was R\$2.02 billion and revenues from these concessions for the year ended December 31, 2007 was R\$935 million.

In the municipality of Santos, in the Baixada Santista, which has a significant population, the Company operates supported by a public authorization deed, a similar situation in other municipalities in that region and in Ribeira valley, where the Company started to operate after the merger of the companies that formed it.

On January 5, 2007, Law 11445 was enacted, establishing the basic sanitation regulatory framework, providing for the nationwide guidelines and basic principles for the provision of such services, such as social control, transparency, the integration authority of sanitation infrastructures, water resources management, and the articulation between industry policies and public policies for urban and regional development, housing, suppression of poverty, promotion of health and environmental protection, and other related issues. The regulatory framework also aims at efficiently improving quality of living and economic sustainability, allowing for the adoption of gradual and progressive solutions consistent with users' payment ability.

As benefits for the Company, this law:

Clarifies the conditions for transitional services, by amending Article 42 of the Concession Law to determine that the Concession Grantor has to perform evaluations, surveys and payment due compensation before retaking the concession assets, as a condition for the validity of the subsequent municipal actions;

Significantly reduces the possibility of success in legal actions for retaking services suddenly and without paying due compensation;

Aims at improving the attainment of public interests related to the environment and supports the state planning of services, without disregarding local peculiarities, taking into consideration the need for the Municipalities to present sanitation plans that are compatible with the hydrographic basin plans;

Imposes the creation of a regulatory agency and the issue of regulations that increase transparency and efficiency in services inspections, as well as in the provision of services itself, safeguarding and converging the different interests of consumers and contractors;

Another important change in the regulatory environment in 2007 was the creation of the São Paulo State Sanitation and Power Regulatory Agency (ARSESP).

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**

**NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The Company's shares have been listed in the Novo Mercado (New Market) segment of the BOVESPA (São Paulo Stock Exchange) since April 2002, and in the New York Stock Exchange (NYSE) as ADRs since May 2002.

The information on concession area, number of municipalities, water and sewage volumes, and other related data disclosed in this report that are not derived from the financial statements is not audited by the independent auditors.

**2. PRESENTATION OF THE FINANCIAL STATEMENTS**

(a) Presentation of financial statements

The Company's statutory financial statements, which are used as the basis for determining income taxes and mandatory minimum dividend calculations, have been prepared in accordance with accounting practices adopted in Brazil, which are based on the Brazilian Corporate Law (Law No. 6,404/76, as amended), the rules and regulations of the Brazilian Securities Commission ("CVM") and the accounting standards issued by the Brazilian Institute of Independent Auditors (IBRACON), collectively referred to hereinafter as Corporate Law or BR CL. The financial statements prepared in accordance with Corporate Law have not been indexed for inflation after 1995.

(b) Inflation accounting under BR CL

BR CL provided a simplified methodology for accounting for the effects of inflation through 1995. This method consisted of restating permanent assets (property, plant and equipment, investments and deferred charges) and shareholders' equity accounts using indices mandated by the Brazilian Federal Government. The net effect of these restatements was credited or charged to the statement of income.

**3. SIGNIFICANT ACCOUNTING PRACTICES**

The Company's accounting practices, which are based on the accrual concept, comply with the Corporate Law but differ in certain significant respects from accounting principles generally accepted in the United States of America (US GAAP). See Note 26 for further discussion of the differences between BR CL and US GAAP and the reconciliation of shareholders' equity and net income between BR CL and US GAAP. Additional disclosure has been included in the notes to the financial statements to comply with the regulations of the U.S. Securities and Exchange Commission (the SEC) for foreign registrants.

(a) Revenues from sales and services

Revenues from water and sewage services are recognized as water is consumed or as services are provided. Revenues from water and sewer services rendered, but not billed, are recorded as unbilled customer accounts receivable based on monthly estimates, in order to match such revenue with costs incurred.

(b) Marketing costs

Marketing costs are recorded in administrative expenses. Marketing costs were R\$ 16,431, R\$ 11,895 and R\$ 17,861 for the years ended on December 31, 2007, 2006 and 2005, respectively. No marketing costs were deferred at December 31, 2007, 2006 and 2005.

(c) Financial income and expenses

Financial income and expense are primarily comprised of interest, monetary and exchange variations on loans and financing, contingencies, accounts receivable and financial investments, and are calculated and reported on the accrual basis of accounting.

(d) Income tax and social contribution

Income and social contribution taxes (a federally mandated tax based on income) are accrued on taxable results.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**

**NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

Income tax is calculated at the rate of 15%, plus a 10% surtax, and social contribution at the rate of 9%. Those rates are reported on an accrual basis.

Deferred taxes are calculated based on taxable or deductible amounts in future years and are recognized to the extent that realization is believed to be probable.

As permitted by the CVM, the Company opted not to recognize the deferred income and social contribution taxes on the revaluation reserve of property, plant and equipment recorded up to 1991.

(e) Other income and expenses

Other income and expenses are recorded on an accrual basis.

(f) Cash and cash equivalents

Cash and cash equivalents comprise primarily bank deposits and financial investments and are carried at cost plus accrued interest, if applicable. Financial investments denominated in Reais have a ready market, and are mostly represented by Bank Deposit Certificates - CDBs in 2007 and 2006 and by Financial Investment Funds - FIFs in 2005. The Company is required by law to invest excess cash with financial institutions controlled by the State Government (see note 6).

(g) Customer accounts receivable and allowance for doubtful accounts

Customer accounts receivable generally do not accrue interest or indexation charges or penalties, except for refinanced agreements.

The Company records an allowance for doubtful accounts for receivable balances in an amount that is deemed by management to be sufficient to cover probable losses in accounts receivable, based on the analysis of the history of receipts. Amounts in excess of R\$ 5 and overdue for more than 360 days and in excess of R\$ 30 and overdue for more than 360 days, which are under judicial collection proceedings, are provisioned. Accounts receivable balances under R\$ 5 and overdue more than 180 days are written off through a direct charge to income.

The Company has not recorded an allowance for doubtful accounts for any amounts due to it by the State Government or entities controlled by the State Government, since it does not expect to incur losses from such balances.

(h) Inventories

Inventories of materials used in operations and in the maintenance of the Company's water and sewage systems are stated at lower of average acquisition cost or realizable value and are classified in current assets. Inventories for capital projects are classified under property, plant and equipment and are stated at the average acquisition cost.

(i) Other current assets and long-term receivables

Other current assets and long-term receivables are stated at the lower of acquisition cost or realization value, plus accrued interest, when applicable.

(j) Property, plant & equipment

Property, plant and equipment are stated at amounts established by independent technical appraisals, plus price-level restatements from the date of the appraisals to 1995. Revaluation increments arising from revaluing assets to appraised values are recorded in the revaluation reserve component of shareholders' equity and subsequently transferred from the reserve to retained earnings as the related assets are depreciated, sold or upon disposal. The price-level restatement adjustments were based on official inflation indices published by the federal government. The Company believes that the distortion caused by indices which understated the independently measured inflation rate have been mitigated by recording revaluation increments.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The revaluation of property, plant and equipment items, carried out in two separate stages in 1990 and 1991, was based on an appraisal report issued by independent experts. The referred revaluation was recorded with a corresponding credit to the Revaluation Reserve account in Shareholder's Equity, and is realized through depreciation, sale, and disposal of the respective assets, with a corresponding entry to Retained Earnings.

Construction-in-progress is recorded at cost and is primarily related to construction projects under contract with third parties. For long-term projects, the Company capitalizes these projects once the Company's engineering department approves that the project milestones have been achieved and the Company takes delivery of the assets.

**Depreciation**

Depreciation of property, plant and equipment, is recorded using the straight-line method based on the estimated useful lives of the underlying assets. The principal depreciation rates are detailed in Note 8.

**Capitalization of interest**

Consistent with the requirements of accounting regulations for Brazilian utility companies, up to 1985, interest was capitalized at 12% per annum on construction-in-progress. Interest capitalized which exceeded interest expense on loans obtained to finance construction-in-progress was recorded in a capital reserve directly in shareholders' equity. Up to 1995, BR CL did not require the capitalization of interest costs incurred during the construction period as part of the cost of the related property, plant and equipment. However, as permitted by the Brazilian Water and Sewage Plan (Plano Nacional de Saneamento Básico - PLANASA), the Company capitalized interest on construction in progress through 1988. No interest was capitalized from 1989 to 1995. Interest was again capitalized beginning in 1996, following changes in the CVM requirements in 1996. Beginning in 1999, the Company has capitalized indexation charges on the real - denominated loans and financing and the foreign exchange effects on foreign currency loans and financing. The Company capitalizes interest incurred on borrowings to the extent that borrowings do not exceed construction-in-progress, which is recorded as a reduction of interest expense.

Interest capitalized is depreciated with the cost of the asset, once the related asset becomes operational. Through December 31, 1998, but not thereafter, such depreciation of capitalized interest was deductible for purposes of determining taxes on income.

**Repairs and maintenance**

Improvements to existing property are capitalized, while costs of general maintenance and repairs are expensed as incurred. Materials allocated to specific projects are added to construction-in-progress.

**Impairment**

The Company reviews long-lived assets, primarily buildings and water and sewage systems, including property, plant and equipment and concession assets, to be held and used in the business, for the purpose of determining and measuring impairment on a recurring basis or when events or changes in circumstances indicate that the carrying

value of an asset or group of assets may not be recoverable. The Company assesses impairment on the basis of the projected recovery of depreciation charges through results of operations. The carrying value of assets or groups of assets is written down to realizable value if and when appropriate.

#### Donations

Donations of property, plant and equipment received from third parties and government entities to enable the Company to provide water supply and sewage services are recorded in property, plant and equipment with a corresponding entry to capital reserve.

#### (k) Intangible assets (concessions)

Beginning in 1999, acquisitions of concession assets and concession rights from third parties have been accounted for at fair values, as determined in technical appraisal reports. Accordingly, the purchase price, plus direct costs of acquisition, is allocated to assets acquired and liabilities assumed based upon their estimated fair values at the date of acquisition. These concessions are recorded as concession assets acquired, included as intangible assets in the balance sheets.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**

**NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

Concession rights are amortized on a straight-line basis over the estimated future periods to be benefited, not to exceed the contractual term of the concession. The straight-line method of depreciation is modified, when applicable, to avoid the backloading of charges in later years by estimating future disbursement commitments to meet the Company's concession obligations.

(l) Deferred charges

Deferred charges are comprised primarily of deferred project costs and technical studies, which are being amortized using the straight-line method over 5 years from the date when benefits start to be generated.

The company also evaluates the realization of each project (quarterly) to make sure if any amount needs to be disposed.

(m) Loans and Financing

Loans and financing are adjusted by indexation charges and foreign exchange variations and include accruals for related interest expenses up to closing date. Loans and financing denominated in foreign currencies are translated to reais using the exchange rate in effect at the balance sheet date. The resulting foreign currency exchange adjustments are recognized as incurred in financial income (expense), net.

(n) Salaries and payroll charges

Salaries and other payroll charges, including provisions for vacation pay, 13th salary and complementary payments agreed upon through collective bargaining agreements, added by the corresponding payroll charges, are recorded on an accrual basis.

(o) Profit sharing

The profit sharing provisions are recorded on an accrual basis in operating expenses.

(p) Provision for Contingencies

Provisions for contingencies are recorded at the estimated amounts to cover probable losses related to labor, tax, civil, commercial, environmental and other claims and lawsuits, at administrative and court levels, when such losses are considered probable by the Company's legal advisors and are estimateable by management. Provisions for contingencies balances are disclosed net of the related escrow deposits.

(q) Environmental costs

Costs relating to ongoing environmental programs are expensed, as incurred. Ongoing programs are designed to minimize the environmental impact of operations and to manage the environmental risks inherent to the Company's activities. Provisions for contingent losses related to environmental claims are recorded when they are considered to be probable and reasonably estimated by Management.

(r) Pension obligation

The Company sponsors a private defined benefit pension plan, which is operated and administered by Fundação SABESP de Seguridade Social ( SABESPREV ). CVM resolution 371 of December 13, 2000 determines the recognition of actuarial liabilities exceeding to the plan assets. As permitted, the Company elected to recognize the transition obligation as of the date of adoption in earnings on a straight-line basis over five years beginning January 1, 2002.

F-14

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## (s) Interest on shareholders' equity

Brazilian corporations are permitted to deduct for tax purposes interest on shareholders' equity, which is a distribution similar to a dividend. For financial reporting purposes, interest on shareholders' equity is recorded as a deduction directly from unappropriated retained earnings. This interest has been recorded in accordance with Law 9249/95, for tax deductibility purposes, limited to the daily pro-rata variation of the Long-Term Interest Rate ( TJLP ). Withholding taxes with respect to the payment of interest on shareholders' equity is generally withheld and paid by the Company on behalf of shareholders (see note 16).

## (t) Use of estimates

The preparation of financial statements requires management to make estimates based on certain assumptions that affect the reported amounts of assets and liabilities and the reported amounts or revenues and expenses for the reporting periods. Actual results could differ from those estimates.

## (u) Earnings per share

Earnings per share are calculated based on the number of shares outstanding at the balance sheet date.

**4. CASH AND CASH EQUIVALENTS**

	2007	2006
Cash and banks	72,833	80,118
Financial investments	392,164	248,088
	464,997	328,206

**5. CUSTOMER ACCOUNTS RECEIVABLE**

The following summarizes customer accounts receivable balances at December 31:

	2007	2006
(a) Private-sector customers		
General customers and special customers (i) (ii)	704,626	667,143
Agreements (iii)	202,037	179,353
	906,663	846,496
Government Entities:		

Municipal	524,519	446,495
Federal	25,792	23,524
Agreements	81,490	85,909
	631,801	555,928
Wholesale customers - municipal authorities: (iv)		
Guarulhos	383,911	340,534
Mauá	135,272	115,189
Mogi das Cruzes	12,549	4,139
Santo André	326,549	289,592
São Caetano do Sul	2,971	2,932
Diadema	99,932	85,620
Total wholesale customers - municipal authorities	961,184	838,006
Unbilled amounts	301,695	290,578
Subtotal	2,801,343	2,531,008
Allowance for doubtful accounts	(1,314,671)	(1,123,157)
Total	1,486,672	1,407,851
Current portion	1,207,885	1,111,289
Non current portion (v)	278,787	296,562

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

(i) General customers - residential and small and medium-sized businesses.

(ii) Special customers - large consumers, commercial industries, plants, condominiums and special billing consumers (industrial waste, wells, etc.)

(iii) Agreements - renegotiation of past due debts into installments, added by monetary variation and interests, with maturity dates between 6 and 12 months, except for agreements with municipal City Halls, with maturity dates up to 2011.

(iv) Wholesale customers - municipal authorities - Accounts receivable from wholesale customers relate to the wholesale of treated water to certain municipalities, which are responsible for distribution, billing and collection with the final customers, some of these municipalities judicially contest the tariffs charged by SABESP and do not pay the amounts in dispute. The past due amounts are classified as non current assets, as demonstrated below:

	2007	2006
Balance in the beginning of year	838,006	727,892
Billings for services provided	292,041	265,298
Collections -current year services	(141,451)	(133,926)
Collections - prior years services	(27,412)	(21,258)
Balance at end of year	961,184	838,006
Current portion	50,769	16,170
Non current portion	910,415	821,836

(v) The non current portion comprises past due and renegotiated accounts receivable with customers and past due amounts from the wholesale supply to municipal authorities, and it is recorded net of the allowance for doubtful accounts.

(b) Customer accounts receivable aging summary

	2007	2006
Current	783,946	705,863
Past due:		
Up to 30 days	148,498	247,970
From 31 to 60 days	81,244	72,064
From 61 to 90 days	55,821	48,962

From 91 to 120 days	46,202	40,540
From 121 to 180 days	81,313	71,101
From 181 to 360 days	151,993	186,387
For more than 360 days	1,452,326	1,158,121
Total	2,801,343	2,531,008

F-16

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

(c) Allowance for doubtful accounts

(i) Changes in the allowance for doubtful accounts are as follows:

	2007	2006
Balance at beginning of year	1,123,157	920,736
Private-sector customers/government entities	86,213	87,160
Wholesale customers	105,301	115,261
Additions in the fiscal year	191,514	202,421
Balance at end of year	1,314,671	1,123,157
Current portion	587,713	501,500
Long-term portion	726,958	621,657

(ii) In the income

Bad debt included as part of selling expenses for the years ended December 31 was as follows:

	2007	2006	2005
Provisions (over five thousand reais)	(228,367)	(241,050)	(207,233)
Recoveries (over five thousand reais)	36,853	38,629	46,137
Direct write-offs (less than five thousand reais and adjustment (e))	(232,791)	(289,191)	(177,138)
Recoveries (less than five thousand reais)	100,966	79,694	82,942
Total bad debt expenses (note 20)	(323,339)	(411,918)	(255,292)

A number of wholesale customers have been contesting certain tariffs since mid-1998. As a result, some municipalities are currently not paying the Company's invoices in full or on a timely basis. In addition, some governmental entities located in municipalities the Company serves are also not paying on a regular basis. While the Company continues to enter into negotiations with municipalities to reschedule the related accounts receivable and continues to file legal proceedings against municipalities to collect overdue amounts, in some cases, the Brazilian

courts have required that the Company continue to provide water on a wholesale basis to municipalities, even if they fail to pay the Company's invoices.

The Company recorded direct charges for probable losses in accounts receivable incurred in 2007, in the amount of R\$ 323,339, being R\$ 131,825 (net of recoveries) written-off from accounts receivable (in 2006 - R\$ 115,739) directly to the income for the year, recorded in Selling Expenses. These losses amounted to R\$411,918 and R\$ 255,292 in 2006 and in 2005, respectively.

Management believes that the allowance for doubtful accounts is sufficient to absorb probable losses in customer accounts receivable.

(d) Unbilled amounts

Unbilled amounts represent water and sewage services provided but not yet billed, which are estimated from the last measurement date to month-end based on prior month's billings.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

**6. TRANSACTIONS WITH RELATED PARTIES**

The Company is party to a number of transactions with its majority shareholder, the State Government, and its related agencies.

## (a) Receivable, payable and revenues and expenses with Shareholder

<u>Receivable, from Shareholder</u>	2007	2006
Current:		
Water and sewage services (i)	311,528	308,030
GESP Agreement (iii) (iv)	26,978	59,834
Total current	338,506	367,864
Long-term:		
Water and sewage services - GESP Agreement	107,911	89,012
Reimbursement for pension benefits paid (ii)	879,077	774,455
Gross long-term receivable from shareholder	986,988	863,467
Total receivable from shareholder	1,325,494	1,231,331
Water and sewage services	446,417	456,876
Reimbursement for pension benefits	879,077	774,455
	1,325,494	1,231,331
<u>Payable to Shareholder</u>		
Interest on Shareholders' Equity	551,974	396,361
<u>Revenue and expenses</u>		
Operating Revenues		
Gross revenue from sales and services		
Water sales	185,976	175,124
Sewage services	149,853	146,074
Collections	(326,065)	(199,375)
Financial revenues	51,469	50,882

The Company has not recorded an allowance for doubtful accounts for any amounts due from the State government or entities controlled by the State Government, since it does not expect losses on such receivables.

(i) Water and sewage services

The Company provides water and sewage services to the State Government of São Paulo and its related agencies under terms and conditions that management believes are equal to those with third parties, except for the settlement of amounts outstanding, as described further below in items (iii) and (iv).

(ii) Reimbursement for pension and benefits paid.

Reimbursement for pension and benefits paid represents supplementary pension and leave benefit paid by the Company to former employees of State Government-owned companies which merged to form SABESP. These amounts should be reimbursed to the Company by the State Government of São Paulo, as the primary obligor, in conformity with Law No. 200/74. At December 31, 2007 and 2006, 2,635 and 2,670 retirees, respectively, received supplementary pension payments, for which the Company paid R\$ 104,622 and R\$ 101,740 at December 31, 2007 and 2006, respectively. There were 144 active employees at December 31, 2007, who will be entitled to such benefits at the time of their retirement, as compared to 163 at December 31, 2006.

On January 2004, the payments that supplement retirement and pension benefits were transferred to the State Treasury Secretariat and would be made in accordance with the calculation criteria determined by the State Attorney's Office (PGE). As a result of a legal decision, the responsibility for the payments is of SABESP again, as they were initially.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## (iii) GESP Agreement

On December 11, 2001, the Company entered into an agreement with the State of São Paulo Government, through the State Department of Finance and the State Department of Water and Energy - DAEE, having the State Secretariat of Sanitation and Energy as intervening party, under which the State Government, by force of Law no 200/74, acknowledged to be responsible for the benefit arising out of supplementation of retirement and pension payments and agreed to pay amounts it owed to the Company in respect of water and sewage services. The value to date of the Agreement was R\$ 678,830, of which R\$ 320,623 refer to supplemental retirement and pension benefits in the period from March 1986 until November 2001, and R\$ 358,207 refer to water supply and sewage collection services invoiced and due from 1985 until December 1, 2001. The agreement foresees the equalizing of the balance of our accounts receivable with the use of dividends, when applicable.

Considering the strategic importance of Taiacupeba, Jundiaí, Biritiba, Paraitinga and Ponte Nova reservoirs, for ensuring the volume of water of the Alto Tietê System to be maintained, it was agreed that DAEE would transfer these properties to the Company, with the fair value of these transferred assets used to reduce the amounts owed to the Company. The reservoirs valuation laud was approved by the Company's Board of Directors, in the amount of 300,880(valuation base- June 2002), however, there is a judicial claim, related to the transfer of these reservoirs. The Company's legal counsels opinion is that there is a probable risk of lose this claim, what would hinder the reservoirs transfer as as partial amortization of the accounts receivables.

Based on Official Notice No. 53/2005 of the State Capital Defense Council (CODEC), dated March 21, 2005, negotiations are still ongoing between the Company and the State Government with a view to restatement of the debt for supplemental retirement and pension benefits, under the terms defined in the December 2001 agreement, including amounts due after November 2001. The Company has retained Fundação Instituto de Pesquisas Contábeis, Atuariais e Financeiras, USP - FIPECAFI to validate the actual values to be reimbursed by the State Government, taking into account the legal advice provided by the General Office of the State Attorney.

On March 26, 2008, the State of São Paulo, through the Treasury Secretariat and the State Secretariat for Sanitation and Energy, and SABESP entered into a Commitment Agreement for the settlement of outstanding debts related to the reimbursement of pension benefits.

Even though the State acknowledges its debts related to the pension benefits, the State disagrees with the criteria adopted by SABESP to grant and pay the benefits, based on the legal opinions issued by the State Attorney General, which restrict State actions and prevent the voluntary reimbursement of all amounts paid by SABESP.

From SABESP's standpoint, the criteria adopted in the past to grant and pay pension benefits were correct, as they were based on specific State authorizations or then effective legal opinions.

The prolongation of the disputes between the State and SABESP is the main reason why the parties did not manage until now to fully implement the provisions of the São Paulo State Government Agreement.

Based on preliminary information gathered, under the calculation and eligibility criteria agreed by the State, SABESP estimates a Indisputable Reimbursement of approximately R\$936 million, which comprises monetary adjustment based on the IPCA (Extended Consumer Price Index) (R\$605.3 million in notional amounts). The amount paid by SABESP was R\$1,422.8 million, adjusted based on the IPCA (R\$879 million in notional amounts).

The parties agree that this discrepancy should not represent an obstacle to the implementation of the commitments made in the São Paulo State Government Agreement.

Fipecafi is validating the Indisputable Reimbursement and the Controversial Amount, estimated by SABESP, as well as other firms are performing a new evaluation of the Reservoirs that might be transferred to SABESP as amortization of the reimbursement payable by the State. The amount of the Indisputable Reimbursement shall be added of the monthly variation of the IPCA from the month of each disbursement made by SABESP to the month the determination work is completed.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

Once the amount of the Indisputable Reimbursement is determined and validated by the parties, and the new evaluation of the reservoirs is concluded, the State shall initiate the 30-day period for payment of the Indisputable Reimbursement, as provided for by the São Paulo State Government Agreement, in 114 monthly, consecutive installments, including the annual IPCA variation, plus interest of 6% per year.

The State confirms it is willing to assume the responsibility for the processing and direct payment of the benefits if SABESP succeeds in reversing the court decision that requires the Company to keep paying the pension benefits, under the current terms and conditions. While the current court decision is not overruled, the State shall transfer to SABESP the cash required to pay the indisputable amount of the monthly due benefits.

SABESP shall not waive the receivables from the State to which the Company considers itself to be legally entitled. Accordingly, it will take all possible actions to resolve the issue at all technical and court levels. Should this dispute persist, the Company will take all the necessary actions to protect the Company's interests.

Based on preliminary calculation, considering the reimbursement of the Indisputable Amount by the São Paulo State Government, estimated at approximately R\$936 million, representing 66% of the amount paid by SABESP and considering, among other aspects, the need to recognize an actuarial liability to reflect the right to benefits that will be paid in the future, the estimated impact on the Company's results of operations as of December 31, 2007 would be R\$513 million, approximately.

No amounts were accrued for loss or the benefits that will be paid in the future as the likelihood of receiving the outstanding amounts and resolving the existing disputed favorably to the Company is highly probable. This expectation is based, in addition to an internal analysis by the Company's staff, on an outside legal opinion, which concludes, after carefully analyzing the matter, that the likelihood of a favorable outcome in a possible recourse action filed by the Company is highly probable. According to this opinion, the circumstances under which the payment of the benefits was made imposes to the São Paulo State Government the duty of reimbursing the Company, since the Company, as the employer, was merely a co-obligator. The analysis of the main disputes allow us to conclude that the criteria adopted by the Company in the past to grant and pay the benefits are reasonable, as they were built based on specific guidance of the São Paulo State Government.

The following summarizes activity with respect to amounts due from the State Government related to the reimbursement of pension and retirement benefits:

	December 31,	
	2007	2006
Receivable from shareholder reimbursement for pension benefits paid:		
Balance at beginning of the year	774,455	672,715
Payments made on behalf of State Government	104,622	101,740
Balance at end of the year	879,077	774,455

The balances for water and sewage services were included in the 1<sup>st</sup> and 2<sup>nd</sup> amendment, as described below (iv).

(iv) First Amendment to GESP Agreement

On March 22, 2004, the Company and the State of São Paulo Government amended the terms of the original GESP Agreement, thereby (1) consolidating and acknowledging amounts due from the State Government for water and sewage services through February 2004, monetarily adjusted through February 2004; (2) formally providing for the offset of amounts due from the State Government against interest on shareholders' equity declared by the Company and any other debt owed to the State Government at December 31, 2003, which were monetarily adjusted through February 2004; and (3) defining the payment terms of the remaining obligations of the State Government for water and sewage services.

Under the terms of the Amendment, the State Government acknowledged amounts due to the Company for water and sewage services provided through February 2004, in the amount of R\$ 581,779, including monetary adjustments based on the Reference Rate ( TR ) at the end of each fiscal year through February 2004. The Company acknowledged amounts due to the State Government with respect to interest on shareholders' equity of R\$ 518,732, including (1) amounts declared and paid for years prior to 2003 (R\$ 126,967), (2) monetary adjustments on these amounts based on the annual change in the Consumer Prices Index (IPC/FIPE) through February 2004 (R\$ 31,098); and (3) amounts declared and paid relating to 2003 (R\$ 360,667).

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The Company and the State Government agreed to the reciprocal offset of R\$ 404,889 (monetarily adjusted through February 2004). The remaining obligation of R\$ 176,890 at February 29, 2004 will be payable in monthly installments from May 2005 through April 2009, which will be subject to monthly monetary adjustment at the Expanded Consumer Price Index (IPCA/IBGE), plus 0.5% .

In 2005 the offset of R\$ 105,520 with interest on shareholders' equity from 2003 occurred, as forecasted. In 2006, the Company received the amount of R\$ 47,228 corresponding to the installments from January through October.

**(v) Second Amendment to the Gesp Agreement**

On December 28, 2007, the Company and the State Government, by means of the Treasury Secretariat, signed the second amendment to the terms of the original Gesp Agreement, (1) agreeing upon the payment in installments of the remaining balance of the First Amendment, amounting to R\$133,709 (on November 30, 2007), to be paid in 60 monthly and consecutive installments of the same amount, the first of which falling due on January 2, 2008. The amount of the installments will be monetarily restated in accordance with the variation of the IPCA-IBGE, plus interest of 0.5% per month. The balance of this agreement, the installments of which have been monthly paid, includes the amount of R\$46,244, which the State does not recognize as due. SABESP's understanding differs from that of the State regarding this amount and does admit the review of these previously agreed-upon amounts without the supported and unequivocal demonstration of the lack of relation between the amounts presented by SABESP and the services effectively provided. For this reason the Company understands that the recognition of an allowance for losses regarding these amounts is not necessary (pursuant to item VII, of the Recitals, of the Second Amendment to the Recognition Instrument, Payment Commitment and Other Covenants between the State of São Paulo and SABESP) (2) with respect to the accounts past due and unpaid in the period between March 2004 and October 2007, arising from the provision of water supply and sewage collection services in the amount of R\$256,608, R\$231,407 has been received and R\$25,201 is pending confirmation of receipt. These amounts are being jointly analyzed by SABESP and the representatives of the many State departments. To date, differences regarding the debtor but not the amount of the debt have been identified. In the event of the reclassification of the entity responsible for paying the account, SABESP will transfer the charge to the respective Entity. The Company has not recognized an allowance for losses in this amount as it understands that the differences are substantially related to the identification of the debtor. (3) The interest on shareholders' equity due by SABESP to the State, related to the period between March 2004 and December 2006, in the amount of R\$400,823, restated between June 2007 and November 2007, based on the Selic (central Bank overnight rate), was paid in the period between January and March 2008. (4) The State and SABESP agreed on immediately resuming the compliance with their mutual obligations under new assumptions: (a) implementation of an electronic account management system to facilitate and speed up the monitoring of payment processes and budget management procedures; (b) structuring of the Rational Water Use Program (PURA) to rationalize the consumption of water and the amount of the water and sewage bills under the responsibility of the State; (c) establishment, by the State, of criteria for budgeting so as to avoid the reallocation of amounts to a specific water and sewage accounts as from 2008; (d) possibility of registering state bodies and entities in a delinquency system or reference file; (e) possibility of interrupting water supply to state bodies and entities in the case of nonpayment of water and sewage bills.

Management believes that the amounts owed by the State Government shall be received and it is not estimated that losses will be incurred with such accounts receivable.

The Amendments to the GESP Agreement does not provide for amounts owed by the State Government for supplementary retirement and pension plan benefits, paid by the Company on behalf of the State Government. Such amounts continue to be subject to the terms of the original GESP Agreement.

Approximately 70% of the billing from November 2007 and February 2008 has already been paid by the State Government. The remaining amount is being analyzed and will be received as soon as the state bodies conclude the checking.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## (b) Cash and cash equivalents

The Company's balance of cash and short-term investments accounts with financial institutions controlled by the State Government was R\$ 421,630 and R\$ 287,999 at December 31, 2007 and 2006, respectively. The financial income from such investments was R\$ 51,469, R\$ 50,882 and R\$ 32,293 in fiscal years ended December 31, 2007, 2006 and 2005, respectively. The Company must, by force of State Decree, invest its excess resources together with financial institutions controlled by the State.

## (c) Arrangements to use reservoirs

The Company uses the Guarapiranga and Billings reservoirs and a portion of some of the reservoirs of the Alto Tietê System, which are owned by the State Department of Water and Energy (DAEE). The Company does not pay any fees with respect to the use of these reservoirs, but is responsible for maintaining and funding the operating costs of these reservoirs. The State of São Paulo does not incur such costs on behalf of the Company. In the event these facilities had not been made available to the Company, it would have had to obtain water from more distant sources which would have been more costly.

As part of these arrangements, the Company funded approximately R\$97,115 of costs for the 1992 and 1997 projects. A portion of these project costs were funded by the State Government, through DAEE. The agreements included the construction of ducts, tunnels and other facilities to interconnect the Tietê River with the Biritiba and Jundiá reservoirs and other bodies of water in exchange for the Company's use of the reservoirs during a 30-year period.

The Company has the right to draw water from and release emissions into the reservoirs during a 30-year period which began in 1997. The Company capitalizes expenditures on the facilities constructed. The assets relating to the original reservoir project were placed in service in 1994 and 2002 and are being depreciated over the remaining term of the original 30 year period. The Company had recorded as part of property, plant and equipment R\$ 52,922 and R\$ 55,660 of amounts capitalized with respect to these agreements, net of accumulated depreciation, at December 31, 2007 and 2006, respectively.

## (d) Contracts with reduced Fare for State and Municipal Public Entities that adhere to the Program of Rational Use of Water

The Company has entered into contracts with public entities related to the State Government and other municipalities involving approximately 7,240 properties that are benefited with a 25% tariff reduction for water and sewage services. The contract provides for the implantation of the program of rational use of water, which considers the reduction in water consumption.

## (e) Guarantees

The State Government and the Brazilian Federal Government, in some cases, provide guarantees of, or security for, the Company's loans and financing. The Company does not pay any fees with respect to these guarantees.



**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

**7. INDEMNITIES RECEIVABLE**

Indemnities Receivable is a non current asset representing amounts receivable from the municipalities of Diadema and Mauá as indemnification for the unilateral withdraw of the concessions of water and sewage services from the Company in 1995. On December 31, 2007 this asset amounted to R\$ 148,794.

Under these concession contracts, the Company invested in the construction of water and sewage systems in those municipalities in order to meet its concession services commitments. Due to the unilateral termination of the concessions of Diadema and Mauá, the municipalities have assumed the responsibility to provide water and sewage services in those areas. At that moment, the Company reclassified the property, plant and equipment balances related to the impounded assets used in those municipalities to non current assets (indemnities receivable) and it has recorded non indemnifiable costs in order to reflect the assets by the recoverable amounts contractually estimated as indemnification by the Company before the competent authorities. The net book value of property, plant, and equipment relating to the Municipality of Diadema, written off in December 1996, amounted to R\$75,231, and the indemnity balance and other receivables from the municipality amounted to R\$62,876 as of December 31, 2007 and 2006. The net book value of the property, plant and equipment items related to the municipality of Mauá, written-off in the fiscal year 1999, was R\$ 103,763, and the indemnity balance totaled R\$85,918 as of December 31, 2007 and 2006.

The Company's rights to the recovery of these amounts are being disputed by the municipalities and no amount has been received to date.

SABESP filed lawsuits to collect the amounts due by the municipalities. With respect to Diadema, the decision of the lower court judge was unfavorable to SABESP, which filed an appeal in November 2000. On December 1, 2005, SABESP's appeal to have the agreement entered into with the municipality of Diadema declared valid was partially accepted. On October 11, 2006, the municipality administration office filed special and extraordinary appeals and on November 21, 2006 the decision that allowed the Company to present its reply to said appeals was published. SABESP presented its reply on December 6, 2006. The appeals were rejected by the Chief Judge on March 27, 2007 and the municipal administration office filed new interlocutory appeals against this decision. The interlocutory appeal filed to the Federal Supreme Court (STF) was accepted but only for the purposes of determining the sentence for the extraordinary appeal that had been rejected. On December 26, 2007, the decision that accepted the execution of the Companhia de Saneamento the Diadema Saned was rendered, ordering this company to be summoned to pay the full amount of the debt within 15 days under the penalty of fine. Currently, the Company awaits the effect of this summons as said decision was published on January 2008 and Saned filed an Interlocutory Appeal against it but, on February 28, 2008, the Reporting Judge, sustained the decision and awaits for information on the lower court decision in order to analyze the motion for suspension.

With regards to Mauá, a first court level decision was given requiring that the Municipality pay an amount of R\$ 153.2 million as compensation for the loss of profits. This decision was appealed by Mauá on April 15, 2005 and it is still pending a decision by the Court of Justice. On July 4, 2006, the decision was converted in diligence consisting of an expert clarification on the amount of the indemnity for loss of profits. The clarification was provided on December 18, 2007 and the expert confirmed the amount of the loss of profits determined by the lower court. On February 20,

2008, the municipality of Mauá provided its opinion about the expert's findings and the case is now with the judge. On April 7, 2008, Sabesp responded to the plaintiffs' charges and now we are awaiting decision on the municipality and SAMA's appeals. Based on our internal legal counsel opinion, our management still believes that we have the legal right to receive the amount related to the indemnity and we continue to monitor the status of these legal proceedings. Considering the legal indexes the adjusted amount of this lawsuit is R\$ 551 million.

Based on the opinion of its legal counsel, Management continues to state that the Company is entitled to receive the amounts related to the indemnity and continues to monitor the status of the lawsuits.

F-23

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## 8. PROPERTY, PLANT AND EQUIPMENT

	December, 31	
	2007	2006
In use:		
Water systems:		
Land	961,538	958,283
Buildings	2,817,488	2,806,526
Connections	972,635	849,144
Water meters	294,846	279,028
Networks	3,492,852	3,372,421
Wells	205,117	206,478
Equipment	514,603	476,952
Other	16,287	14,322
	9,275,366	8,963,154
Accumulated depreciation	(3,667,909)	(3,365,745)
Total water systems	5,607,457	5,597,409
Sewage system:		
Land	348,508	346,471
Buildings	1,652,146	1,516,769
Connections	944,588	881,024
Networks	5,570,794	4,933,032
Equipment	559,080	436,444
Other	4,904	126,899
	9,080,020	8,240,639
Accumulated depreciation	(2,727,252)	(2,476,692)
Total sewage systems	6,352,768	5,763,947
General use:		
Land	107,707	107,707
Buildings	138,120	133,705
Transportation equipment	141,708	136,129
Furniture, fixtures and equipment	315,515	310,122

Accumulated depreciation	703,050 (386,054)	687,663 (407,012)
Total general use	316,996	280,651
Non Operational assets, net of accumulated depreciation	26,479	26,478
Subtotal	12,303,700	11,668,485
Construction in progress:		
Water systems	734,016	708,097
Sewage systems	1,018,620	1,454,994
Other	3,737	5,922
	1,756,373	2,169,013
	14,060,073	13,837,498

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The fixed assets represent the assets involved in the service providing of supply of water and collection of sewage in 352 municipalities. In the other municipalities, which were negotiated by financial economic appraisal, described in the item above, SABESP holds the possession of the assets.

In 2007, one hundred and seventy four (174) concession contracts expired, 106 of which signed the program contracts and the remainder are in the final stage for formalizing procedures. The net book value of the property, plant and equipment used in the municipalities where the concessions are in the final stage for formalizing procedures or will expire in 2008 totaled R\$2,02 billion.

In 2007, the depreciation charges of these municipalities were R\$79,713.

The concession contracts provide for the assets to be returned to the concession grantor at the end of the term by means of an indemnity at the net book value or fair value in accordance with what is stipulated in each contract. In the program contracts, the indemnity will correspond to the present value of the cash flow in the remaining period on the date the services are resumed, monetarily restated, plus interest to the date of the effective payment.

**(a) Depreciations**

Depreciation is calculated based on the following annual rates: - buildings 4%, interceptors and networks 2%, furniture, fixtures and equipment 10%, water meters 10%, vehicles 20%, hardwares 20%, building connectors 5% and office furniture 10%.

**(b) Disposals of property, plant and equipment**

The Company wrote-off property, plant and equipment in the amount of R\$ 68,568, R\$ 54,350, and R\$ 19,051 in 2007, 2006 and 2005, respectively. Of these losses, R\$14,247, R\$ 21,348 and R\$ 9,879 in 2007, 2006 and 2005, respectively, were related to the obsolescence, theft or disposal of assets in use. The remaining balances of losses, of R\$ 54,103, R\$ 26,459 and R\$ 9,172 were related to the write-off of construction in progress projects which were determined to be no longer economically feasible.

**(c) Capitalization of interests and financial charges**

The Company capitalized interests and monetary variation, including foreign currency exchange variation, to property, plant and equipment in the amount of R\$ 13,338 for the year ended on December 31, 2007 (2006 - R\$ 5,784), during the period in which the related assets were under construction.

**(d) Construction in Progress**

Construction in progress primarily related to new projects and operating improvements, are as follows:

2007	2006
------	------

Water systems:		
Networks and connections	178,977	227,360
Transmission	22,281	29,626
Water treatment	71,375	80,130
Sub-transmission	225,646	188,342
Production and storage	160,602	126,519
Other	75,135	56,669
Total water systems	734,016	708,646
Sewage systems:		
Collection	710,960	1,133,958
Treatment	179,604	187,047
Others	128,056	133,440
Total sewage systems	1,018,620	1,454,445
Others	3,737	5,922
Total	1,756,373	2,169,013

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**

**NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

Estimated disbursements relating to construction works already contracted are estimated to be approximately R\$ 2,050 million for fiscal years from 2008 to 2015 (unaudited).

(e) Expropriations

Development of major water and sewage systems frequently requires the expropriation or establishment of rights of way through third-party properties. The owners of these properties are generally compensated either through negotiated settlements or judicial arbitration.

Disbursements to be effected as from fiscal year 2007 are estimated to be approximately R\$ 472 million (unaudited), which will be paid out of Company funds. The related assets acquired as a result of these negotiations are recorded as property, plant and equipment when the expropriation is complete. In 2007, the amount referring to expropriations was R\$ 16,813 (2006 - R\$ 8,385).

(f) Assets in guarantee

At December 31, 2007 and 2006, the Company had assets in the amount of R\$ 249,034 provided as guarantee under the Special Tax Debt Refinancing Program - PAES (Note 12).

Additionally, three of the Company's real estate properties, in the amount of R\$ 60,539, was pledged as guarantee for financing together with the International Bank for Reconstruction and Development - Bird (note 10). The last installment of this financing was paid in April, 2007 and the real estate properties are waiting for the Federal Government release.

(g) Non-operating assets

The Company had R\$ 26,479 at December 31, 2007 and 2006 referring to other non-operating assets given as free leases, comprised primarily of lands surrounding reservoirs.

(h) Revaluation

Property, plant and equipment items were revalued in 1990 and 1991 and are depreciated at annual rates that correspond to their remaining useful lives determined in the related reports, which, as general rule, fall into the periods of the rates presented above.

As allowed by CVM Instruction No. 197/93, the Company did not recognize a provision for the deferred tax effect on the appreciation arising from the revaluation of property, plant and equipment in 1990 and 1991. Should income and social contribution taxes be recognized on the revaluation reserve, the unrealized amount as of December 31, 2007 would total R\$400,606 (2006 - R\$430,375). The amounts of R\$87,670 and R\$102,272 of the revaluation reserves were realized in the years ended December 31, 2007 and 2006, respectively.

(i) Totally depreciated assets

On December 31, 2007 the book value of fully depreciated assets which are still in use is R\$ 606,142 (2006 - R\$ 426,659).

#### 9. INTANGIBLE ASSETS

In the period between 1999 and 2006, the negotiations for new concessions were conducted on the basis of the economic and financial results of the transaction, determined in an appraisal report issued by independent experts.

The amount determined in the respective contract, after the transaction is closed with the municipal authorities, with payment through Company shares or in cash, is recorded in this account and amortized over the period of the related concession (usually 30 years). As of December 31, 2007 and 2006 there were no amounts pending related to these payments to the municipalities.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The net disclosed amount refers to the assumption of the following municipalities:

Municipalities	Year ended December 31,	
	2007	2006
Agudos	7,773	7,538
Bom Sucesso do Itararé	350	338
Campo Limpo Paulista	15,269	11,811
Conchas	3,541	2,250
Duartina	1,589	1,462
Estância de Serra Negra	15,124	13,255
Itapira	16,123	14,729
Itararé	5,784	5,554
Marabá Paulista	1,603	444
Miguelópolis	4,431	4,083
Osasco	288,025	269,068
Paraguaçu Paulista	14,418	14,166
Paulistânia	154	150
Sandovalina	2,384	215
Santa Maria da Serra	1,147	1,090
São Bernardo do Campo	237,463	237,459
Várzea Paulista	13,250	11,999
Total	628,428	595,611
Less accumulated amortization	(120,639)	(100,493)
Concession assets, net	507,789	495,118

Amortization expense related to intangible concession rights was R\$ 20,147, R\$ 20,030 and R\$ 19,617 for the years ended December 31, 2007, 2006 and 2005, respectively. Amortization expense for the next five years is estimated to be approximately R\$ 20,000 per year.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## 10 - LOANS AND FINANCING

	2007			2006			Guarantees	Final Maturity Date	Annual interest rate	Adjusted to in
	Current	Non Current	Total	Current	Non Current	Total				
In local currency: Banco do Brasil							State of S. Paulo Government and Own Funds			
Debtures 5th Issue	238,194	1,642,644	1,880,838	215,723	1,854,042	2,069,765		2014	8.50%	U
Debtures 6th Issue	-	-	-	46,038	-	46,038		2007	10.65%	IG
Debtures 7th Issue	-	427,657	427,657	231,813	397,165	628,978		2010	11%	IG
Debtures 8th Issue	-	312,362	312,362	-	304,350	304,350		2010	CDI+1.5% / 10.8%	IG
Caixa Econômica Federal FIDC - SABESP I	-	737,438	737,438	-	709,815	709,815		2011	CDI+1.5% /	IG
National Bank for Economic and Social Development - BNDES	58,267	490,904	549,171	49,648	477,628	527,276	Own Funds	2008/2022	5% to 9.5%	U
Other Accrued Interest and	55,555	125,000	180,555	55,555	180,556	236,111	Own Funds	2011	CDI + 0.70%	U
	41,904	165,689	207,593	31,515	154,043	185,558	Own Funds	2013	3% + TJLP LIMITE 6%	U
	3,146	18,753	21,899	2,791	23,136	25,927		2009/2011	12% / CDI /TJLP + 6%	U
	93,398	32,036	125,434	99,252	20,891	120,143				

financial  
charges

490,464 3,952,483 4,442,947 732,335 4,121,626 4,853,961

In foreign  
currency:

Eurobonus:

US\$ 238,052  
thousand (2006

-US\$

238,052

thousand)

173,680

247,982

421,662

-

508,955

508,955

2008/2016

12% /  
7.5%

Interamerican

Development

Bank (IDB):

US\$

432,099

thousand

(2006-US\$

435,867

thousand)

64,764

700,613

765,377

99,930

831,952

931,882

Federal  
Government

2016/2025

3.00% to  
5.61%

International

Bank for

Reconstruction

and

Development -

BIRD ( World

Bank ): (2006-

US\$ 2,223

thousand)

-

-

-

4,752

-

4,752

Federal  
Government

2007

5.15%

JBIC - Yens

2,654,422

(2006-Yens

652,814)

-

42,043

42,043

-

11,721

11,721

Federal  
Government

2029

1.8% /  
2.5%

Accrued

Interest and

financial

charges

13,206

-

13,206

15,458

-

15,458

251,650

990,638

1,242,288

120,140

1,352,628

1,472,768

Total loans and

financing

742,114

4,943,121

5,685,235

852,475

5,474,254

6,326,729

Exchange rate at December 31, 2007: US\$ 1.7713; Yens 0.015839 - (2006 - US\$ 2.1380; Yens 0.017954) .

During 2007, the Company did not contract any short-term loans and financing.



**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## (a) Banco do Brasil

In March 1994, existing loan agreements with Caixa Econômica Federal were refinanced and the loan rights were transferred by that financial institution to the Federal Government, with Banco do Brasil acting as an agent. Under the terms of the agreement signed with the Federal Government, charges and payments are made on the Price amortization system, indexed monthly to the Standard Reference Unit (UPR), which is equal to the Government's benchmark Interest Rate (TR), plus interest 8.5% per year. Interest and principal are payable monthly, with final maturity in 2014. This financing is guaranteed by the State of São Paulo Government's revenue and by the Company's own revenues.

## (b) Debentures

(i) 5<sup>th</sup> Issue

On April 1, 2002 the Company made a public placement for the 5<sup>th</sup> issue of simple, book-entry, registered, unsecured, non-convertible debentures, with face value of R\$ 10. The amount of the 2<sup>nd</sup> issue is monthly changed, due to its characteristics, in accordance with the indenture.

40,000 debentures were issued, distributed in two series, as follows:

	1 <sup>st</sup> Series	2 <sup>nd</sup> Series
Placement date	05/16/2002	05/16/2002
Number	31,372	8,628
Face value of Issue	R\$ 313,720	R\$ 86,280
Original yield	CDI + 1.85% per year Quarterly, except for last	IGP-M + 13.25% per year Annual, except for last
Interest payments	installment on 03/01/2007 3 installments on 04/01/2005,	installment in 03/01/2007 3 installments on 04/01/2005,
Amortization	04/01/2006 and 03/01/2007	04/01/2006 and 03/01/2007

The interest rates for the two series were renegotiated for the last time in April 2005, whereby the rate for the 1<sup>st</sup> Series was changed from CDI (Interbank Deposit Certificate) + 2.0% per year to CDI + 1.1% per year, and the rate for the 2<sup>nd</sup> Series was changed from IGPM + 12.7% per year to IGPM (General Market Price Index) + 10.65% per year, in effect until the agreement conclusion.

Interest expense was R\$0, R\$ 10,991 and R\$ 45,015 in 2007, 2006 and 2005, respectively relating to the 1<sup>st</sup> Series, and R\$ 837, R\$ 6,089 and R\$ 11,584, respectively, relating to the 2<sup>nd</sup> Series.

On April 19, 2006, the Company made the anticipated settlement of the 5<sup>th</sup> issue of debentures, 1<sup>st</sup> series which maturity was scheduled for March 2007, through the use of part of the resources obtained from the funding of the

Investment Fund in Credit Rights SABESP I - FIDC, in the amount of R\$ 106,373.

On March 1, 2007, the 2nd series of this issue was paid in full.

(iii) 6th Issue

On September 17, 2004, the Company registered with the CVM a securities program in the total amount of R\$ 1,500,000. As part of such program, on September 1, 2004 the Company issued 600,000 non-convertible debentures, distributed in three series, without renegotiation with face value of R\$ 1, totaling R\$ 600,000. The date of the financial settlement of the transaction was September 21, 2004 for the 1<sup>st</sup> series, and September 22, 2004, for the 2<sup>nd</sup> and 3<sup>rd</sup> series.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The debentures were placed on the market as follows:

	Amount	Adjustment	Interest	Interest payment	Amortization	Maturity date
			CDI+1.75%			
1 <sup>st</sup> Series	231,813	-	p.a.	Semiannual	Single payment	Sep/2007
2 <sup>nd</sup> Series	188,267	IGP-M	11% p.a.	Annual	Single payment	Sep/2009
3 <sup>rd</sup> Series	179,920	IGP-M	11% p.a.	Annual	Single payment	Sep/2010

Interest expense was R\$ 21,708, R\$ 38,054 and R\$ 46,481 in 2007, 2006 and 2005, respectively, relating to the 1<sup>st</sup> series; R\$ 23,290, R\$ 21,932 and R\$ 21,420, respectively, relating to the 2<sup>nd</sup> series, and R\$ 22,258, R\$ 20,960 and R\$ 20,470, respectively, relating to the 3<sup>rd</sup> series. Remaining accrued interest balances to be paid in the amount of R\$7,366 (2006 - R\$ 6,841 and 2005 - R\$ 6,757) for the 2<sup>nd</sup> series, and R\$ 7,040 (2006 - R\$ 6,538 and 2005 - R\$ 6,458) for the 3<sup>rd</sup> series. Such amounts are recorded under Loans and financing in current liabilities.

On September 3, 2007, the 1<sup>st</sup> series was paid integrally.

(iv) 7<sup>th</sup> Issue of Debentures

Within the program registered together with the CVM on September 17, 2004, the Company issued, in March 1, 2005, 300,000 non-convertible debentures, distributed into two series, without renegotiation, at the par value of R\$ 1, totaling R\$ 300,000. The date of the financial settlement was March 14, 2005.

The debentures were placed in the market as follows:

	Amount	Adjustment	Interests	Interest Payment	Amortization	Maturity Date
			CDI +			
1 <sup>st</sup> series	200,000	-	1.5%p.a.	Semiannual	Single payment	Mar/2009
			10.80%			
2 <sup>nd</sup> series	100,000	IGP-M	p.a.	Annual	Single payment	Mar/2010

Interest expense was R\$ 26,159, R\$ 32,305 and R\$ 33,378 in 2007, 2006 and 2005, respectively, relating to the 1<sup>st</sup> series; and R\$ 11,974, R\$ 11,162 and R\$ 9,013, respectively, relating to the 2<sup>nd</sup> series. Remaining accrued interest balances to be paid, in the amount of R\$ 7,788 (2006 - R\$9,304 and 2005 - R\$ 12,631) for the 1<sup>st</sup> series and R\$ 9,975 (2006 - R\$ 9,218 and 2005 - R\$ 9,013) for the 2<sup>nd</sup> series, are recorded under Loans and financing in current liabilities.

(v) 8<sup>th</sup> Issue of Debentures

In completion to the program registered at the CVM on September 17, 2004 the Company issued, on June 1st, 2005, 700,000 non-convertible debentures, using the option to increase the quantity of debentures allowed up to 20%, according to the paragraph 2 of article 14 of the CVM inscription nr. 400/03, distributed in two series, without renegotiation, at par value of R\$ 1, amounting to R\$ 700,000. The settlement date of the financial operation was June 24, 2005. The amount received has been destined to the settlement of the Eurobonds contract.

The debentures were placed in the market as follows:

	Amount	Adjustment	Interests	Interest Payment	Amortization	Maturity Date
1 <sup>st</sup> series	350,000	-	CDI+1.5% p.a.	Semiannual	Single payment	Jun/2009
2 <sup>nd</sup> series	350,000	IGP-M	10.75% p.a.	Annual	Single payment	Jun/2011

Interest expense was R\$ 45,744, R\$ 56,385 and R\$ 41,028 in 2007, 2006 and 2005, respectively, relating to the 1<sup>st</sup> series, and R\$ 40,496, 37,953 and R\$ 21,420, respectively, relating to the 2<sup>nd</sup> series. Remaining accrued interest

balances to be paid, in the amount of R\$ 3,187 (2006 - R\$ 3,668 and 2005 - R\$ 5,341) for the 1<sup>st</sup> series, and R\$ 23,444 (2006 - R\$ 21,773 and 2005 - R\$ 21,420) for the 2<sup>nd</sup> Series, are recorded under Loans and financing in current liabilities.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

Financial covenants of the 6<sup>th</sup>, 7<sup>th</sup> and 8<sup>th</sup> issue of debentures

- Adjusted current ratio (current assets divided by current liabilities, excluding from the current liabilities the short-term portion of the long-term debts undertaken by the Company) over 1.0.
- EBITDA/Financial Expenses equal to or less than 1.5.
- Non-compliance with these obligations will not be evidenced unless if recorded in quarterly financial statements, for at least two consecutive quarters, or for two non-consecutive quarters within a period of twelve months.

(c) Caixa Econômica Federal

Pro-Sanitation Program

(i) Water and sewage agreements

From 1996 through 2004, the Company entered into several loan agreements under Pro-Sanitation Program, with a view to expanding and improving the water supply and sewage systems of several municipalities of the State of São Paulo and of the City of São Paulo. The loans are collateralized by collections of the daily billings from water supply and sewage services up to the total amount of the debt.

Contractually established repayment terms range from 120 to 180 months, from the date the related projects become operational.

The balance at December 31, 2007 is R\$ 527,669 (2006 - R\$ 506,221), being the amount to use from these contracts of R\$ 396,221.

Contract charges are as follows:

	Contract executed in:		
	1996	1997	1998 - 2004
Interest rates	9.5% p.a.	6.5% to 8.0% p.a.	6.5% to 8.0% p.a.
In the grace period:			
Risk fee	1.0%p.a. on disbursed amount	1.0%p.a. on disbursed amount	0.6% p.a. or 2% p.a. on outstanding balance
Management fee	0.12% p.m. on contract value	2.0% p.a. on disbursed value	1.0% p.a. on disbursed value or 2% p.a. on outstanding balance for agreements executed in 2003-2004.

In the repayment stage:

Management fee	Difference between calculation of installment at the rate of 10.5% p.a. less rate of 9.5% p.a.	1.0% p.a. on outstanding balance	1.0% p.a. on outstanding balance
----------------	--	----------------------------------	----------------------------------

(ii) Pro-sanitation Program - Pró-Sanear

In 1997 and 1998 contracts were signed under the Pro-Sanitation - Pró-Sanear program for the improvement of water and sewage services in several municipalities of the Metropolitan Region of São Paulo, with the participation of the communities receiving the services. The loans are collateralized by collections of the billings from water supply and sewage services up to the total amount of the debt. Contractually established repayment terms are 180 months from the date the related projects become operational. Outstanding loan balances at December 31, 2007 and 2006 were R\$ 21,502 (2006 - R\$ 21,055), being the amount available for use from these loans for projects already in progress of R\$ 8,676.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

Applicable financial charges:

Interest rate - 5.0% p.a.;

Management fee (Grace period) - 2.0% p.a. on outstanding balance;

Management fee (amortization stage) - 1.0% p.a. on outstanding balance;

Risk fee (grace period) - 1.0% on disbursement.

Financial covenants:

- Under the Performance Improvement Agreement, goals are set for financial indexes (operating margin, personnel expense margin and revenue evasion index) and operating indexes which, based on the previous 2 years, are annually projected for the next 5 years.

(d) BNDES

Agreement 01.2.619.3.1 - Executed in August 2002, in the total amount of R\$ 60,000, with the purpose of financing part of the Company's counterparty in the performance of the Tietê River Depolluting Project - Stage II, object also of loan agreement no. 1212/OC - BR, with the Interamerican Development Bank - IDB. The related project is in the execution stage and the outstanding balance at December 31, 2007 was R\$ 51,896 (2006 - R\$ 46,389).

Onlending agreement 10/669.748 -6, in the total amount of R\$ 180,000, distributed among the financial agents in the following proportions:

Agent	Amount
Unibanco - União de Bancos Brasileiros S.A.	60,000
Banco BBA Creditanstalt S.A.	51,000
Banco Alfa de Investimento S.A.	39,000
Banco Itaú S.A.	30,000
Total	180,000

The related project is in the execution stage, the total amount disbursed the outstanding balance at December 31, 2007 was R\$ 155,697 (R\$ 139,169 in 2006). The onlending agreement funds are passed on from BNDES to the financial agents, and by the agents to the Company. The onlending agreement has the same purpose as the agreement entered into between BNDES and the Company, and the charges and amortization terms are equal for both, being:

Interest - Long-Term Interest Rate (TJLP) limited to 6% p.a., plus a spread of 3% per annum, payable quarterly during the grace period, and monthly in the repayment period. The portion of the TJLP that exceeds 6% p.a. shall be

incorporated into the outstanding balance.

Monthly principal repayments began in September 2005, with final maturity in February 2013. The agreements are collateralized by part of the revenue from water and sewage services.

Financial covenants:

- Adjusted current ratio: over 1.0;
- EBITDA / ROL: equal or higher than 38%;
- Total connections (water and sewage) / own employees: equal to or higher than 520;
- EBITDA / Debt Service: equal to or higher than 1.5;
- Shareholders Equity / Total Liabilities: equal to or higher than 0.8.

F-32

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## (e) FIDC

On March 23, 2006 a single series of senior quotas and 26 (twenty six) subordinated quotas were issued, kept in deposit account in name of their respective holders, with unit value at the date of issuance corresponding to R\$500,000 (five hundred thousand reais). The senior quotas are being amortized in 54 (fifty four) monthly installments, beginning on October 2006 and with final maturity in 2011. On December 31, 2007 the balance related to the subordinated quotas was R\$ 16,121 (2006 R\$ 14,316), recorded as Other Accounts Receivable in non current assets; the balance related to the senior quotas was R\$ 180,555 (2006 R\$ 236,111) recorded as Loans and Financing. The subordinated quotas were underwritten and paid up exclusively by SABESP. The fund has a profitability parameter corresponding to 100% (one hundred per cent) over the DI rate, added by a pre-fixed coupon of 0.70% (seventy centesimal points per cent) interest per year, based on 252 working days, observed the terms of its regulation.

The Fund is managed by Caixa Econômica Federal and has as custody and underwriting agent Banco do Brasil S.A.

The resources obtained, in the amount of R\$ 250 million, were used by the Company for the settlement of debts during the year 2006.

## (f) Eurobonds

(i) In June 2003, the Company issued US\$ 225 million 12% Notes due 2008. Interest is payable semiannually with final maturity in June 2008. The Bank of New York acted as lead arranger and The Bank of Tokyo Mitsubishi Ltd. as principal paying agent. These funds were used for final settlement of the Eurobonds issue of US\$ 200,000 thousand matured in July 2003.

On November 6, 2006, the Company settled in advance part of this loan, in the amount of R\$272,811, with funds raised through the issue of Eurobonds in the amount of US\$140 million.

(ii) On November 3, 2006 an issue of Eurobonds took place (Eurobonds 2016) in the foreign market in the amount of US\$140,000 thousand, having as leader Deutsche Bank Trust Company Americas and as principal paying agent Deutsche Bank Luxembourg S.A., with interest rate of 7.5% p.a. paid semi-annually and with final maturity in November 2016. As mentioned in (i) above, the resources were used for the advanced and partial settlement of the issue of Eurobonds of US\$225,000 thousand with final maturity in June 2008, and the redeemed amount was US\$126,948 thousand.

Due to the payment in advance of Eurobonds 2008, an amendment to the loan agreement was signed cancelling the mandatory calculation of covenants.

Financial Covenants - for Eurobonus 2016.

Limiting the incurrence of new debt in such a way that:

- the total adjusted indebtedness in relation to Ebitda shall not be higher than 3.65

- the Company's debt service coverage ratio determined in the date of incurrence shall not be less than 2.35.

(g) Inter-American Development Bank (IDB)

Agreement 229 - In June 1987, the Company signed a loan agreement with the IDB for US\$ 163 million destined to the execution of a sewage program in the São Paulo Metropolitan Region. Semiannual principal repayments began in January 1994, with final maturity in July 2007. The loan bears interest of 7.7% per annum. A guarantee agreement between the Federative Republic of Brazil and the IDB was executed in June 1987, to warrant the provision of funds to meet the obligations set forth in the financing agreement. The last installment was paid on July, 2007.

Agreement 713 - In December 1992, the Company signed a loan agreement with the IDB for US\$ 400 million destined to the execution of the Tietê River Clean-up Project - Stage I. Semiannual principal repayments began in June 1999, with final maturity in December 2017. The loan bears interest at variable rate based on the cost of funding to the IDB. A guarantee agreement between the Federative Republic of Brazil and the IDB was executed in December 1992, to warrant the provision of funds to meet the obligations set forth in the financing agreement. The outstanding balance of such agreement on December 31, 2007 was US\$ 224,688 thousand, equivalent to R\$ 397,990 (2006 - R\$ 507,974).

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

Agreement 896 - In December 1992, the Company signed an additional loan agreement with the IDB for US\$ 50 million for the Tietê River Clean-up Project - Stage I. This loan bears interest at 3.0% per annum. Semiannual principal repayments began in June 1999, with final maturity in December 2016. A guarantee agreement between the Federative Republic of Brazil and the IDB was executed in December 1992, to warrant the provision of funds to meet the obligations set forth in the financing agreement. The outstanding balance of such agreement at December 31, 2007 was US\$ 25,000 thousand, equivalent to R\$ 44,282 (2006 - R\$ 59,389).

Agreement 1.212 - In July 2000, the Company signed a loan agreement with the IDB for US\$ 200 million to finance the Tietê River Clean-up Project - Stage II. The related project is in the execution stage, the total amount disbursed in 2007 having been US\$ 33,664 thousand and the amount available for use from these loans is US\$ 2,434 thousand. The loan will be repaid in semiannual installments and the last one is in July, 2025. The loan bears interest semiannually, on the daily outstanding balance, at the annual rate determined in accordance with the costs of loans borrowed by the bank in the previous semester, plus a spread, being variable for each semester. The outstanding balance of such agreement at December 31, 2007 was US\$ 182,411 thousand, equivalent to R\$ 323,105 (2006 - R\$ 336,625).

## Financial covenants

- Agreements 713, 896 and 1.212 - Tariffs must: a) produce enough revenue to cover the system operating expenses, including those related to management, operation, maintenance and depreciation; b) ensure profitability on property, plant and equipment of not less than 7%. During the performance of the project the outstanding balances of short-term loans must not exceed 8.5% of the Company's shareholders' equity.

## (h) International Bank for Reconstruction and Development - BIRD

Agreement 3.504 - Aiming at transferring the funds of the agreement executed between the State of São Paulo and the BIRD in December 1992 and destined to the execution of the environmental clean-up of the Guarapiranga Basin, an onlending agreement between the State of São Paulo and the Company was executed in March 1993. In December 1992, a guarantee agreement was executed between the Federal Republic of Brazil and the BIRD, to warrant the provision of funds to meet the obligations set forth in the financing agreement. Semiannual principal repayments began in October 1997, and the last installment was paid on April, 2007.

## (i) Japan Bank For International Cooperation ( JBIC )

On August 6, 2004, the Company executed a financing agreement with the JBIC - Japan Bank for International Cooperation, guaranteed by the Federal Government, in the amount of 21,320 million Japanese Yens, equivalent to approximately R\$ 337,687, which is intended for the Environment Recovery Program for the Metropolitan Region of Santos Coastal Area. The total term of the financing agreement is 25 years, comprising 18 years for amortization in semiannual installments and 7 years for grace period. Interests is being paid semiannually beginning in 2006 at the rate of 2.5% p.a. for the sewage network and 1.8% p.a. for sewage treatment facilities. The outstanding balance of this contract in December 31, 2007 was R\$ 42,043 (2006 - R\$11,721).

## (j) Financial Commitments - Covenants

At December 31, 2007 and 2006, the Company was in compliance with all debt covenants and, consequently, the balances of the loans and financings are duly classified between short and long term, in accordance to the contracts.

F-34

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## (k) Maturity dates of loans and financing

	2008	2009	2010	2011	2012	2013	2014 onward	Total
In local currency	490,464	1,208,383	787,837	831,493	447,961	445,678	231,131	4,442,947
In foreign currency	251,650	64,764	64,764	65,900	67,037	67,037	661,136	1,242,288
Total	742,114	1,273,147	852,601	897,393	514,998	512,715	892,267	5,685,235

## 11. TAXES AND CONTRIBUTIONS

Income tax and social contribution (a federally mandated tax based on income) are accrued on taxable results at the applicable tax rates, generally 25% for income tax and 9% for social contribution tax (34% composite rate).

## (a) Reconciliation of the effective tax rate

The amount recorded as income tax and social contribution expenses in the financial statements is reconciled from the nominal rates provided by law, as shown below:

	2007	2006	2005
Income before taxes on income	1,480,271	1,189,805	1,217,148
Statutory rate	34%	34%	34%
Tax expense at statutory rate	(503,292)	(404,534)	(413,830)
Permanent differences			
Realization of revaluation reserve	(29,808)	(34,772)	(30,413)
Interest on shareholders' equity	102,253	92,086	118,393
Other differences	(721)	(28,558)	9,471
Income and social contribution taxes	(431,568)	(375,778)	(316,379)
Current Income and social contribution taxes	(543,345)	(383,123)	(343,426)
Deferred Income and social contribution taxes	111,777	7,345	27,047
Effective rate	29%	32%	26%

## (b) Composition of deferred taxes and social contributions

In current assets:	2007	2006
Provision for contingencies	108,792	7,078
Tax loss carryforwards	-	-
	108,792	7,078
In long-term assets:		
Provision for contingencies	225,697	226,265
Provision for pension obligations	121,039	106,097
Other	10,490	10,292
	357,226	342,654
Total deferred tax assets	466,018	349,732
In current liabilities:		
Revenue from public entities	75,249	76,359
In non current liabilities		
Profit for governmental agencies	86,487	81,978
Revenue for governmental agencies	73,378	64,923
	159,865	146,901
Total deferred tax liabilities	235,114	223,260

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## (i) In current assets

Mainly calculated on temporary differences in the amount of R\$ 319,977 (2006 - R\$ 20,819).

## (ii) In long-term assets

Mainly calculated on temporary differences in the amount of R\$ 1,043,388 (2006 - R\$ 1,000,985) related to income tax and R\$ 1,070,876 (2006 - R\$ 1,026,756) related to social contribution.

As per a technical feasibility study, the temporary differences mentioned in items (i) and (ii) are likely to be realized in 2008 and 2009.

## (iii) In current liabilities

Substantially calculated on amounts invoiced to government agencies, with taxes being deferred upon receipt of the invoices.

## (iv) In non current liabilities

-Income tax and social contribution

Substantially calculated based on temporary differences in the amount of R\$ 267,636 (2006 - R\$ 254,376) relating to income tax and R\$ 217,530 (2006 - R\$ 204,269) relating to social contribution.

- Pasep e Cofins

Substantially calculated on amounts invoiced to government agencies, which are accrued for when services are rendered and which are paid when the related amounts are effectively received by the Company.

## 12. TAXES PAYABLE

	Current		Non Current	
	2007	2006	2007	2006
Income tax	4,420	-	-	-
Social contribution	5,331	-	-	-
COFINS and PASEP	41,629	38,142	-	-
Paes	43,918	41,897	197,635	230,440
Inss	20,072	18,230	-	-
Other	12,365	7,283	-	-

Total	127,735	105,552	197,635	230,440
-------	---------	---------	---------	---------

The Company applied for enrollment in the Special Tax Debt Refinancing Program ( PAES ) on July 15, 2003 in accordance with Law No. 10,684 of May 30, 2003, in which the Company included certain tax liabilities related to COFINS and PASEP, debts involved in a lawsuit brought against the enforcement of Law No. 9718/98, and consolidated the previously outstanding balance of tax liabilities included under the Tax Recovery Program ( REFIS ). The total amount of tax liabilities included in the PAES was R\$ 316,953, as follows:

Tax	Principal	Fine	Interest	Total
Cofins	132,499	13,250	50,994	196,743
Pasep	5,001	509	2,061	7,571
Refis	112,639	-	-	112,639
Total	250,139	13,759	53,055	316,953

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The PAES obligation is being paid in 120 months. The amounts paid in 2007, 2006 and 2005 were of R\$ 43,002, R\$ 40,824 and R\$ 37,986, respectively, and financial expenses were recorded in the amount of R\$ 12,218, 17,646 and R\$ 24,852, respectively. The outstanding balance in December 31, 2007 was R\$ 241,553 (2006 R\$ 272,337). Assets pledged as guarantee under the previous REFIS Program, in the amount of R\$ 249,034, continue to secure amounts under the PAES Program.

**13. PENSION AND HEALTH BENEFIT PLANS****(a) Health benefit plan**

Managed by Fundação SABESP de Seguridade Social - SABESPREV, the plan is comprised of free-election health benefit plans, funded by contributions from the sponsor and the participating employees, which were the following in the year:

Company: average of 7.2% (2006 - 7.0%) on the payroll;

Participating employees: 3.21% of base salary and bonus, corresponding to 2.3% of the gross payroll, on average.

**(b) Pension benefits**

Managed by Fundação SABESP de Seguridade Social - SABESP, the defined benefit pension plan is supported by monthly contributions as follows: 2.10% from the Company and 2.3% from the participating employees. In order to meet the provisions of CVM Resolution No. 371, of December 13, 2000, below is a description of the amounts of pension and retirement benefits paid granted and payable, to which the employees will be entitled after their service time.

Based on independent actuarial reports (Assistants - Assistants Assessoria, Consultoria e Participações Ltda.) at December 31, 2007, calculated in conformity with the Projected Unit Credit Method, the Company had a net actuarial liability of R\$ 365,234 (R\$ 321,212 in 2006), representing the difference between the present value of the Company's liability to the participating employees, retired employees, and pensioners, of the related assets, as shown below:

(i) Reconciliation of assets and liabilities	2007	2006
Present value of actuarial liabilities	(1,386,563)	(1,096,219)
Fair value of plan assets	969,440	812,909
Gains to be recognized in future years	51,889	(37,902)
Net actuarial liability	(365,234)	(321,212)
Net liability recognized in the balance sheet	(365,234)	(321,212)

(ii) Expenses recognized in the statements of income	2007	2006
Current service cost	33,440	17,545
Interest cost	131,848	93,270
Expected return on plan assets	(96,439)	(83,065)
Amortization (gain)/loss	-	(9,508)
Employee contributions	(12,925)	(15,411)
Amortization of past service cost	-	53,214
Total	55,924	56,045

F-37

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

(iii) Changes in net actuarial liabilities	2007	2006
Present value of the net actuarial liability in the beginning of the year	(321,212)	(276,558)
Current service cost	(33,440)	(17,545)
Interest cost	(131,848)	(93,270)
Expected return on plan assets	96,439	83,065
Amortization (gain)/loss	-	9,508
Employee contributions	12,925	15,411
Amortization of past service cost	-	(53,214)
	(377,136)	(332,603)
Actual contributions by the Company in the year	11,902	11,391
Present value of net actuarial liability at the end of the year	(365,234)	(321,212)
(iv) Reconciliation of changes in the present value of assets	2007	2006
Fair value of plan assets in the beginning of the year	812,909	678,185
Actual return on plan assets	183,748	138,444
Actual contributions in the year	24,827	26,802
Benefits paid	(52,044)	(30,522)
Fair value of plan assets at the end of the year	969,440	812,909
(v) Reconciliation of changes in the present value of liabilities	2007	2006
Present value of liabilities in the beginning of the year	1,096,219	790,552
Current service cost	33,440	17,545
Interest cost	131,848	93,270
Benefits paid	(52,044)	(30,522)
Loss (gain) in the present value of liabilities	177,100	225,374
Present value of liabilities at the end of the year	1,386,563	1,096,219

(vi) Estimated expenses	2008	2007
Current service cost	33,347	33,440
Interest cost	164,124	131,848
Expected return on plan assets	(117,317)	(96,439)
Amortization (gain)/loss	-	-
Employees contributions	(13,025)	(12,925)
Amortization of past service cost	-	-
Total	67,129	55,924

## (vii) Actuarial assumptions

Several statistical and other factors that attempt to project future events are used in calculating the expense and liability related to the plans. These factors include assumptions about the discount rate, expected return on plan assets and the rate of future salary increases as determined by the Company, within certain internal guidelines. In addition, the actuary also uses subjective factors such as termination, turnover and mortality rates to estimate these factors. The actuarial assumptions used by the Company are reviewed on a regular basis and may differ materially from actual results due to changing market and economic conditions, regulatory events, judicial rulings, higher or lower termination/withdrawal rates or longer or shorter life spans of participants. Such differences may result in a significant impact on the amount of pension expense recorded by the Company.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The assumptions used for the actuarial valuation were as follows:

Economic assumptions	2007	2006
Discount rate	10.85% p.a.	12.32% p.a.
Expected rate of return assets	10.85% p.a.	12.06% p.a.
Future salary increases	6.08% p.a.	6.08% p.a.
Growth in social security benefits and limits	4.00% p.a.	4.00% p.a.
Capacity factor		
- Salaries	98%	98%
- Benefits	98%	98%
Demographic assumptions for	2007	2006
Mortality table	AT 83	AT 83
Disabled mortality table	RRB 44	RRB 1944
Disability entry table	RRB 44	Modified RRB 1944
Turnover table	Prudential	Prudential
Retirement age	First age with entitlement to one of the benefits	First age with entitlement to one of the benefits
% active participants married at time of retirement	95%	95%
Age difference between participants and their spouses	Wives are 4 years younger than husbands	Wives are 4 years younger than husbands

For the 2007 actuarial valuation, to conform the study to the current long-term economic circumstances, the Company changed its discount rate to 10.85% per year, from 12.32% per year as a result of an interest rate of 6.59%, plus an annual inflation rate of 4%.

The number of active participants at December 31, 2007 and 2006 was 15,881 and 16,681 respectively. The number of inactive participants at December 31, 2007 and 2006 was 4,245 and 3,692 respectively.

The evaluation of SABESPREV costing plan is made by an independent actuarial expert (Assistants), based on different assumptions than those adopted for purposes of ascertaining benefits to employees, as set forth in CVM Resolution no. 371. SABESPREV's technical deficit at December 31, 2007 is R\$ 319,463 (2006 - R\$ 491,391). The calculation is substantially different as for the actuarial method in calculating risk benefits before retirement, with sharing to SABESPREV and capitalization for the purpose of meeting CVM Resolution no. 371.

As permitted by CVM Resolution No. 371, the Company has elected to amortize the actuarial liability R\$ 266,074 at December 31, 2001 over five years using the straight-line method beginning in 2002. The amortization of the

transition obligation for past service cost is being recorded as an Extraordinary Item , net of tax effects, in the statement of income for the year as follows:

	2007	2006	2005
Extraordinary item	-	53,215	53,215
Deferred income and social contribution taxes	-	(18,093)	(18,093)
Net extraordinary item	-	35,122	35,122
Liabilities on December 31, 2001			266,074
Extraordinary item recorded for the period from 2002 to 2006			(266,074)

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The Sponsor and the SABESPREV are in process of negotiation so that the technical deficit is resolved, by changing from the Defined Benefit Plan to Variable Contribution Plan. Management expects not to incur in additional costs resulting from the change of the referred plans.

**14. PROFIT SHARING AND BONUS**

As a result of negotiations held by the Company with entities representing the employees, a Profit Sharing Program was implemented.

In December 2005 the Company made an advance payment of R\$ 22,906, equivalent to 50% of one month's payroll. The payment of the remainder was made in August 2006 in the amount of R\$ 25,082.

The amount of R\$ 54,128, referring to the period from January through December 2006, was paid in February 2007. The Company paid in November, 2006, a bonus of R\$ 31,035 referring to the performance evaluation for the year 2006.

For 2007 it was considered the period from January to December, 2007, with the payment of the amount corresponding to up to one month's payroll, depending on achievement of targets.

In December 2007, the Company paid an advance of R\$17,361, with the supplementary payment, of R\$ 509 made in April, 2008.

**15. PROVISIONS FOR CONTINGENCIES****(a) Provisions for contingencies:**

The Company is party to a number of claims and legal proceedings arising in the normal course of business, including civil, labor, environmental, tax and other matters. The Company has accrued amounts deemed by its legal advisors and its management to be enough to cover probable losses. As of December 31, 2007 and 2006, these provisions are as follow, in accordance with the nature of the respective cases:

	2007	2006
Customer claims (i)	526,302	273,258
Contractor claims (ii)	174,556	168,547
Other civil claims (iii)	127,890	76,909
Tax claims (iv)	34,491	21,162
Labor claims (v)	61,747	71,213
Environmental claims (vi)	50,075	65,988
Subtotal	975,061	677,077
Escrow deposits	(29,805)	(19,525)

Total, net of escrow deposits	945,256	657,552
Current portion	290,172	2,294
Non current portion	655,084	655,258

F-40

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

Changes to the provision for contingencies for the year ended in December 31, 2007 are demonstrated below:

	December 31, 2006	Additions	Payments	Interests, Monetary Adjustment and Reversals	December 31, 2007
Customer claims	273,258	198,570	(46,408)	100,882	526,302
Contractor claims	168,547	9,838	(14,863)	11,034	174,556
Other civil claims	76,909	36,131	(26,302)	41,152	127,890
Tax claims	21,162	4,477	(3,042)	11,894	34,491
Labor claims	71,213	8,112	(27,102)	9,524	61,747
Environmental claims	65,988	9,827	(34,281)	8,541	50,075
Sub-total	677,077	266,955	(151,998)	183,027	975,061
Escrow deposits	(19,525)	(26,276)	17,031	(1,035)	(29,805)
Total	657,552	240,679	(134,967)	181,992	945,256

## (b) Lawsuits with possible likelihood of loss

The lawsuits in course in administrative and judicial levels, in different courts, where the Company is the contrary party, considered by its legal counsels of possible likelihood of loss, not being, for this reason, provisioned in the financial statements, are distributed as follows:

	2007	2006
Customer claims (i)	709,000	789,300
Contractor claims (ii)	254,100	198,500
Other civil claims (iii)	195,300	141,600
Tax claims (iv)	199,900	104,900
Labor claims (v)	70,400	43,700
Environmental claims (vi)	514,400	192,400
Total	1,943,100	1,470,400

(c) Summary of claims and assessments

(i) Customer claims

Approximately 1,170 lawsuits were filed by commercial customers, which claim that their tariffs should be equal to the tariffs of another consumer category, and therefore claim the refund of the amounts collected by SABESP. The Company was granted both favorable and unfavorable final decisions at several courts, and recognized a provision when the likelihood of loss is considered probable. In 2007, the volume of the lawsuits decisions allowed the management to evaluate the contingency process and based on this evaluation, the Company quantified the lawsuits involving customers, considering the most recent history of favorable and unfavorable court decisions to improve its disbursement estimate. The result of this process evidenced the need to increase the provision by approximately R\$253 million, net of exclusions.

(ii) Contractor claims

Contractors' claims include lawsuits filed by some building companies alleging an underpayment of monetary adjustments, withholding of amounts related to the understatement of official inflation rates after the Real economic plan, and the economic and financial imbalance of the agreements. These lawsuits are in progress at different courts and a reserve is recognized when the likelihood of loss is considered probable. The R\$55,600 increase in lawsuits whose likelihood of loss is considered possible is related to the inclusion of monetary adjustment, interest and fees for the year.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## (iii) Other civil claims

The Company is a party to several civil lawsuits related to indemnities for property damage, pain and suffering, and loss of profits allegedly caused to third parties. As of December 31, 2007, the Company recognized provisions of R\$127,890 (R\$76,909 in 2006) for claims whose likelihood of loss is considered probable. There was an increase both in lawsuits with probable and possible risk of loss, arising from the increase in lawsuits and the review of the expected outcomes, comprising monetary adjustment, interest and fees for the year.

The Association of Distinguished Bars and Restaurants (Associação de Bares e Restaurantes Diferenciados ABREDI), has initiated several lawsuits to challenge the 10.0% penalty fee we charge on late water and sewage payments. In several of these cases, lower courts have dismissed the lawsuits based on the lack of standing by the plaintiff to initiate such a lawsuit. In other cases, the lawsuits were dismissed because a civil public action with respect to the same matter was already being heard at the civil courts of the State of São Paulo. In this civil public action, a decision was granted against us and we appealed against this decision and a final decision is still pending. Notwithstanding these legal proceedings, we have reduced to 2.0% the penalty fee we charge on late bill payments by all of our customers.

The São Paulo State Public Attorney's Office has filed a public civil action against Sabesp, seeking to ensure a water supply in the municipality of Guarujá within accepted levels of potability and in accordance with current legislation. The lawsuit also seeks the company be sentenced to start building ETA (Water Treatment Station), restore fees charged to consumers and pay compensation for moral and property damages caused by allegedly improper water consumption. An injunction was granted and we appealed against such decision. However, the appellate court rejected the appeal. Sabesp has offered a defense and the lawsuit is currently in discovery phase. We have not estimated the disbursement yet for there are no sufficient data to estimate the amounts. We evaluated this demand as a possible loss.

## (iv) Tax Claims

The provision for tax contingencies refers mainly to issues related to tax collections challenged due to differences in the interpretation of legislation by the Company's legal counsel.

In 2006, the Federal Revenue Service, by means of a tax execution, audited the Company's compliance with the tax obligations related to income and social contribution taxes for calendar 2001, and recognized taxes payable in the amount of R\$277 million (R\$298 million adjusted through December 31, 2007). The Company filed a timely objection and will appeal against the tax assessment at administrative level and in courts. According to its legal counsel, the likelihood of loss in approximately 90% of this administrative proceeding is considered remote and 10% possible.

The company filed for a preliminary injunction to challenge the revocation of the exemption from tax service granted by the Municipality of São Paulo, under a City Law enacted in 2002. In April 2003, the exemption request was granted under an injunction determining the suspension of tax payments. In May 2005, the courts issued a decision overruling the injunction. In July 2005, SABESP filed an appeal to ensure the preliminary injunction granted remained in effect. There is no final decision on the lawsuit, and the likelihood of loss is considered possible. Concurrently, on September 18, 2006, the São Paulo Municipal Finance Department issued a tax deficiency notice,

against which the Company filed timely administrative objection, with subsequent rejection of the appeal filed with lower courts, whose involved amount is estimated at R\$70.0 million (R\$120 million as adjusted through December 31, 2007). We evaluated this demand as a possible loss.

The Company filed lawsuits against the Municipalities of Bragança Paulista and São Paulo due to the collection of a charge on the use of public areas to install water and sewage networks used for the water supply and sewage services provided to these municipalities. In the lawsuit filed against the Municipality of Bragança Paulista, the Company was granted a preliminary injunction this charge and preventing the Municipality from collecting any current or future amounts related to such charge until there is a final decision on the merit of the lawsuit. In June 2005, the lower court decided favorably to the Company and the initial remedy was maintained. The Municipality appealed against the decision, which is awaiting judgment by the Court of Appeals. As regards the lawsuit filed against the Municipality of São Paulo, the lower court issued a decision confirming the legality of the municipal charge. The Company filed an appeal and awaits judgment. Subsequently, a new Law was approved to implement the collection of a charge on the use of public areas in the city of São Paulo. In April 2004, the Company filed for an injunction to suspend the collection of the municipal charge. The injunction was granted by the lower court and confirmed when the decision was issued, which recognizes the charge as undue. The Municipality filed an appeal and is awaiting judgment by the Court of Justice. The Company, based on the assessment of its legal advisors, did not recognize any provision for this municipal charge. We evaluated this demand as a possible loss.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

All tax collection proceedings involving the Company and the Municipality of Ferraz de Vasconcelos were reviewed, resulting in an increase of approximately R\$39 million, changing the likelihood assessment from remote to possible. On December 31, 2007, the amount estimated as possible loss is R\$51 million.

## (v) Labor claims

The Company is a party to labor lawsuits, involving issues such as overtime, health hazard premium and hazardous duty premium, prior notice, change of function, salary equalization, and other. Part of the amount involved is in provisional or final execution at various court levels, and thus is classified as of probable loss and accordingly a provision was recognized.

On October 6, 1989, Sintaema (Union of the Water, Sewage, and Environmental Workers of São Paulo) filed a lawsuit against the Company claiming the payment of salary differences arising from health hazard premium from September 1987 to February 1991. On December 19, 1997, the Superior Labor Court issued a decision unfavorable to SABESP. The Company appealed against this decision, which was maintained by the Superior Labor Court. Sintaema started the execution of the court decision and the court expert report presented on February 21, 2007 determined the payment of R\$28,313 (R\$30,735 adjusted through December 31, 2007). The Company's legal counsel considered the risk of loss as probable.

As of March 2008 we are party to approximately 2,939 labor proceedings and one public civil action filed by some of our current and former employees. These lawsuits seek to negotiate certain benefits granted by Law 4,819, as of August 26, 1958. Approximately 40 plaintiffs are claiming the same benefits at the civil court and in these cases, we allege that the São Paulo State government, and not us, should be responsible for the payments due to the plaintiffs. In the public civil action filed against us and the State Treasury, an injunction was granted in lower court requiring us to pay the benefits foreseen in Law 4,819/58 to all the plaintiffs. A lower court decision was rendered on April 5, 2005, granting relief to such proceeding and confirming the injunction granted to the effect that we are to continue to pay the benefits. We have appealed at the Regional Labor Court. There are currently other pending individual lawsuits discussing the same claims, and up to the date of this report neither Sabesp nor the São Paulo State Government had reached an agreement as to the indemnification amounts related to these proceedings.

## (vi) Environmental Claims

Refers to several administrative proceedings and lawsuits filed by government entities, including Companhia de Tecnologia de Saneamento Ambiental - Cetesb and the São Paulo State Public Prosecution Office for the imposition of fines for environmental damages allegedly caused by the Company.

Significant litigation involving the São Paulo State Public Prosecution Office is as follows:

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

(a) On April 4, 2002, the Company was included in a public action filed by the District Attorney's Office of São Bernardo do Campo for the remediation of damages caused by slurry discharges made by the Company's water treatment facilities, and demanding the discontinuation of such discharges. The lower court issued a decision favorable to the Company, against which an appeal was lodged. The Court of Appeals decided against the Company and ordered it to discontinue discharging waste within one year from the date the decision is considered final, provide environmental remediation within two years after the date set as final, or pay a daily fine of R\$10,000 and compensation for the environmental damage caused. The Company's legal counsel assessed the risk of loss as probable and the reserve recognized represents the adjusted amount of R\$163, which reflects the amount attributed to the lawsuit; (b) Public lawsuit filed by the São Paulo State Public Prosecution Office against SABESP to force the Company to discontinue the discharge of untreated sewage in the Borá river or any other river in the Borá municipality, and invest in the water supply and sewage treatment system of the same municipality by building the necessary facilities. The court expert estimated the damages at R\$41,022, which is not yet final as there is no court decision on this lawsuit; (c) On February 25, 2003, an environmental public lawsuit was filed by the Public Prosecution Office against SABESP to force the Company to discontinue the discharge of untreated sewage in the Boa Esperança river or any other river in the Lutécia municipality, and invest on the water and sewage treatment system of the same municipality by building the necessary facilities, and pay indemnity for the environmental damages caused. The court expert estimated the damages at R\$82,779, which is not yet final as there is no court decision on this lawsuit. Lawsuits (b and c) are at settlement stage with the Public Prosecution Office and the Company recognized a reserve in the amount of the expected disbursement, budgeted in the action plans for the Lutécia municipality at the adjusted amount of R\$3,889, related to Reforesting, the Urban Sewage Master Plan, and the Lutécia Sewage System and Recyclable Material Receiving Center; the action plan for the Borá municipality includes the adjusted amount of R\$744, which refers to Reforesting, the Urban Sewage Master Plan, and the Resort Recovery and Adaptation. (d) Public civil action filed by the Public Attorney's Office against Sabesp us and the Cotia Mayor's Office seeking individual and joint adverse judgments of the defendants in relation to: (i) the definitive permanent cessation of releasing untreated water affluents into the Cotia River or its tributaries, under the penalty of subject to a daily fine in the case of noncompliance; (ii) the treatment of sewage prior to releasing it into the Cotia River, under the penalty of a daily fine, in the event of non-compliance; (iii) the full restoration of soil, of surface and underground water bodies and of vegetation to their original condition, under the penalty of a daily fine, in the event of non-compliance and (iv) the payment of compensation for environmental damages caused to soil, to water sources and to underground and surface water bodies that cannot be recovered. The appellate court rendered favorable decisions to us with respect to items (i), (iii) and (iv) mentioned above. According to evaluations by the court's technical expert, compensation for environmental damages shall be was R\$5.8 million as of October 17, 2006. (10/17/2006). This amount is still under discussion and its approval is subject to a final decision by the court. Our in-house counsel has considered it as a probable loss. In December 2007, we recorded the total provision in the amount of stood as R\$ 6.9 million. (e)The São Paulo State Public Prosecution Office filed a public lawsuit against SABESP, AES Eletropaulo, Dae, Cetesb and the São Paulo State Treasury Secretariat seeking conviction of these entities for the alleged environmental damages caused because of the inversion of the Pinheiros River stream to the Billings Dam. The lower court decision, based on an experts' report that estimated damages at R\$284,525, jointly convicted the parties to pay this amount, monetarily adjusted since June 2,000 through December 2007, totaling R\$491,575. SABESP, Dae, AES Eletropaulo, Cetesb and the State Treasury Secretariat filed an appeal with the Appeal Court and are awaiting a decision, as they understand that there is no factual evidence of the damages. There is no guarantee that this joint conviction will be maintained by the Appeal Court. Due to the recent decision, this lawsuit, previously classified as of remote loss, is now assessed by

the Company's legal counsel as of possible loss. (f) A public civil action filed by the Piracicaba Civil Entities Coordination Board against Sabesp us and the National Water Agency seeking remedy for damages caused by the use of the Piracicaba, Jundiaí and Capivari rivers' basin to supply the São Paulo Metropolitan Region through the Cantareira Water System for nearly 30 years. The value attributed to the claim is R\$11.4 billion (12/10/2003) updated to R\$ 15.1 billion on December 31, 2007. This lawsuit is in its initial stage and is pending judgement from the lower court. So far no value has been set for the damages alleged. Our in-house counsel has evaluated the case as a remote loss and therefore, no provisions have been made referring to this lawsuit.

The Company is a party to other environmental lawsuits in municipalities where it operates, arising from the discharge of untreated waste, assessed as probable and possible risks of loss by its legal counsel. The amounts recognized in reserves do not always represent the final amount to be disbursed as indemnity of alleged damages, in view of the current stage in which the such lawsuits are and Management's ability to reasonably estimate the amounts of future disbursements. As of December 31, 2007, total provision represents the R\$50,075, already including the amounts referred to in items (a), (b), (c) and (d).

(vii) Settlements reached in 2007

a) The Company reached a settlement with the Municipality of Bragança Paulista related to the tax collection proceeding for the payment of R\$13,105, adjusted through December 6, 2007, arising from fines imposed by the City Health Department. The Municipality granted a discount totaling R\$4,323 on interest and fine. On December 27, 2007, part of the Municipality's debt to SABESP was offset against the fines imposed by the Municipality Health Department, in the amount of R\$8,782, and the remaining debt balance from unpaid tariffs, in the amount of R\$1,080, was divided into 99 installments, monetarily adjusted through the settlement execution date.

b) The Company reached a settlement with the Public Prosecution Office for the construction of the Domestic Sewage Treatment System facilities in the municipality of Boituva and Environmental Compensation within 54 months as from the signature of the settlement, estimated at R\$12,776. From this amount, R\$3,933 will be built by municipality contractors and R\$8,843 will be the responsibility's of SABESP.

c) The Company reached a settlement with the Public Prosecution Office for the construction of the Domestic Sewage Treatment and Deviation System facilities in the municipality of Santa Cruz do Rio Pardo and Environmental Compensation for the recovery of riverbank forest of the Mandaguari river, which total R\$1,250. The start of the riverbank forest recovery project is scheduled for February 2008, to be completed by February 2012.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

d) Public lawsuit filed with the Paraguaçu Paulista District (1st Court of Paraguaçu Paulista) seeking compensation for and discontinuation of the environmental damages allegedly caused by the discharge of untreated sewage by Company in the Alegre river, located in the municipality of Paraguaçu Paulista. The lower court judge issued a decision unfavorable to the Company, ordering the Company to: (a) discontinue the discharge of untreated sewage in the Alegre river; (b) invest in the water and sewage treatment systems in the municipality of Paraguaçu Paulista; and (c) paid an indemnity for the remediation of the environmental damages, arbitrated by the court at the adjusted amount of R\$168.9 million. The decision also determined that failure to comply with items (a) and (b) above subjects the Company to the payment of daily fines. The Company appealed against the decision. On September 21, 2006, the Company's appeal was judged by the São Paulo State Court of Justice. The Company reached a settlement with the Public Prosecution Office of R\$42,789 and 54 months to complete construction, of which R\$34,070 refers to compensation for environmental damages.

(viii) Other proceedings related to the Concession

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

On December 2, 1997, the Municipality of Santos enacted a law taking over the Company's water and sewage systems in Santos. In response, the Company filed an action seeking an injunction that stayed this takeover. The injunction was denied by the lower court; however, this decision was later overruled by the São Paulo State Court of Justice, which granted an injunction suspending this law. The lower court issued a decision favorable to the Company, and the Municipality of Santos filed an appeal against such decision. This decision was sustained by the Appeal Court; however, it is not final.

The Municipality of Itapira declared the nullity of the concession agreement and filed a Repossession Action, which was accepted by the court. SABESP filed an appeal against this decision which is pending judgment, and the Company, due to the lawsuit filed against said Municipality, withdrew the appeal because of previous appreciation of the same matter.

The Municipality of Tuiuti filed a declaratory action claiming the recognition of the lack of a legal relationship with SABESP that would allow the Company to continue providing water supply and sewage services in the Tuiuti municipality, and to determine the takeover by the Municipality of such utility services. SABESP filed a counterclaim to have the existence of a legal relationship between the parties declared and seeking compensation for the investments made. The lawsuit is at fact-finding phase, so that an inspection can be conducted.

The Municipality of Cajobi filed a Repossession Action to regain control over the water supply and sewage services before the agreement termination and termination of the concession, which occurred on November 13, 2006, and the consequent return to the Concession Grantor of all returnable assets, rights and privileges transferred. The action also

seeks convicting SABESP to the payment of damages for the amounts received as water supply and sewage tariffs that the Municipality did not receive from the provision of these services, since the enactment of Municipal Decree No. 767, of November 13, 2006 (which provides for the repossession of the services granted), and the use of the concession assets. The lawsuit is in fact-finding phase.

The Municipality of Monte Alto filed a Repossession Action combined with a claim for damages and declaration of termination of the concession agreement, as it intends to resume the provision of the water supply and sewage services before the termination of the concession, which occurred on October 23, 2006, and the consequent return to the Concession Grantor of all returnable assets and the management of the services under the concession agreement. The injunction was granted by the Fourth Public Law Chamber of the Court of Justice based on the bill of review filed by the Municipality and fulfilled on November 17, 2006. The lawsuit is in fact-finding phase.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The Municipality of Araçoiaba da Serra filed a Repossession Action to obtain an injunction that authorized the Municipality to enter the facilities related to the concession, including all the chattels and properties related to the water supply and sewage services, and start to manage, operate and exploit such services, before the termination of the concession on September 23, 2006. At the end, the Municipality claims the definite repossession, ensuring the return of all the assets, rights and privileges previously transferred to SABESP. The injunction was initially granted and afterward maintained by the Appeal Court, granting the Municipality the right to remain in charge of the services. In addition, SABESP filed for a writ of prevention requiring evidence be produced in advance. The lawsuit is in fact-finding phase.

The municipality of Sandovalina has brought a legal action against us seeking to (1) obtain the termination of the concession entered into with us and (2) obtain remedies for environmental damage and alleged losses caused to the municipality due to our failure to provide sewage treatment, as well as other damage caused to public property. We are also seeking the payment of a contractual indemnification based on the early termination of the contract. We are currently operating the water and sewage treatment facility of Sandovalina, and the lawsuit is still in the fact-finding phase. We have not made any provisions for this proceeding. The lawsuit is currently suspended while the parties discuss the procedures. No provisions have been made for this proceeding.

**16. SHAREHOLDERS EQUITY****(a) Authorized capital**

The Company is authorized to increase its capital up to a maximum of R\$ 4,100,000 registered common shares without par value, upon resolution of the board of directors.

In case of a capital increase, issue of convertible debentures and/or share warrants through private placement, the shareholders shall have preemptive rights proportional to the number of shares held at the time, in compliance with Article 171 of Law No. 6,404/76.

**(b) Reverse stock split**

The Shareholders Meeting held on April 30, 2007, approved the reverse stock split proposal. The shares were grouped at the ratio of 125-for-1 and since June 4, 2007 are traded in Brazilian reais per share. Capital started to be represented by 227,836,623 registered common shares, without par value, and SABESP's capital remains unchanged.

Concurrently with the reverse stock split, the American Deposit Receipts (ADRs) started to be traded at the ratio of 1 ADR for each to 2 shares.

**(c) Subscribed and paid-up capital**

Subscribed and paid-up capital is represented by 227,836,623 common shares, without par value, distributed as follows:

Shareholders	2007		2006	
	Number of shares	%	Number of shares	%
Secretaria da Fazenda	114,508,087	50.26	14,313,511,867	50.26
Companhia Brasileira de Liquidação e Custódia	61,690,601	27.08	7,722,535,287	27.11
The Bank Of New York ADR Department (Equivalent to stock )(*)	51,409,636	22.56	6,415,657,250	22.53
Other	228,299	0.10	27,873,423	0.10
	227,863,623	100.00	28,479,577,827	100.00

(\*) each ADR equals 2 shares

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## (d) Distribution of earnings

Shareholders are entitled to a mandatory minimum dividend distribution of 25% of adjusted net income, calculated in conformity with Brazilian Corporate Law. This requirement can be met through payments made in the form of dividends and interest on shareholders' equity (net of withholding tax), to the extent amounts are available for distribution. Dividend distributions are limited to retained earnings as determined in accordance with BR CL. At December 31, 2007, as required by the CVM, management designated the retained earnings balance to a discretionary investment reserve account (see (f) below).

For purposes of BR CL, and in accordance with the by-laws of the Company, adjusted annual net income is an amount equal to the Company's annual net income adjusted to reflect allocations to or from (i) statutory legal reserve, (ii) an equity contingency reserve for anticipated losses, if any, and (iii) an unrealized revenue reserve, if any. The calculation of the mandatory minimum dividends for 2007 is as follows:

Net income for the year	1,048,703
(-) Legal reserve 5%	52,435
Net income	996,268
Mandatory minimum dividend	249,067

The Company by-laws also provide for distribution of interest on shareholders' equity as an alternative form of distribution to shareholders. The interest rate is limited to the variation in the TJLP during the applicable period and the deductible distribution cannot exceed the greater of 50% of net income (before distribution and deductions for income taxes) for the period or 50% of retained earnings. Distribution of interest on shareholders' equity is a tax-deductible expense for both income tax and social contribution purposes. The amount paid to shareholders as interest on shareholders' equity, net of any withholding tax, is taken into account in determining the mandatory dividend.

In 2007, the Company accrued interest on shareholders' equity attributed to dividends in the amount of R\$279,494, net of withholding income tax in the amount of R\$21,250. In 2006, the Company declared interest on shareholders' equity, in lieu of dividends, in the amount of R\$ 251,238, net of withheld income tax in the amount of R\$ 19,603. In 2005, the amount was R\$ 324,461 net of income tax of R\$ 23,755. Interest on shareholders' equity was calculated in conformity with article 9 of Law No. 9249/95, at the Long-term Interest Rate (TJLP); this interest was originally recorded in Financial expenses for income and social contribution tax deductibility purposes and subsequently, for presentation purposes, was reflected directly in Shareholders' equity.

## (e) Capital reserves

Capital reserve comprises tax incentives and donations from government agencies and private entities, which increased R\$ 17,565 in 2007 (R\$ 27,870 in 2006).

The tax incentive reserve results from an option to invest in the capital stock of companies undertaking specified government-approved projects. In lieu of paying part of the income tax due, the amount is credited to income tax and subsequently appropriated from retained earnings to this reserve.

The donations reserve reflects the value of assets received from government entities, principally enabling the Company to provide service access to properties. No shares are issued in exchange nor other remuneration provided in connection with assets received. These donations are recorded as a direct benefit to shareholders' equity.

(f) Investment reserve

The Investment reserve is comprised specifically of internal funds for expansion of water supply and sewage service systems.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The following summarizes the allocation of net income to the investment reserve for the years ended December 31,

	2007	2006
Net income	1,048,703	778,905
(+) Revaluation reserve realization	87,670	102,272
(-) Interest on shareholders' equity	300,744	270,841
(-) Legal reserve 5%	52,435	38,946
Investment reserve	783,194	571,390

At the Shareholders' Meeting held on April 29, 2008, Management proposed the transfer of the retained earnings balance of R\$783,194 to the Investment reserve account, to cover the needs of investments with own funds, as planned in the Capital Budget. Also the Management proposed the capitalization of part of the profit reserve in the amount of R\$2,800,000, as this reserve exceeded capital. The proposed was approved and after the capitalization of the profit reserve, capital will be R\$6,203,688.

## (g) Legal (statutory) reserve

Under Brazilian Corporate Law, the Company is required to record a legal reserve to which it must allocate 5% of the adjusted net income each year until the amount of the reserve equals 20% of paid-in capital. Accumulated deficit, if any, may be charged against the legal reserve.

## 17. INSURANCE COVERAGE

Insurance policies held by the Company provide the following coverage, taking into account the risks and nature of the related assets:

Type of insurance	Insured amount - R\$	Premium
	(*)	(*)
Engineering risk	288,494	644
Fire	307,743	331
Civil liability - officers and employees	80,000	3,000
Civil liability - construction in progress	11,051	482
Civil liability - operations	1,500	160

(\*) **Unaudited information**

The Company does not have an environmental and loss of profits insurance.

#### 18. FINANCIAL INSTRUMENTS AND RISK

In accordance with CVM Instruction No. 235/95, the Company estimated the fair value of their financial instruments, using available market information and appropriate estimation methodologies. However, considerable judgment is required to interpret market data and to develop the estimates of fair value. Accordingly, the estimates presented are not necessarily indicative of the amounts that could be realized in a current market exchange. The use of different market assumptions and/or valuation methodologies may have a material effect on the estimated fair values.

As of December 31, 2007 and 2006, the carrying amounts and fair values of the main financial instruments are as follows:

F-48

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

	December 31, 2007			December 31, 2006		
	Book value	Market value	Unrealized gain/(loss)	Book value	Market value	Unrealized gain/(loss)
Financial investments (i)	392,164	392,164	-	248,088	248,088	-
Loans and financing (ii)	(5,685,235)	(5,702,906)	(17,671)	(6,326,729)	(6,041,812)	284,917
	(5,293,071)	(5,310,742)	(17,671)	(6,078,641)	(5,793,724)	284,917

**(a) Fair value of financial instruments**

The Company's main asset and liability financial instruments as of December 31, 2007 are described below, as well as their measurement criteria:

(i) Temporary cash investments The fair value of these assets approximates the amounts stated in the Company's balance sheets.

(ii) Loans and financing Liability financial instruments are divided into two groups:

a. Market debts Debts incurred to obtain funds in the market to cover possible cash requirements of the Company. The financial instruments composing this group are debentures, bonds and FIDC (Receivables Investment Funds), placed in the financial market through book building or similar procedures, in which yield rates demanded by investors are defined at the time of negotiation.

The fair value measurement criteria adopted by the Company for these financial instruments was the UP (unit price) average-deviation method used in the last negotiations, in 2007, carried out in the secondary market in relation to the average UP in the curve.

The information necessary for this measurement was extracted from the following sources: SND Sistema Nacional de Debêntures (National Debenture System), BovespaFix and Bloomberg.

b. Institutional debts Debts incurred for the purpose of financing a project related to SABESP's corporate purpose: water supply and sewage works.

This financing has long-term features, at specific interest rates defined by development agencies (Caixa Econômica Federal, National Bank for Economic and Social Development, Fehidro), and multilateral agencies (IDB, BIRD, JBIC), which prevents us from measuring this financing at fair value.

**(b) Exchange rate risk**

This risk arises from the possibility that the Company may incur in losses due to exchange rate fluctuations, which would increase the liability balances of foreign currency-denominated loans and financing obtained in the market and

the related financial expenses. The Company does not have hedge or swap contracts to hedge against this risk, in view of the amounts, costs involved and opportunities. However, when possible, it makes advance purchases of foreign currencies and obtains funding in local currency, as a way to protect itself against exchange rate fluctuations.

A significant portion of the Company's debt is denominated in US dollar, in Yen and other foreign currencies, totaling R\$1,242,288 (Note 10). The Company's net exposure to the exchange rate risk as of December 31, 2007 is summarized as follows:

	In thousands			
	December 31, 2007		December 31, 2006	
	US\$	Yens	US\$	Yens
Loans and financing	670,151	2,654,422	676,142	652,814

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## (c) Interest rate risk

This risk arises from the possibility that the Company may incur losses due to interest rate fluctuations and indices that increase their interest expenses on loans and financing. The Company has not entered into any derivative contract to hedge against this risk; however, it continually monitors market interest rates, in order to evaluate the possible need to replace its debt. As of December 31, 2007, the Company had R\$1,021,118 in loans and financing which were obtained at variable interest rates (CDI and TJLP).

Another risk faced by the Company is the lack of correlation between the monetary adjustment indices of its debt and those of its receivables. Water supply and sewage treatment tariffs do not necessarily follow the increases in the interest rates affecting the Company's debt.

## (d) Credit risk

Credit risk is mitigated by selling to a geographically dispersed customer base.

No single customer represented more than 10% of the Company's sales and services rendered in the years ended December 31, 2007, 2006, and 2005.

## 19. GROSS REVENUE

	2007	2006	2005
Metropolitan São Paulo	4,888,077	4,534,093	4,044,191
Regional systems (i)	1,560,134	1,449,919	1,312,135
Total	6,448,211	5,984,012	5,356,326

(i) Comprises the municipalities served in the country side and coastal area of the State of São Paulo

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## 20. OPERATING EXPENSES

	2007	2006	2005
<b>Cost of sales and services:</b>			
Salaries and payroll charges	970,065	966,751	851,290
General supplies	121,821	117,872	105,333
Treatment supplies	112,339	104,466	98,823
Outsourced services	384,114	326,422	297,469
Electric power	472,525	446,974	421,319
General expenses	31,316	32,560	29,840
Depreciation and amortization	603,516	621,719	572,301
	2,695,696	2,616,764	2,376,375
<b>Selling expenses:</b>			
Salaries and payroll charges	158,338	159,094	142,685
General supplies	5,373	5,276	6,632
Outsourced services	88,585	80,467	82,354
Electric power	736	768	941
General expenses	58,554	58,946	46,636
Depreciation and amortization	4,627	2,716	3,291
Allowance for doubtful accounts, net of recoveries	323,339	411,918	255,292
	639,552	719,185	537,831
<b>Administrative expenses:</b>			
Salaries and payroll charges	137,267	132,554	112,458
General supplies	4,621	4,574	3,973
Outsourced services	66,300	79,379	94,153
Electric power	1,218	1,119	1,250
General expenses	291,803	118,646	88,027
Depreciation and amortization	14,406	17,736	20,389
Tax expenses	43,575	33,399	29,334
	559,190	387,407	349,584
<b>Total costs of sales and services, selling and administrative and expenses:</b>			
Salaries and payroll charges	1,265,670	1,258,399	1,106,433
General supplies	131,815	127,722	115,938
Treatment supplies	112,339	104,466	98,823

Outsourced services	538,999	486,268	473,976
Electric power	474,479	448,861	423,510
General expenses	381,673	210,152	164,503
Depreciation and amortization	622,549	642,171	595,981
Tax expenses	43,575	33,399	29,334
Allowance for doubtful accounts, net of recoveries	323,339	411,918	255,292
	3,894,438	3,723,356	3,263,790

**Financial expenses:**

Interest and other charges on loans and financing - local currency	447,046	517,547	526,585
Interest and other charges on loans and financing - foreign currency	66,329	121,194	141,844
Interest on shareholders' equity (note 16 (e))	300,744	270,841	348,216
Interest on shareholders' equity (reversal)	(300,744)	(270,841)	(348,216)
Other expenses on loans and financing	-	7	1,825
Income tax on remittances abroad	6,346	12,564	9,450
Other financial expenses	69,287	38,642	35,574
Monetary variations on loans and financing	101,310	86,594	80,411
Other monetary and foreign exchange variations	8,059	10,937	1,611
Interest and monetary variations on provisions for contingencies	183,027	(2,675)	76,482
	881,404	784,810	873,782

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

**Financial income:**

Monetary variation	34,281	28,475	34,803
Income from financial investments	51,469	50,882	32,292
Sale of third parties shares	-	207	-
Interest on accounts receivable	46,618	46,383	48,368
Other	41	-	44
	132,409	125,947	115,507
<b>Financial result, net</b>	<b>748,995</b>	<b>658,863</b>	<b>758,275</b>

**Foreign exchange, net**

Exchange variations on loans and financing	(188,411)	(96,071)	(312,116)
Other exchange variations	87	-	-
Foreign exchange income	286	473	845
	(188,038)	(95,598)	(311,271)

**21. MANAGEMENT COMPENSATION**

Compensation paid by the Company to the members of its board of directors and Management totaled R\$ 2,373, R\$3,084 and R\$ 2,104 for the years ended December 31, 2007, 2006 and 2005, respectively. An additional amount of R\$509, related to the 2007 bonus, was paid in April, 2008.

**22. COMMITMENTS****(i) Rentals**

Operating, administrative and property leases already contracted require the following minimum payments, as follows:

2008	7,844
2009	2,456
2010	660
2011	314
<b>TOTAL</b>	<b>11,274</b>

Lease expenses for the years ended December 31, 2007, 2006 and 2005 were R\$ 8,214, R\$9,810 and R\$ 9,505, respectively. Lease expenses refer to the following: property rentals, machinery and equipment leases, IT equipment leases, and photocopiers leases.

(ii) Electricity

The Company has entered into long-term contracts with electric power providers. The amounts already contracted by the company are shown as follows:

2008	182,008
2009	128,947
2010	128,164
2011	133,367
2012	133,730
2013	78
2014	39
TOTAL	706,333

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

Electric power expenses for the years ended December 31, 2007, 2006 and 2005 were R\$ 474,762, R\$ 449,089 and R\$ 423,814, respectively.

**23. AGREEMENT WITH THE MUNICIPALITY OF SÃO PAULO**

On November 14, 2007, the Company and the Municipality of São Paulo (the Parties) entered into an Agreement to establish the conditions that ensure the stability in the provision of water supply and sewage, and environmental utility services in the city of São Paulo, the main provisions of which are as follows:

- the Parties made the commitment to take basic sanitation and environmental actions, complementary to the actions of the Municipality of São Paulo, by investing in the deployment and continuity of programs such as: Programa Córrego Limpo (Clean River Program) and Programa de Uso Racional da Água PURA (Rational Water Use Program), the purpose of which is to ensure a decrease in water consumption by City government units, ensuring water supply to and the quality of living of the population;
- starting November 14, 2007, all the amounts paid by the Municipality of São Paulo to SABESP, referring to consumption by City departments, agencies, and foundations, net of taxes, will be used in basic sanitation and environmental actions in the municipality;
- the Municipality made the commitment to resume the payment of consumption bills issued by SABESP, starting November 14, 2007;
- the Parties shall complete, within 90 days, the projects required to determine the outstanding amounts and prepare the drafts of the Bill to obtain the approval of the City Council to the Cooperation Agreement and Metropolitan Program Contract, to ensure the stable provision by SABESP of water supply and sewage services in the municipality, through associated management of the assumed utility services, jointly by the Municipality and the State of São Paulo, pursuant to the general basic sanitation service principles laid down in State Law 11,445/2007 and related State legislation;
- the Parties and the State shall conclude, within 90 days after the execution of the Agreement, the terms and conditions of the Cooperation Agreement and Metropolitan Program Contract, to ensure the stable provision by SABESP of water supply and sewage services in the municipality;
- the approval of Municipal Authorization Law is an essential condition both for signing the Cooperation Agreement, to be signed by the Municipality and the State of São Paulo, and the Metropolitan Program Contract, to be signed by the Municipality and SABESP;
- after the Bill is submitted to the City Council, the Parties will enter into an instrument from settlement of outstanding debts. A discount in the amount of R\$120 million on the City's debts will be granted, under contract (there is no provision of this amount for December 31, 2007). These debts will be paid free of financial charges arising from interest, fines and monetary adjustment, and part of the debts shall be paid by December 2008 and the rest under Municipal Interdepartmental Administrative Rule 01/2005, in seven annual installments;
- the Parties shall require the termination of the collection lawsuits filed by SABESP, where SABESP shall pay the court fees, and each Party shall pay the lawyers' fees, in an estimated amount of R\$1.9 million.

On February 10, 2008, the Parties decided to extend the agreement for a period equal to the original period, so that the Parties may conclude the required understandings to settle the outstanding debts and prepare the drafts of the

Cooperation Agreement, the Metropolitan Contract Program, and the Authorization Bill.

The stages already in progress are the conclusion of the drafts of said instruments, sending the Bill to the City Council, concluding the required understandings to settle the outstanding debts, and jointly defining the sanitation and environmental actions to be taken.

On May 9, 2008, the Parties signed the Second Amendment to the Agreement with the Municipality of São Paulo extending the term for an equal period and providing for automatic renewals, for equal periods, should the parties do not express otherwise.

#### 24. CONCESSIONS

As mentioned in Note 1, in 2007 a new regulatory framework was established for the sanitation industry, after the approval of the Sanitation Law and the Law that creates the São Paulo State Sanitation and Power Regulatory Agency (Arseps).

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**

**NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

Consistently with the regulatory framework, SABESP tried to build a new relationship with the municipalities, which resulted in the renewal of 106 agreements and 124 authorization laws approved by city councils.

In addition to program contracts, the municipalities entered into with the São Paulo State Government, cooperation agreements that permitted delegating service regulation and inspection to ARSESP.

**Program Contracts**

The purpose of the program contracts entered into by the municipalities and the Company, under the terms and conditions set forth by the Cooperation Agreements entered into by the São Paulo State Government and the municipalities, is the provision of municipal utility water supply and sewage services, exclusively by SABESP, over a thirty-year period, which can be renewed for an equal period.

**i) Tariff**

The service price arrangement shall be based on a tariff, adjusted every 12 months, based on the index based on the variation of SABESP costs (IRT – Tariff Adjustment Index) approved by ARSESP. Connections to municipal buildings shall be classified under the public use category and shall enjoy this category's tariff benefits.

**ii) Economic and financial balance**

Both the tariff and the economic and financial terms and conditions of the contracts shall be reviewed every four years to ensure the full amortization and payment of investments, and operating, management, maintenance and service expansion costs.

**iii) Debt settlement**

SABESP shall collect past-due debts on unpaid water supply and sewage services.

**iv) Exemption from municipal taxes**

The Company shall be exempt from municipal taxes levied on operating areas and facilities.

**v) Regulation and inspection**

The regulation and inspection of water supply and sewage services delegated by the Municipalities shall be carried out by the State Service Regulatory Agency.

**vi) Contract termination**

Upon contract termination, if the cash flows from services do not allow the full payment of the investments made, including investments existing prior to the Program Contract, the Municipality can elect one of the following

compensation method:

- a) maintain the contract and the cooperation agreement for the period required for payment an amortization;
- b) resume services by paying to SABESP the corresponding compensation;
- c) formalize an agreement for the payment in installments of the compensation due;

SABESP shall continue providing the services under the same terms of the contract, respecting the agreed economic and financial balance, until the actual payment of the compensation.

vii) Returnable assets

F-54

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**

**NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

All assets existing prior to the program contracts are controlled, managed and owned by SABESP, and those acquired or built during contract effectiveness, attached or indispensable to the provision of the services, whose ownership and management shall be assigned to SABESP, are an integral part of the water supply and sewage services.

viii) Compensation criteria

The compensation payable by the Municipality to SABESP shall be equivalent to the present value of cash flows for the remaining period on the date services are resumed by the Municipality, based on a business valuation report of the contract, monetarily adjusted, plus interest through payment date. These contracts can also be measured at book value and other rights and possible losses may also be collected.

25. AMENDMENT TO BRAZILIAN CORPORATE LAW, EFFECTIVE JANUARY 2008

On December 28, 2007, Law No. 11,638 was enacted, altering, revoking and adding new provisions to the Brazilian Corporate Law, especially with respect to chapter XV, Fiscal Year and Financial Statements. This Law is effective for fiscal years beginning on or after January 1, 2008 and was designed primarily to update the Brazilian Corporate Law, so as to enable the convergence of Brazilian accounting practices with international accounting standards (IFRS) and allow the Brazilian Securities Commission (CVM) to issue new accounting standards and procedures, in conformity with such international accounting standards.

The changes in Brazilian Corporate Law are applicable to all companies incorporated as corporations, including public companies, and introduce a new requirement for large companies to prepare and report financial statements in accordance with provisions of the Brazilian Corporate Law. Furthermore, private companies may choose to prepare such financial statements in accordance with standards issued by the CVM.

Certain of these changes shall be applied as of the beginning of the Company's fiscal year while others are subject to regulation by regulatory agencies.

The main changes are summarized as follows:

- Replacement of the statement of changes in financial position by the statement of cash flows.
- Requirement for the presentation of a Statement of Value Added.
- Possibility of maintaining separate accounting records for purposes of complying with tax legislation and reflecting necessary adjustments in order to prepare the financial statements in conformity with Brazilian Corporate Law.
- Creation of the account groups Intangible Assets to permanent assets and valuation adjustments to shareholders' equity.

- Standardization of the criteria for measurement and classification of financial instruments, including derivatives.
- Requirement that periodic review and analysis of the recoverability of amounts recorded in property, plant and equipment, and intangible assets.
- Elimination of the possibility to record the premium received on issue of debentures and donations and government investment grants (including tax incentives) directly as capital reserves in shareholders' equity.
- Tax incentives arising from donations and government investment grants for investments will no longer be classified as capital reserve, becoming part of income for the year. The Company's management may allocate a portion of net income resulting from these incentives to the formation of profit reserve and may be deducted from the calculation basis of the mandatory dividend.

F-55

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

- Requirement to record under the caption property, plant and equipment those rights in tangible assets that are maintained or used in the operations of the Company's business, including those rights received as a result of transactions that transfer the benefits, risks and control of such assets to the Company (e.g., capital lease).
- Modification of the definition of those assets to be recorded under the caption deferred charges.
- Adjustments to present value for assets and liabilities arising from long-term transactions, as well as for significant short-term transactions.
- Elimination of the revaluation reserve. Any balance of existing revaluation reserve shall be maintained until its effective realization or reversed by the end of the fiscal year in which the Law comes into effect.

The Company considers that even though most of the provisions amended by the new Law still depend on regulation to be issued by CVM, the material issues that might change the presentation of the financial statements are already being adopted or disclosed, and refer to the segregation of the group Intangible assets in permanent assets, the disclosure of the statements of cash flows (as disclosed in note 28), and measurement at market value of the financial instruments, disclosed comparatively to their carrying amount in note 18.

**26. SUMMARY OF DIFFERENCES BETWEEN BR CL AND US GAAP**

*The Company's primary financial statements have been prepared in accordance with BR CL which differs significantly from US GAAP as described below:*

**(a) Inflation accounting methodology and indices**

In Brazil, because of highly inflationary conditions which prevailed in the past, a form of inflation accounting had been in use for many years to minimize the impact of the distortions in financial statements caused by inflation. Two methods of inflation accounting were developed: one required under BR CL; and the other known as the Constant Currency Method. The primary difference between BR CL and the Constant Currency Method relates to accounting for the effects of inflation. Under BR CL, inflation accounting was discontinued effective January 1, 1996. Prior to that date, BR CL required inflationary indexation of property, plant and equipment, investments, deferred charges and shareholders' equity, the net effect of which was reported in the statement of operations as a single line item. The Constant Currency Method is similar to U.S. Accounting Principles Board Statement No. 3 ("APS 3"), except that the former continues to apply inflationary accounting in periods of low inflation. Under US GAAP, the Brazilian economy ceased to be highly inflationary effective July 1, 1997. The other significant difference between the two sets of principles relates to the present-value discounting of fixed-rate receivables and payables, which is required by the Constant Currency Method and is prohibited under BR CL.

Financial statements prepared in accordance with BR CL have been, and continue to be, required of all Brazilian corporate entities and are used by the Brazilian tax authorities in determining taxable income. Financial statements prepared in accordance with the constant currency method were required through 1995 for those entities whose securities were registered with the CVM. Since 1996, presentation of supplemental financial statements under the

Constant Currency Method has been optional.

(i) Additional inflation restatement in 1996 and 1997 for US GAAP

In the reconciliation from BR CL to US GAAP, consistent with the position paper prepared by the U.S. AICPA International Practice Task Force, an adjustment for inflation accounting has been included for the period from January 1, 1996 to December 31, 1997. During this period, inflation accounting was prohibited by BR CL but was required by APB statement 3 under US GAAP. Shareholders' equity under US GAAP was increased by R\$1,103,962 and R\$ 1,171,576 at December 31, 2007 and 2006, respectively, due to the additional inflation restatement adjustments.

(ii) Supplementary inflation restatement replaces revaluation of property, plant and equipment for US GAAP

F-56

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The price-level restatement methodology under BR CL relied on an official inflation index announced by the Brazilian Federal government which was also used for purposes of determining taxes payable. Shortly after the launch of an economic stabilization plan in 1990, the government announced an inflation rate for that year which was materially understated in relation to the general and consumer price indexes as measured by independent economic institutes. In 1991, the government acknowledged this distortion and companies were required to re-present their statutory financial statements using a revised inflation index and the effects thereof were also used to determine income taxes, retroactively. The same law (Law No. 8,200/91) also granted companies the option (and the CVM required adoption when the effects were significant) to reprocess the accumulated inflation accounting effects since the date of acquisition of assets based on an independently sourced consumer or general price index. This supplemental indexation of property, plant and equipment, investments and deferred charges was to be recorded in the statutory BR CL accounting books but would have no effect for tax purposes. The Company anticipated the effects of this measure by contracting an independent firm of experts to perform an appraisal to market value of its property, plant and equipment and recorded the revaluation increment in its statutory BR CL accounting records, without affecting its tax position, in much the same way as Law No. 8,200/91 later required. As the revaluation increment had eliminated the effects of the supplemental price-level restatements, no further action was taken and the Company did not apply the incremental indexation.

Under US GAAP, revaluations of assets to market value are not permitted and the effects of the revaluation have been reversed in the reconciliation to US GAAP. However, in order to preserve the integrity of the historical cost of its assets based on the price-level restatement convention adopted by BR CL, the Company has recorded the supplemental price-level restatement adjustments, in accordance with Article 2 of Law No. 8,200/91, as an adjusting item in the reconciliation to US GAAP. The Company has presented the balances of shareholders' equity and net income under BR CL, adjusted for the effects of the revaluation and the replacement of the reversal by the supplemental price-level restatements, and related tax effects, as a subtotal, prior to presenting the reconciling items to US GAAP. The subtotal also includes the effects of including an additional two years' inflation accounting adjustments through to 1997 for purposes of US GAAP.

Shareholders' equity under US GAAP was increased by R\$ 2,705,277 and R\$ 2,806,638 at December 31, 2007 and 2006, respectively, due to the supplementary inflation restatement adjustments and reduced by R\$ 2,339,829 and R\$ 2,427,499 at December 31, 2007 and 2006, respectively, due to the reversal of the revaluations, before tax effects.

**(iii) Inflation indexes**

The indexation of the financial statements through 1995, except for the year 1990, under BR CL was based on an official government index, the *Unidade Fiscal de Referência* - UFIR and for the year ended December 31, 1990 on a consumer price index (*Índice de Preços ao Consumidor*, or IPC). For purposes of US GAAP, a general price index, the *Índice Geral de Preços - Mercado*, or IGP-M, was used to record the additional inflation restatement in 1996 and 1997 and the supplementary inflation restatement through 1995.

**(b) Income taxes and social contribution**

Under BR CL, deferred tax assets are recognized at the estimated amounts that management considers are probable to be recovered. In addition, deferred income taxes are shown gross rather than net.

Under US GAAP, deferred taxes are recorded on all temporary tax differences. Valuation allowances are established when it is more likely than not that deferred tax assets, including tax loss carryforwards, will not be recovered. Deferred tax assets and liabilities are classified as current or long-term based on the classification of the asset or liability underlying the temporary difference, and are presented net.

For purposes of deferred tax accounting, the US GAAP adjustments relating to inflation restatement of land and the push-down expenses from the Plan G0 pension fund (j)(ii) below and sabbatical paid leave benefits are treated as permanent tax differences, as such items are not deductible for tax purposes by the Company.

Taxes on income in Brazil consist of two types of taxes: income tax and social contribution. In Brazil, the tax law and tax rates are sometimes significantly altered by provisional measures ("*medidas provisórias*") announced by Presidential decree. The provisional measures can affect tax rates as well as other areas that could impact deferred taxes. Until September 2001, these measures remained in force for one month and expired automatically if they were not extended for an additional one-month period. In September 2001 all provisional measures were automatically enacted, and the Presidential decree powers restricted. Under BR CL, when calculating deferred income taxes, the provisional measures are usually taken into account.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**

**NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

Under US GAAP, only enacted tax rates may be used to calculate deferred taxes. Tax rates for future periods which have been established by provisional measures are not considered to have been enacted and are ignored. However, the provisional measure, to the extent it has not lapsed, is used for determining the amount of current tax payable.

Shareholders' equity under US GAAP was reduced by R\$ 1,281,468 and R\$ 1,356,545 at December 31, 2007 and 2006, respectively, due to deferred tax adjustments on US GAAP differences, excluding revaluations and permanent differences related to monetary readjustment on land of approximately R\$ 150 million.

No valuation allowance adjustments were required to be included in the reconciliation between BR CL and US GAAP.

(c) Financial instruments and concentration of credit risk

Under BR CL, there are less detailed requirements regarding the disclosure of information on financial instruments not reflected on the balance sheet or on concentration of financial instruments with credit risk.

Under US GAAP, the applicable accounting practice for financial instruments depends on management's intention for their disposition and requires adjustments to their market or fair values. Additional information on face or contract or notional principal amount; nature and terms including (i) credit and market risk, (ii) cash requirements and (iii) accounting policy followed; amount of loss, if any party to the financial instrument fails to perform; and policy as to requiring collateral is required. Disclosure as to concentration of credit risk arising from all financial instruments is required to include information about the activity, region or other characteristic that identifies the concentration; amount of loss if parties to the concentrated risk fail to completely perform; and policy as to requiring collateral.

Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities" of the U.S. Financial Accounting Standards Board ( FASB ) establishes accounting and reporting standards for derivative instruments and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities and measure those instruments at fair value. This statement was effective January 1, 2001 and did not have a significant impact on the Company's financial statements.

No adjustments have been included in the reconciliation from BR CL to US GAAP.

(d) Cash and cash equivalents

Under BR CL, cash equivalents are not defined.

Under US GAAP, SFAS No. 95, "Statement of Cash Flows", defines cash equivalents as short-term highly liquid investments that are both (i) readily convertible to known amounts of cash and (ii) so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Generally, only investments with original maturities of three months or less qualify under that definition

The Company holds certain highly liquid, low risk financial investments, comprised principally of high quality government debt, which are classified as cash equivalents under BR GAAP. Although the investments have high level of liquidity and present insignificant risks of changes in value, under US GAAP, since these investments have original maturities of over 90 days, such investments do not qualify as cash equivalents.

There are also, some securities with donor-imposed restrictions that are presented as Cash and cash equivalents under BR CL. These securities, under US GAAP, must be classified as restricted cash and the classification on the Cash Flow Statement must be related to the nature of the restriction.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The effect of these differences in classification on the Company's balance sheets and statements of cash flows for the periods presented are as follows:

		2007	2006	
Cash and cash equivalents under Brazilian GAAP		464,997		328,206
Difference in classification of restricted cash		(7,657)		-
<b>Cash and cash equivalents under US GAAP</b>		<b>457,340</b>		<b>328,206</b>
Cash Flows	2007	2006		2005
Operating activities under Brazilian GAAP	2,215,600	2,020,824		1,737,575
Cash flows relating to short-term investments under US GAAP	-	155,783		(99,815)
Operating activities under US GAAP	2,215,600	2,176,607		1,637,760
Financing activities under Brazilian GAAP	(1,197,113)	(1,122,755)		(919,733)
Cash flows relating to restricted cash under US GAAP	(7,657)	-		-
Financing activities under US GAAP	(1,204,770)	(1,122,755)		(919,733)
Cash and cash equivalents at beginning of the year under Brazilian GAAP	328,206	280,173		105,557
Difference in classification of temporary investments at beginning of the year	-	(155,783)		(55,968)
Cash and cash equivalents at beginning of the year under US GAAP	328,206	124,390		49,589
Increase in cash and cash equivalents under Brazilian GAAP	136,791	48,033		174,616
Cash flows relating to short-term investments under US GAAP	-	155,783		(99,815)
Cash flows relating to restricted cash under US GAAP	(7,657)	-		-
Cash and cash equivalents at end of year under US GAAP	457,340	328,206		124,390

(e) Investments in debt and equity securities

Under BR CL, marketable debt and equity securities are generally stated at the lower of inflation-indexed amortized cost or market value less interest or dividends received. Gains and losses are reflected in earnings.

Under US GAAP, in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities", the accounting and reporting for investments in equity securities that have readily determinable fair values and for all investments in debt securities is as follows:

(i) Debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and are reported at amortized cost.

(ii) Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings;

(iii) Debt and equity securities not classified as either held to maturity or trading securities are classified as available for sale securities and reported at fair value, with unrealized gains and losses excluded from earnings and reported in a separate component of shareholders' equity.. For purposes of US GAAP, certain unrealized gains and losses from the Company's available-for-sale securities are recorded directly in shareholders' equity, net of tax effects, until realized. Shareholders' equity under US GAAP was increased by R\$ 88 and reduced by R\$ 93 on December 31, 2007 and 2006, respectively, for unrealized gain/losses from available-for-sale securities.

(f) Property, plant and equipment

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## (i) Revaluations of property, plant and equipment.

BR CL permits appraisal write-ups, provided that certain formalities are complied with. The revaluation increment is credited to a reserve account in shareholders' equity. Depreciation of the asset revaluation increments is charged to income and an offsetting portion is relieved from the revaluation reserve in shareholders' equity and transferred to retained earnings as the related assets are depreciated or are disposed

For US GAAP reconciliation purposes, net revaluation of property, plant and equipment in the amounts of R\$ 2,339,829 and R\$ 2,427,499 at December 31, 2007 and 2006, respectively, have been eliminated in order to present property, plant and equipment at historical cost, indexed for inflation through 1997 based on a general price index, less accumulated depreciation. The depreciation on such revaluation charged to income, totaling R\$87,670, R\$102,272 and R\$ 89,449 for the years ended December 31, 2007, 2006 and 2005, respectively, has also been eliminated for US GAAP purposes in the reconciliation of net income.

Under BR CL, no deferred tax liability was recorded on the revaluation increment. Under US GAAP, although the depreciation from the additional inflation restatement ((a)(i) above) and the supplementary inflation restatement ((a)(ii) above) will not be deductible for tax purposes, these depreciation charges are considered to be temporary tax differences as the expense will reverse through income in the future, and, as such, are recorded for purposes of determining deferred tax liabilities.

## (ii) Different criteria for capitalizing and depreciating capitalized interest

Under BR CL, until December 31, 1995, capitalization of interest cost incurred during the construction period as part of the cost of the related property, plant and equipment was not required. However, as permitted by the Brazilian Water and Sewage Plan (*Plano Nacional de Saneamento Básico - PLANASA*), SABESP capitalized interest on construction-in-progress through 1989. Also, under BR CL as applied to companies in the utilities industry, during the period from 1979 to 1985, a notional interest rate was applied to construction-in-progress computed at the rate of 12% per annum of the balance of construction-in-progress; that part which related to interest on third-party loans was credited to interest expense based on actual interest costs with the balance relating to the self-financing portion being credited to capital reserves. Beginning in 1999, SABESP has capitalized indexation charges on the real - denominated loans and financing and the foreign exchange effects on foreign currency loans and financing.

Under US GAAP, in accordance with SFAS No. 34, "Capitalization of Interest Cost", interest incurred on borrowings is capitalized to the extent that borrowings do not exceed construction-in-progress. Such interest is capitalized as part of the cost of the related assets with a corresponding credit to financial expenses. Under US GAAP, the amount of interest capitalized excludes the indexation charges associated with the borrowings and the foreign exchange gains and losses on foreign currency borrowings.

The effects of these different criteria for capitalizing and amortizing interest are presented below:

	2007	2006	2005
--	------	------	------

Interest capitalized under US GAAP in the period from 1989 to 1995	205,459	206,227	208,826
Amortization thereof	(112,683)	(105,964)	(100,222)
Capitalized interest credited to income under BR CL (12% per annum, applied monthly to the balance of construction-in progress) in excess of actual interest	(32,448)	(32,569)	(32,983)
Amortization thereof	30,245	29,188	28,285
Indexation charges and foreign exchange losses capitalized since 1999 under BR CL, net	93,165	50,576	27,528
US GAAP difference in shareholders' equity at December 31	183,738	147,458	131,434
US GAAP difference on pre-tax income for the year ended December 31	36,280	16,024	25,929

(iii) Valuation of long-lived assets

F-60

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

Under BR CL, companies are required to determine if operating income is sufficient to absorb the depreciation or amortization of long-lived assets, within the context of the balance sheet as a whole, in order to assess potential asset impairment. As it pertains to property, plant and equipment, in the event that such operating income is insufficient to recover the depreciation due to their permanent impairment, the assets, or groups of assets, are written-down to recoverable values, preferably, based on the projected discounted cash flows of future operations.

Under US GAAP, SFAS No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets", requires companies to periodically evaluate the carrying value of long-lived assets to be held and used, and for long lived assets to be disposed of, when events and circumstances require such a review. The carrying value of long-lived assets is considered impaired when the anticipated undiscounted cash flows from identified assets, representing the lowest level for which identifiable cash flows largely independent of the cash flows of other groups of assets and liabilities, is less than their carrying value. In that event, a loss is recognized to the extent that the carrying value exceeds the fair market value of the assets.

No adjustment has been included in the reconciliation from BR CL to US GAAP to take account of differences between the measurement criteria, as based on analysis of cash flows measured at the smallest unit of assets groups for which cash flow data is captured no impairment provisions were required. Losses recognized on the write-off of property, plant and equipment arose primarily from adjustments related to the withdrawal of concession assets, construction-in-progress projects which were deemed to be no longer economically feasible and obsolescence write offs.

(g) Deferred charges

Under BR CL deferral of feasibility study costs and pre-operating expenses incurred in the construction or expansion of a new facility is permitted until such time as the facility begins commercial operations. Deferred charges are amortized over a period of five to ten years.

Under US GAAP, such amounts do not meet the conditions established for deferral and accordingly are charged to income as incurred.

The balance of feasibility study costs outstanding, amounted to R\$ 3,474 and R\$ 10,035 at December 31, 2007 and 2006, respectively, has been written-off for US GAAP purposes. The net effects from amortization and deferrals in the statement of operations at December 31, 2007, 2006 and 2005 were an increase of R\$ 6,561, R\$ 10,496 and R\$ 18,566 respectively.

(h) Pension benefits

Under BR CL, prior to 2002, amounts related to the pension plan were recorded on an accrual basis as the obligations for contributions fell due. In accordance with a new accounting standard issued by IBRACON and approved by the CVM, effective January 1, 2002, Brazilian public companies must account for pension obligations based on actuarial calculations and provide certain disclosures related to their pension plans. Under the new standard, the actuarial pension obligation determined at the date of adoption could be either recorded directly in shareholders' equity, or

prospectively, during the five-year period ending December 31, 2006 in results of operations. As permitted, the Company has elected to recognize this transition obligation on a straight-line basis through income over five years beginning in 2002. The amortization of the liability is being presented as an Extraordinary item in the statements of operations, net of applicable tax effects.

Under US GAAP, the Company accounts for its pension plans in accordance with the provisions of SFAS No. 87, "Employers' Accounting for Pensions," which among other requirements, requires that the Company recognize the actuarially-determined liability of its pension plan obligations. SFAS No. 87 also requires that an additional liability (minimum pension liability) is required to be recorded when the accumulated benefit obligation exceeds the fair value of the plan assets, less accrued pension amounts. This additional minimum liability is recorded as a charge to accumulated other comprehensive income in equity.

SFAS No. 132 (revised 2003), Employers' Disclosures about Pensions and Other Postretirement Benefits sets forth the requirements for information that must be disclosed with respect to the Company's pension plans.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

After the issuance of SFAS 158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R) , in September 2006, an employer is required to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multi-employer plan) as an asset or liability in its statement of financial position and to recognize changes in that funded status in the year in which the changes occur through comprehensive income of a business entity or changes in unrestricted net assets of a not-for-profit organization. This Statement also requires an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions.

Another requirement of the statement is that the employer must disclose in the notes to financial statements additional information about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation. An employer with publicly traded equity securities is required to initially recognize the funded status of a defined benefit postretirement plan and to provide the required disclosures as of the end of the fiscal year ending after December 15, 2006.

The additional adjustments required by SFAS 158 has been made after the accounting according to the SFAS 87 and SFAS 132.

Although the adopted accounting standard under BR CL requires the Company to recognize pension obligation based on actuarial methods effective January 1, 2002, differences under BR CL related to the prescribed actuarial methods, date of first adoption and amortization of transition obligations, among others, as compared with those under US GAAP, generate reconciling adjustments for US GAAP purposes.

(i) Pension plan (Plan G1)

The Company sponsors a defined-benefit plan for its employees (Plan G1). For the purposes of calculating the funded status of Plan G1, the provisions of SFAS No. 87, were applied with effect from January 1, 1992, because it was not feasible to apply them from the effective date specified in the standard.

(ii) Supplementary pension plan (Plan G0)

Pursuant to a law enacted by the State Government, certain employees who provided service to the Company prior to May 1974 and retired as an employee of the Company acquired a legal right to receive supplemental pension payments (which rights are referred to as Plan G0 ). The Company pays these supplemental benefits on behalf of the State Government and makes claims for reimbursement from the State Government, which are recorded as accounts receivable, shareholder under BR CL. No expense is recognized for these benefits under BR CL.

Consistent with the guidance in SEC Staff Accounting Bulletin Topic 5-T ("SAB No. 5-T"), under US GAAP, the Company recognizes the costs and obligations associated with Plan G0 supplemental pension benefits incurred by the State Government on behalf of the Company with respect to its employees on a push-down basis, as the Company is the recipient of the benefits of the employee service for which the supplemental pension benefits are made. These benefits are accounted for in accordance with SFAS No. 87. Eventual amounts received as reimbursement from the State Government, if any, are treated as additional paid-in-capital.

Retained earnings was reduced in the first year of presentation (1998) for the actuarial liability computed under SFAS No. 87. and the balance of amounts due from the State Government for pensions paid was charged to income, as this amount relates to a charge for past services rendered by the Company's former employees. Amounts reimbursed to the Company by the State Government were accounted for as additional paid-in capital and a reduction of the actuarial liability to reflect gross benefits paid. The remaining unpaid reimbursable balance due from the State Government (effectively a subscription receivable) was charged off as a deduction to shareholders' equity.

(iii) Sabbatical paid leave

The Company also pays amounts equivalent to three months of vacation for each five years' of service as a form of sabbatical paid leave to certain of the Company's employees for which it also claims reimbursement from the State Government. Consistent with the guidance in SAB Topic 5-T, under US GAAP the Company recognizes the costs and obligations associated with these sabbatical leave benefits incurred by the State Government on behalf of the Company with respect to its employees on a push-down basis, as the Company is the recipient of the benefits of the employee service for which the supplemental pension benefits are made. The Company has accounted for this sabbatical expense by relieving directly against retained earnings for the first year presented and subsequently the Company recognized as a charge to income the receivable due from the State Government, for sabbatical leave paid, as this amount relates to a charge for past services rendered by the Company's former/current employees. Amounts reimbursed by the State Government, if any, are accounted for as additional paid-in capital.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

During the year ended December 31, 2000, in the financial statements prepared in accordance with BR CL, sabbatical leave accruals totaling R\$ 23,747, which had in prior years been charged to income, and were accounted for as a receivable (reimbursement) due from the State Government, were reversed, as the Company does not consider this to be an expense under BR CL. Similarly, during December 31, 2007, 2006 and 2005, total amounts not accrued were R\$1,319, R\$ 1,991 and R\$ 968, respectively. Such amounts, consistent with the US GAAP difference mentioned above, were pushed down as expenses in the reconciliation to US GAAP.

## (iv) Summary of pension benefits adjustments

The effects included in the shareholders' equity reconciliation arising from these different criteria for pension and benefit accounting are presented below:

	2007	2006
Plan G1		
Accrued pension liability under US GAAP (SFAS 87)	(666,095)	(644,760)
Accrued pension liability under BR CL	365,234	321,212
Difference Plan G1 (SFAS 87)	(300,861)	(323,548)
Incremental Effect of Applying SFAS N° 158	248,972	361,450
Difference Plan G1	(51,889)	37,902
Plan G0		
Accrued pension cost under US GAAP (SFAS 87)	(1,192,624)	(1,156,492)
Incremental Effect of Applying SFAS N° 158	(45,043)	(87,575)
Difference Plan G0	(1,237,667)	(1,244,067)
Sabbatical paid leave		
Recognition of reversed expense (i) (iii)	(7,246)	(8,565)
Push-down accounting of Plan G0 and sabbatical		
Paid leave		
Gross amount paid for Plan G0 and sabbatical paid leave		
recorded as receivables from the State		
Government (i)	(994,047)	(889,425)

Additional paid-in capital - Plan G0 and sabbatical paid leave reimbursed by the State Government (i)	114,970	114,970
--	---------	---------

F-63

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The effects included in the reconciliation of net income (los) arising from these different criteria for pension and benefit accounting are presented below:

	2007	2006	2005
Plan G1			
Accrued pension obligation Plan G1	22,687	(14,469)	45,163
Plan G0			
Accrued pension obligation Plan G0	(36,132)	(25,981)	(27,258)
Sabbatical paid leave			
Recognition of reversed expense	1,319	1,991	968
Gross amount paid for Plan G0 and sabbatical Paid leave recorded as receivables from the State Government	(104,622)	(101,741)	(96,388)

## (i) Capitalization of debt issuance costs

Under BR CL the costs associated with issuance of debts are recognized as a operational expenses. Under US GAAP, APB 21 Interest on Receivables and Payables debt issue costs are deferred and amortized using the effective interest method over the remaining term of the applicable debt obligations. At December 31, 2007, the balance of deferred debt issue costs included as an adjustment to shareholders equity, related to debt issue costs was R\$ 7,481 (in 2006 was R\$ 11,331), net of accumulated amortization.

## (j) Donations

Under BR CL these amounts, which comprise principally contributions of property, plant and equipment that we receive from third parties, were recorded at fair value, generally determined based on estimates of the current replacement cost of the assets contributed, as other income until December 31, 2003 an as a credit to other capital reserves after this date.

For U.S. GAAP purposes, the amounts recorded as revenues and capital reserves related to donations received from third parties would be classified as a deferred credit, recorded as a reduction of the related amount of property, plant and equipment in the balance sheet, and amortized to reduce depreciation expense over the related estimated useful life of the donated assets. Prior to 2006, we did not account for any differences between BR CL and US GAAP, as the amounts of such donations have not historically been, and were not expected to be material. However, in light of the cumulative nature of such donations, beginning January 1, 2006, we began accounting for such differences.

As a result, shareholders equity under U.S. GAAP was lower by R\$ 83,316, net of tax effects, as compared to BR CL at December 31, 2007 (in December 31, 2006 was R\$ 69,535) . Net income in 2007 was also lower by R\$ 3,487 (2006 was R\$ 15,871), net of tax effects, as compared to BR CL, as a result of the cumulative differences in the accounting for donations under BR CL. The related impacts on prior year results of operations were not considered material.

(k) Segment reporting

Under BR CL, no separate segment reporting is required.

Under US GAAP, SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" establishes the standards for the manner in which public enterprises are required to report financial and descriptive information about their operating segments. SFAS No. 131 defines operating segments as components of an enterprise for which separate financial information is available and evaluated regularly as a means for assessing segment performance and allocating resources to segments. A measure of profit or loss, total assets and other related information are required to be disclosed for each operating segment.

The Company operates in two segments: water services and sewage services.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## (l) Comprehensive income

BR CL does not embody the concept of comprehensive income.

Under US GAAP, the Company has adopted the provisions of SFAS No. 130, "Reporting Comprehensive Income." A foreign (i.e., non-U.S.) registrant may present the statement of comprehensive income in any format permitted by SFAS No. 130. The information required by SFAS No. 130, has been included in the condensed financial statement information as prepared in accordance with US GAAP below.

## (m) Provision for dividends and interest on shareholders' equity

Under BR CL, at each annual balance sheet date management is required to propose a dividend distribution from earnings and accrue for this in the financial statements. Under BR CL, companies are permitted to distribute a notional amount of interest, subject to certain limitations, calculated based on the government TJLP interest rate, on shareholders' equity. Such amounts are deductible for tax purposes and are presented as a deduction from shareholders' equity. Although not affecting net income except for the tax benefit, in certain cases companies include this notional charge in interest expense and reverse the same amount before totaling net income. The Company presents the financial expense net of the reversal in its financial statements.

Under US GAAP, since proposed dividends must be ratified or modified at the annual shareholders' meeting, dividends would generally not be considered as declared at the balance sheet date and, as such, would not be accrued. However, because the State Government is the Company's controlling shareholder, the minimum dividend proposal when made by management at year end is maintained as a provision, and therefore, no adjustments has been included in the reconciliation from BR CL to US GAAP. Interim dividends paid or interest credited to shareholders as interest on shareholders' equity under BR CL is considered as declared for US GAAP purposes. Under US GAAP, no similar interest distribution concept exists.

Distributions per share data (in the form of dividends or interest on shareholders' equity) is not required to be disclosed under BR CL.

Interest on shareholders' equity per common shares(\*) for the years ended December 31, 2007, 2006 and 2005 were as follows:

	December 31,		
	2007	2006	2005
Interest on shareholders' equity per shares	1.32	1.19	1.53

(\* ) The weighted-average number of shares used in Interest on shareholders' equity per share for December 31, 2007, 2006 and 2005 was 227,836,623, reflecting the effects of the reverse stock split as discussed in note 26 (r).

(n) Related parties

Under BR CL, related parties are generally defined in a more limited manner and require fewer disclosures than US GAAP. The Company has expanded its disclosure for purposes of BR CL.

No adjustments have been included in the reconciliation from BR CL to US GAAP.

(o) Items posted directly to shareholders' equity accounts

Under BR CL, various items are posted directly to shareholders' equity accounts. Examples include certain capitalized interest, the effects of adjustments to tax rates and tax incentive investment credits received. As noted in (a) above, Brazilian utility companies used to capitalize interest attributable to construction-in-progress at the rate of 12% per annum of the balance of construction-in-progress and that part which relates to interest on third-party loans is credited to interest expense based on actual interest costs with the balance relating to the self-financed portion being credited to capital reserves.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

Under US GAAP, such items relating to third-party debt would be posted to the statement of operations. Since the original posting to equity accounts would, under US GAAP, be made directly to the statement of operations, these adjustments are included in the reconciliation of shareholders' equity and net income determined in accordance with US GAAP.

(p) Discounting

Under BR CL, discounting of trade receivables and payables to present value is not permitted. Under US GAAP, APB No. 21 "Interest on Receivables and Payables", such discounting, in certain cases, is required to record the effects of implicit interest income or expense or which are different from market rates on long-term assets and liabilities, except for transactions in which interest rates are affected by the tax attributes or legal restrictions prescribed by a government agency. The company does not have original long term agreements.

No adjustments have been included in the reconciliation from BR CL to US GAAP as the Company had no long-term trade accounts payables or receivables potentially subject to discounting at December 31, 2007, 2006 and 2005.

(q) Classification of statement of operations line items

Under BR CL, as noted above, the classification of certain income and expense items is presented differently from US GAAP. The Company has recast its statement of operations under BR CL to present a condensed statement of operations prepared in accordance with US GAAP. The reclassifications are summarized as follows:

(i) Interest income and interest expense, together with other financial charges, are displayed within operating income in the statement of operations presented in accordance with BR CL. Such amounts have been reclassified to non-operating income and expenses in the condensed statement of operations prepared in accordance with US GAAP;

(ii) Under BR CL, gains and losses on the disposal or impairment of permanent assets are classified as non-operating income (expense). Under US GAAP, gains and losses on the disposal or impairment of property, plant and equipment are classified as an adjustment to operating income;

(iii) Following the issue of an accounting standard under BR CL, effective January 1, 2002, the Company is amortizing the related transition obligation related to Plan G1 over five years. The related amortization, as permitted, is being presented as an Extraordinary item net of taxes, in the statement of operations. Under US GAAP, this amortization expense would be included as part of operating income.

(r) Earnings per share

Under BR CL, net income per share is calculated on the number of shares outstanding at the balance sheet date. Information is disclosed per lot of one thousand shares, because this is the minimum number of shares of the Company that can be traded on the stock exchanges.

Under US GAAP, in accordance with SFAS No.128, "Earnings per Share", the presentation of earnings per share is required for public companies, including earnings per share from continuing operations and net income per share on the face of the statement of operations, and the per share effect of changes in accounting principles, discontinued operations and extraordinary items either on the face of the statement of operations or in a note. A dual presentation is required: basic and diluted. Computations of basic and diluted earnings per share data are based on the weighted average number of shares outstanding during the period and all potentially dilutive shares outstanding during each period presented, respectively.

Statement 128 requires the retroactive restatement of earnings-per-share computations for stock dividends, stock splits, and reverse splits. If a stock dividend or split is consummated after the close of the period but prior to the issuance of the financial statements, the earnings-per-share computation should be based on the new number of shares.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**

**NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The Board of Directors, in its meeting on March 30, 2007, approved the proposal for submission to the Annual Shareholders Meeting, which took place on April 30, 2007, of the Grouping of Shares. On June 4, 2007, the shares were grouped in the proportion of 125 (one hundred twenty five) shares to 1 (one) share. The capital stock is represented by 227,836,623 common nominative and scriptural shares, without par value, remaining unchanged Sabesp's capital stock.

Simultaneously to the grouping operation, the American Depositary Receipts (ADR's) started to be traded in the proportion of 2 (two) shares to each ADR.

Considering the grouping of shares mentioned above the weighted-average number of shares used in computing basic earnings per share for December 31, 2007, 2006 and 2005 was 227,836,623. The Company had no potentially dilutive shares outstanding during 2007, 2006 or 2005.

(s) Leasing Transactions

Under Brazilian GAAP, generally, lessees account for long-term leases as operating leases, whereas in accordance with U.S. GAAP such leases could be accounted for as operating or capital leases. As a result, under Brazilian GAAP, lease payments by lessees with respect to leases are charged as an expense as incurred. Under U.S. GAAP, the lease payments may be charged as an expense as incurred (operating leases) or the leased asset and the corresponding lease liability may be recognized in the balance sheet and the effect of depreciation and interest expense in the results of operations (capital leases).

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

*Net income (loss) reconciliation of the differences between BR CL and US GAAP**The following is a reconciliation of the differences in net income (loss) between BR CL and US GAAP:*

		2007	2006	2005
Net income as reported under the BR CL		1,048,703	778,905	865,647
Depreciation of additional inflation restatement in 1996 and 1997	(a)(i)	(67,614)	(75,541)	(61,955)
Reversal of depreciation of revaluation increments	(f)(i)	87,670	102,272	89,449
Depreciation of supplementary restatement prior to 1991	(a)(ii)	(101,361)	(118,243)	(103,420)
Deferred tax effects on above (excluding revaluation)	(b)	57,452	65,887	56,228
Net income as reported under the BR CL, adjusted for inflation restatements and revaluations		1,024,850	753,280	845,949
Accrued pension cost - Plan G1	(h)(iv)	22,687	(14,469)	45,163
Accrued supplementary pension cost - Plan G0	(h)(iv)	(36,132)	(25,981)	(27,258)
Sabbatical leave benefits	(h)(iv)	1,319	1,991	968
Actuarial liability (Plan G0) and sabbatical leave benefits push-down recognition	(h)(iv)	(104,622)	(101,741)	(96,388)
Capitalized interest	(f)(ii)	36,280	16,024	25,929
Interests on Capital Leasing	(s)	(6,322)	6,967	(645)
Deferred charges, net of effects of accumulated amortization	(g)	6,561	10,496	18,566
Capitalization of debt issuance costs	(i)	(3,850)	(2,645)	13,976
Deferred Credits - Donations	(j)	5,283	(26,622)	
		946,054	617,300	826,260
Deferred income taxes effects:				
Other GAAP differences above, excluding reversal of revaluation increments	(b)	(20,618)	5,184	(35,016)

Net income under US GAAP		925,436	622,484	791,244
Net income per thousand common shares Basic and diluted (in reais)	(r)	4.06	2.73	3.47
Weighted average number of common shares outstanding on December 31, 2007	(r)	227,836,623	227,836,623	227,836,623

F-68

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

*Shareholders' equity reconciliation of the differences between BR CL and US GAAP**The following is a reconciliation of the differences in shareholders equity between BR CL and US GAAP:*

		2007	2006
Shareholders' equity, as reported under BR CL		9,784,006	9,018,482
Add (deduct):			
Additional inflation restatement in 1996 and 1997, net	(a) (i)	1,103,962	1,171,576
	(a) (ii)/		
Reversal of revaluation increments, net	(f) (i)	(2,339,829)	(2,427,499)
Supplementary restatement prior to 1991, net	(a) (ii)	2,705,277	2,806,638
Deferred tax effects on above (excluding revaluation)	(b)	(1,244,233)	(1,301,684)
Shareholders' equity, as reported under BR CL, adjusted for inflation restatements and revaluations		10,009,183	9,267,513
Accrued pension cost - Plan G1	(h) (iv)	(51,889)	37,902
Accrued supplementary pension cost -Plan G0	(h) (iv)	(1,237,667)	(1,244,067)
Actuarial liability (Plan G0) and sabbatical leave expense push-down recognition	(h) (iv)	(994,047)	(889,425)
Additional paid-in capital - Plan G0 and sabbatical expense reimbursed by the State Government	(h) (iv)	114,970	114,970
Sabbatical paid leave of absence benefits	(h) (iv)	(7,246)	(8,565)
Capitalized interest	(f) (ii)	183,738	147,458
Interests on Capital Leasing	(s)	-	6,322
Deferred charges expensed, net	(g)	(3,474)	(10,035)
Capitalization of debt issuance costs	(i)	7,481	11,331
Deferred Credits - Donations	(j)	(92,271)	(80,286)
Other GAAP differences	(e)	88	(93)
Deferred income taxes effects:	(b)		
Other deferred tax effects on US GAAP differences above, excluding adjustments for available-for-sale securities, inflation restatements and revaluation increments		(37,235)	(54,861)
Shareholders' equity under US GAAP		7,891,631	7,298,164



**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

**Supplemental Condensed Financial Statement Information in Accordance with US GAAP.**

The following presents condensed financial statement information in accordance with US GAAP.

	2007	2006
<i>Assets</i>		
Current assets		
Cash and cash equivalents	457,340	328,206
Restricted cash (PMSP)	7,657	-
Customer accounts receivable, net	1,207,885	1,111,289
Receivables from shareholder, net	338,506	367,864
Inventories	53,141	48,889
Taxes recoverable	33,543	31,582
Other current assets	55,190	28,852
Total current assets	2,153,262	1,916,682
Investments		
Intangible assets - concession rights, net	808	627
Property, plant and equipment, net	507,789	495,118
	15,620,950	15,473,542
Other long-term assets		
Customer accounts receivable, net	278,787	296,562
Receivables from shareholder, net	107,911	89,012
Escrow deposits	49,611	33,835
Indemnities receivable	148,794	148,794
National water agency program(Agência Nacional de Águas)	57,332	36,989
Other assets	3,675	7,536
	646,110	612,728
Total assets	18,928,919	18,498,697



**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

	2007	2006
Liabilities and shareholders' equity		
Current liabilities		
Accounts payable to suppliers and contractors	165,267	144,167
Loans and financing	742,114	852,475
Accrued payroll and related charges	166,797	177,705
Deferred income taxes	-	69,281
Taxes payable	127,735	105,552
Accrued pension obligation		
Plan G0	109,920	110,059
Provisions for contingencies	319,977	2,294
Interest on shareholders' equity	680,339	511,519
Services Received	156,987	152,953
Other current liabilities	57,323	99,312
Total current liabilities	2,526,459	2,225,317
Long-term liabilities		
Loans and financing	4,925,439	5,459,938
Taxes payable	197,635	230,440
Accrued pension obligation		
Plan G0	1,127,747	1,134,008
Plan G1	417,123	283,310
Provisions for contingencies	655,084	655,258
Deferred income taxes	1,084,107	1,160,792
Other liabilities	103,694	51,470
Total long-term liabilities	8,510,829	8,975,216
Commitments and contingencies		
Shareholders' equity		
Paid-in capital	3,518,658	3,518,658
Capital reserves	53,323	53,026
Supplementary and additional inflation restatement reserves	3,809,239	3,978,214
Accumulated other comprehensive income net of taxes	119,279	150,982
Appropriated earnings	306,654	254,219
Accumulated profits / (deficits)	84,478	(656,935)

Total shareholders equity	7,891,631	7,298,164
Total liabilities and shareholders equity	18,928,919	18,498,697

F-71

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

**Condensed Statements of Operations in accordance with US GAAP**

	2007	2006	2005
Gross revenue from sales and services	6,448,211	5,984,012	5,356,326
Taxes on sales and services	(477,369)	(456,679)	(402,963)
Net revenue from sales and services	5,970,842	5,527,333	4,953,363
Cost of sales and services	(2,848,560)	(2,822,616)	(2,570,180)
Gross profit	3,122,282	2,704,717	2,383,183
Operating expenses			
Selling	(648,134)	(737,303)	(555,435)
Administrative	(609,909)	(428,670)	(350,180)
Other operating expenses, net	(23,292)	(87,380)	(7,356)
Income from operations	1,840,947	1,451,364	1,470,212
Financial expenses, net	(520,777)	(542,266)	(401,894)
Income before taxes on income	1,320,170	909,098	1,068,318
Income and social contribution taxes	(394,734)	(286,614)	(277,074)
Net income for the year	925,436	622,484	791,244
Net income per thousand shares Basic and diluted (in reais)	4.06	2.73	3.47
Weighted average number of common shares outstanding	227,836,623	227,836,623	227,836,623

**Condensed Statement of Comprehensive Income (Loss) in accordance with US GAAP (under SFAS No. 130)**

	2007	2006	2005
Net income for the year	925,436	622,484	791,244
Unrealized gains (losses) on available-for-sale securities	181	(63)	62

Effects of Applying SFAS N° 158:

Pension Plan - Plan G1	(74,235)	-	-
Pension Plan - Plan G0	42,532	-	-
Comprehensive income	893,914	622,421	791,306

F-72

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

**Condensed Statement of Changes in Shareholders' Equity in accordance with US GAAP.**

	2007	2006	2005
Balance at beginning of the year	7,298,164	6,821,396	6,364,777
Donations	297	(25,794)	13,529
Unrealized gains (losses) on available-for-sale securities	181	(63)	62
Effects of Applying SFAS N° 158:			
Pension Plan - Plan G1	(74,235)	238,557	-
Pension Plan - Plan G0	42,532	(87,575)	-
Net income for the year	925,436	622,484	791,244
Interest on shareholders' equity	(300,744)	(270,841)	(348,216)
Balance at end of the year	7,891,631	7,298,164	6,821,396

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

**Recently Issued Accounting Pronouncements**

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes, An Interpretation of SFAS No. 109, ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. FIN 48 requires that realization of an uncertain income tax position must be more likely than not (i.e., greater than 50% likelihood of receiving a benefit) before it can be recognized in the financial statements.

Further, this interpretation prescribes the benefit to be recorded in the financial statements as the amount most likely to be realized assuming a review by tax authorities having all relevant information and applying current conventions. Additionally, FIN 48 provides guidance on derecognition, income statement classification of interest and penalties, accounting in interim periods, disclosure, and transition. This interpretation is effective for fiscal years beginning after December 15, 2006. The adoption of FIN 48 has not impacted SABESP's financial statements of 2007, see note 27 (b).

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements ( SFAS 157 ). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The transition adjustment, which is measured as the difference between the carrying amount and the fair value of those financial instruments at the date this statement is initially applied, should be recognized as a cumulative effect adjustment to the opening balance of retained earnings for the fiscal year in which this statement is initially applied. SABESP is currently evaluating the effect the application of SFAS No. 157 will have on its financial statements.

In February 2007, the FASB issued SFAS No. 159 which provides reporting entities an option to report selected financial assets, including investment securities designated as available for sale, and liabilities, including most insurance contracts, at fair value. SFAS No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The standard also requires additional information to aid financial statement users' understanding of a reporting entity's choice to use fair value on its earnings and also requires entities to display on the face of the balance sheet the fair value of those assets and liabilities for which the reporting entity has chosen to measure at fair value. SFAS No. 159 is effective as of the beginning of a reporting entity's first fiscal year beginning after November 15, 2007. As allowed by the standard, the Company has elected not to adopt SFAS No. 159 for the measurement of any eligible assets or liabilities.

In December 2007, the FASB issued Statement No. 141 (revised 2007), "Business Combinations.", that requires the acquiring entity in a business combination to recognize all (and only) the assets acquired and liabilities assumed in the transaction; establishes the acquisition-date fair value as the measurement objective for all assets acquired and liabilities assumed; and requires the acquirer to disclose to investors and other users all of the information they need to evaluate and understand the nature and financial effect of the business combination. SFAS 141(R) is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. We do not expect the adoption of SFAS 141(R) to have an impact on SABESP's financial statements.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 ( SFAS 160 ). SFAS 160 establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. SFAS 160 is effective for fiscal years beginning on or after December 15, 2008. We do not expect the adoption of SFAS 160 to have an impact on SABESP 's financial statements.

On March 19, 2008, the FASB issued Statement 161, which amends Statement 133 by requiring expanded disclosures about an entity 's derivative instruments and hedging activities, but does not change Statement 133 's scope or accounting. This statement requires increased qualitative, quantitative, and credit-risk disclosures. Statement 161 also amends Statement 107 to clarify that derivative instruments are subject to Statement 107 's concentration-of-credit-risk disclosures. Although the FASB intended Statement 107 to apply to all financial instruments, including derivatives, it believes the clarification was necessary to address differing views on whether entities ' disclosures about concentration of credit risk should include derivative instruments.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

This Statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. We do not expect the adoption of SFAS 161 to have an impact on SABESP's financial statements, since we do not have derivative instruments nor hedging activities.

On May 9, 2008, the FASB issued Statement 162, which reorganizes the GAAP hierarchy. The purpose of the new standard is to improve financial reporting by providing a consistent framework for determining what accounting principles should be used when preparing U.S. GAAP financial statements. Under this new Statement, the hierarchy is as follows:

**Level A** FASB Statements of Financial Accounting Standards and Interpretations, FASB Statement 133 Implementation Issues, FASB Staff Positions, AICPA Accounting Research Bulletins and APB Opinions that are not superseded by actions of the FASB, and rules and interpretive releases of the SEC for SEC registrants.

**Level B** FASB Technical Bulletins and, if cleared by the FASB, AICPA Industry Audit and Accounting Guides and Statements of Position.

**Level C** AICPA Accounting Standards Executive Committee Practice Bulletins that have been cleared by the FASB, consensus positions of the EITF, and Topics discussed in Appendix D of EITF Abstracts.

**Level D** Implementation Guides (Q&As) published by the FASB staff, AICPA Accounting Interpretations, AICPA Industry Audit and Accounting Guides and Statements of Position not cleared by the FASB, and practices that are widely recognized and prevalent either generally or in the industry.

Prior to issuing FASB Statement No. 162, The Hierarchy of Generally Accepted Accounting Principles, GAAP hierarchy was defined in the AICPA SAS No. 69, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. This Statement shall be effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board (PCAOB) amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.

On May 23, 2008, the FASB issued Statement 163 to decrease the inconsistencies in Statement 60 in accounting for financial guarantee insurance contracts by insurance companies. Statement 163 addresses the differing views in Statement 60 regarding the recognition and measurement of premium revenues and claim liabilities and enhances the disclosure requirements for insurance contracts. Statement 163 requires insurance enterprises that issue financial guarantee insurance contracts to initially recognize the premium received (or premiums expected to be received) for issuing the contract as unearned premium revenue and recognize that premium revenue over the period the protection is provided and in proportion to it. Statement 163 also requires recognition of a claim liability before an event of default if there is evidence that credit deterioration of the guaranteed obligation has occurred. The FASB hopes that these changes will bring consistency to financial reporting for financial guarantee insurance contracts and will increase the comparability and quality of financial information. We do not expect the adoption of SFAS 163 to have an impact on SABESP's financial statements, since we do not operate as an insurance company.

On April 25, 2008, the FASB issued FSP FAS 142-3, which amends the list of factors an entity should consider in developing renewal or extension assumptions used in determining the useful life of recognized intangible assets under Statement 142. The new guidance applies to (1) intangible assets that are acquired individually or with a group of other assets and (2) intangible assets acquired in both business combinations and asset acquisitions. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008. SABESP is currently evaluating the effect the application of FSP FAS 142-3, will have on its financial statements.

F-75

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## 27. ADDITIONAL DISCLOSURES REQUIRED UNDER US GAAP

## (a) Pension and post-retirement benefits

## (i) Pension plan - Plan G1

The Company sponsors a defined-benefit pension plan ("Plan G1"), which is operated and administered by SABESPREV. The status of this pension plan and the related actuarial assumptions presented in accordance with US GAAP are as follows:

	2007	2006		
Accumulated benefit obligation				
Vested	755,011	331,324		
Non-vested	467,947	669,684		
Total	1,222,958	1,001,008		
Projected benefit obligation	1,386,563	1,096,219		
Fair value of plan assets	(969,440)	(812,909)		
Funded position	417,123	283,310		
Unrecognized net transition obligation	-	-		
Unrecognized net gains	248,972	361,450		
Accrued pension liability (SFAS N° 87)	666,095	644,760		
Incremental Effect of Applying SFAS N° 158	(248,972)	(361,450)		
Accrued pension liability recorded in Balance Sheet (SFAS N° 158)	417,123	283,310		
	2008(1)	2007	2006	2005
Net periodic pension cost				
Service cost	33,347	33,440	17,545	9,889
Interest cost	164,124	131,848	93,270	91,886
Expected return on assets	(117,317)	(96,439)	(83,065)	(70,222)

Amortization of transition obligation	-	-	29,082	29,082
Amortization of actuarial gain	(11,032)	(22,687)	(29,092)	(26,341)
Employee contributions	(13,025)	(12,925)	(15,410)	(13,752)
Total net periodic pension cost	56,097	33,237	12,330	20,542
Weighted-average assumptions				
Discount rate (nominal)		10.8%	12.3%	12.3%
Projected long-term inflation rate		4.0%	4.0%	4.0%
Expected return on plan assets		10.8%	12.1%	12.1%
Rate of compensation increase		6.1%	6.1%	6.1%

(1) Expected NPPC (net periodic pension cost) for 2008 according to the Actuarial Report.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The reconciliation of changes in the projected benefit obligation and the fair value of plan assets is as follows for the years ended December 31:

	2007	2006	2005
Change in projected benefit obligation			
At beginning of year	1,096,219	790,552	760,015
Service cost	33,440	17,545	9,889
Interest cost	131,848	93,270	91,886
Actuarial (gain) loss	177,100	225,373	(40,978)
Benefits paid	(52,044)	(30,521)	(30,260)
At end of year	1,386,563	1,096,219	790,552
Change in fair value of plan assets			
At beginning of year	812,909	678,185	584,702
Actual return on plan assets	183,748	138,444	98,667
Employer contributions	11,902	11,391	11,324
Employee contributions	12,925	15,410	13,752
Gross benefits paid	(52,044)	(30,521)	(30,260)
At end of year	969,440	812,909	678,185
Funded status	417,123	283,310	112,367
Unrecognized actuarial gain	248,972	361,450	502,352
Unrecognized net transition obligation	-	-	(29,082)
Net amounts recognized in financial statements (SFAS N° 87)	666,095	644,760	585,637
Incremental Effect of Applying SFAS N° 158	(248,972)	(361,450)	-
Net amounts recognized in financial statements (SFAS N° 158)	417,123	283,310	585,637

The measurement date used to determine pension benefits was December 31, 2007.

The amortization of the unrecognized liability at transition is over 16 years commencing on January 1, 1990.

The expected long-term rate of return on plan assets was determined based on the weighted average estimated return of the plan assets, which includes equity securities, real state, loans and fixed income, based on information obtained from SABESPREV. This projected long-term rate includes the projected long-term inflation rate and takes into consideration such factors as projected future interest yield curves and economic projections available in the market.

The plan's investment policies and strategies are aimed to reduce investment risk through diversification, considering such factors as the liquidity needs and funded status of plan liabilities, types and availability of financial instruments in the local market, general economic conditions and forecasts as well as requirements under local pension plan law. The plan's asset allocation and external asset management strategies are determined with the support of reports and analyses prepared by SABESPREV and independent financial consultants. Under its current investment strategy, pension assets of the Company are allocated with a goal to achieve the following distribution:

<b>Assets category</b>	<b>%</b>
Equity securities	20
Real estate	4
Loans	2
Fixed rate securities	74
<b>Total</b>	<b>100</b>

F-77

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

Restrictions with respect to asset portfolio investments, in the case of federal government securities for internal management, are as follows:

- papers securitized by the National Treasury will not be permitted.
- exposure to fluctuations in exchange rates will not be permitted, i.e., if there are any exchange bills in the portfolio, swaps must be used to hedge existing exposure.

Restrictions with respect to asset portfolio investments, in the case of variable-income securities for external management, are as follows:

- day-trade operations will not be permitted.
- sale of uncovered options is prohibited.
- swap operations without guarantee are prohibited.
- leverage will not be permitted, i.e., operations with derivatives representing leverage of asset or selling short are prohibited; such operations cannot result in losses higher than invested amounts.

The weighted average actual asset allocations of Plan G1 at December 31 by asset category, are as follows for the years ended December 31:

Asset Category	%	
	2007	2006
Equity securities	20	13
Real estate	4	6
Loan	2	3
Fixed rate securities	74	78
Total	100	100

Expected future benefit payments, which reflect expected future service as appropriate, under Plan G1 are as follows:

	G1 Plan
2008	59,135

2009	64,591
2010	69,747
2011	74,748
2012	80,175
Years 2013-2022	969,111
Total	1,317,507

The expected Company's contributions for 2008 amounts to R\$11,688.

F-78

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## (ii) Pension plan - Plan G0

The Company is also co-obligor to a supplemental defined benefit pension plan ("Plan G0").

The status of the supplemental pension benefit plan and the related actuarial assumptions used in accordance with US GAAP are as follows:

	2007	2006
Accumulated benefit obligation		
Vested	1,038,593	1,195,637
Non-vested	67,854	1,299
Total	1,106,447	1,196,936
Projected benefit obligation	1,237,667	1,244,067
Funded position	1,237,667	1,244,067
Unrecognized actuarial gain	(45,043)	(87,575)
Accrued pension liability (SFAS N° 87)	1,192,624	1,156,492
Incremental Effect of Applying SFAS N° 158	45,043	87,575
Accrued pension liability recorded in balance sheet (SFAS N° 158)	1,237,667	1,244,067

	2008(1)	2007	2006	2005
Net periodic pension cost				
Service cost	9	24	397	1,858
Interest cost	140,879	146,167	126,262	121,685
Amortization of transition obligation	-	-	-	-
Total net periodic pension cost	140,888	146,191	126,659	123,543

Weighted-average assumptions			
Discount rate (nominal)	10.8%	12.3%	12.3%
Projected long-term inflation rate	4.0%	4.0%	4.0%
Rate of compensation increase	6.1%	6.1%	6.1%

(1) Expected NPPC (net periodic pension cost) for 2007 according to the Actuarial Report.

F-79

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

The reconciliation of changes in the projected benefit obligation is as follows:

	Years Ended December 31,		
	2007	2006	2005
Change in projected benefit obligation			
At beginning of year	1,244,067	1,096,517	1,034,285
Service cost	24	397	1,858
Interest cost	146,167	126,262	121,685
Actuarial (gain) loss	(42,532)	121,568	34,975
Benefits paid	(110,059)	(100,677)	(96,286)
At end of year	1,237,667	1,244,067	1,096,517
Funded status	1,237,667	1,244,067	1,096,517
Unrecognized actuarial gain	(45,043)	(87,575)	33,994
Net amounts recognized in financial statements (SFAS N° 87)	1,192,624	1,156,492	1,130,511
Incremental Effect of Applying SFAS N° 158	45,043	87,575	-
Net amounts recognized in financial statements (SFAS N° 158)	1,237,667	1,244,067	1,130,511

The date used to determine pension benefits was December 31, 2007.

The amortization of the unrecognized liability at transition was over 15 years commencing on January 1, 1988.

Expected future benefit payments, which reflect expected future service as appropriate, under Plan G0 are as follows:

	G0 Plan
2008	109,920
2009	109,837
2010	109,750
2011	109,742
2012	109,661

Years 2013-2022	1,061,948
Total	1,610,858

## (b) Income taxes (FIN 48 implementation):

The Company adopted the provisions of FIN 48 on January 1, 2007 and recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. Changes in recognition or measurement are reflected in the period in which the change in judgment occurs. As a result of the implementation of FIN 48, the company did not record any further tax benefit related to uncertainty in income taxes, beyond those already recorded under BR CL (notes 11 and 12). As of December 31, 2007 SABESP has no unrecognized tax benefit

In compliance with FIN 48 the company has the accounting policy of classifying income taxes interest and penalties as Financial expenses.

Brazilian income tax returns are normally open to examination by Brazilian tax authority for five years.

## (c) Other information

## (i) Concentration of labor in unions

Approximately 70% of all the Company's employees are members of unions. The four main unions that represent the Company's employees are the *Sindicato dos Trabalhadores em Água, Esgoto e Meio Ambiente de São Paulo* SINTAEMA, *Sindicato dos Trabalhadores da Região Urbana de Santos, São Vicente, Baixada Santista, Litoral Sul e Vale Ribeira* SINTIUS, the *Sindicato dos Engenheiros do Estado de São Paulo* SEESP and the *Sindicato dos Advogados de São Paulo* SASP. Every year the Company negotiates collective bargaining agreements, which establish the level of compensation and other benefits of the employees.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP**

**NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

(ii) Law 11.445/07

On January 5, 2007, Law No. 11,445 was enacted to regulate the basic sanitation industry in Brazil. This law is in its initial stage of implementation and we cannot anticipate the effects that it will have on our operations and business. There are several uncertainties related to the new legislation, mainly with respect to the creation of the regulatory authority for the basic sanitation industry and the tariff adjustment formula and structure that will be used for new concession contracts that we enter into under the new law, which could have a material adverse effect on us.

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

## 28. SUPPLEMENTAL INFORMATION

## (a) Statement of Cash Flow

The statement of cash flows reflects the Company's operating, investing and financing activities derived from accounting records prepared in accordance with Brazilian Corporate Law and has been presented in accordance with International Accounting Standards (IAS) No. 7 - Cash Flow Statements .

	Year ended December 31,		
	2007	2006	2005
<b>Cash flow from operating activities:</b>			
Net income for the year	1,048,703	778,905	865,647
Adjustments to reconcile net income:			
Deferred taxes and contributions	(104,432)	(8,473)	(32,470)
Provisions for contingencies	477,722	144,480	143,586
Reversal of provision for losses	(945)	(8,819)	
Other provisions	155	7,504	
Pension obligation	59,931	60,070	68,665
Write-off of property, plant and equipment	68,349	47,807	19,051
Write-off of deferred assets	1,276	5,195	6,700
Write-off of investments	-	20	4,360
Gain in the sale of fixed assets	219	(1,294)	
Depreciation	597,118	614,051	564,392
Amortization	25,431	28,120	31,589
Interests calculated on loans and financing payable	519,672	619,909	677,921
Interests, Monetary and foreign exchange variation	(91,542)	(8,380)	(226,573)
Bad debt expense	323,339	411,918	255,292
<b>Changes in Working Capital:</b>			
Customers accounts receivable	(400,944)	(458,824)	(359,894)
Inventories	(3,307)	(12,851)	(6,466)
Transactions with related parties	(81,741)	(151,343)	(250,530)
Other assets	8,997	(66,412)	(15,288)
<b>Change in Liabilities:</b>			
Suppliers	(14,055)	50,176	8,950
Payroll and related charges	(10,908)	60,416	10,061
Taxes and contributions Payable	(22,840)	(43,899)	(50,064)

Contingencies	(145,668)	(79,801)	(13,921)
Other obligations	(38,930)	32,349	36,567
<b>Cash flow from operating activities</b>	<b>2,215,600</b>	<b>2,020,824</b>	<b>1,737,575</b>
Cash flow from investment Activities:			
Purchase of property, plant and equipment	(848,878)	(842,454)	(638,372)
Increase in intangibles	(32,818)	(12,630)	(4,748)
Sale of property, plant and equipment	-	7,837	-
Increase in deferred asset	-	(2,789)	(106)
<b>Net cash from in investment activities</b>	<b>(881,696)</b>	<b>(850,036)</b>	<b>(643,226)</b>
Cash flow from financing activities			
Loans and Financing			
Funds raised	222,474	706,774	1,153,479
Repayments	(1,283,201)	(1,660,482)	(1,991,370)

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

	Year ended December 31,		
	2007	2006	2005
Payment of interest on shareholders' equity	(136,386)	(169,047)	(81,842)
<b>Net cash used in financing activities</b>	<b>(1,197,113)</b>	<b>(1,122,755)</b>	<b>(919,733)</b>
Increase in cash and cash equivalents	136,791	48,033	174,616
Cash and cash equivalents at the beginning of the year	328,206	280,173	105,557
Cash and cash equivalents at the end of the year	464,997	328,206	280,173
<b>Supplementary cash flow information:</b>			
Interests and fees paid on loans and financings	548,417	637,989	701,641
Income tax and social contribution paid	499,318	404,272	359,826
<b>Non - cash transactions</b>			
Property, plant and equipment received as donations	17,565	27,870	13,529

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

**29. SEGMENT INFORMATION**

The Company has two identifiable reportable segments: (i) water supply systems; and (ii) sewage collection systems. The chief operating decision maker uses these two segments to analyse the Company and uses income from operations before financial expenses, net as a measure of segment profit or loss.

Total assets by segment is not readily available, and therefore not regularly provided to, nor reviewed by the Company's chief operating decision maker. However, total property, plant and equipment by segment is readily available and reviewed regularly by the Company's chief operating decision maker to make decisions about resource allocations and to measure performance. As such, management believes that total property, plant and equipment is a relevant measure for its operating segments and is disclosed by segment in Note 8.

	Year Ended December 31, 2007		
	Water system	Sewage system	Consolidated
Gross revenue from sales and services	3,325,826	2,724,400	6,050,226
Gross sales revenue - wholesale	291,705	8,002	299,707
Other sales and services	64,359	33,919	98,278
	3,681,890	2,766,321	6,448,211
Taxes on sales and services	(272,575)	(204,794)	(477,369)
Net revenue from sales and services	3,409,315	2,561,527	5,970,842
Cost of sales and services and operating expenses	(2,534,679)	(1,359,759)	(3,894,438)
Income from operations before financial expenses, net	874,636	1,201,768	2,076,404

	Year Ended December 31, 2007			
	Water system	Sewage System	Common assets and concession assets acquired	Consolidated
Depreciation and amortization charges				

BR CL	(346,887)	(275,662)	-	(622,549)
US GAAP	(400,187)	(318,018)	-	(718,205)

Additions to property, plant and equipment

BR CL	394,951	479,463	46,662	921,076
US GAAP	394,951	523,493	46,662	965,106

F-84

---

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

	Year Ended December 31, 2006		
	Water system	Sewage system	Consolidated
Gross revenue from sales and services	3,093,122	2,530,796	5,623,918
Gross sales revenue - wholesale	265,298	1,870	267,168
Other sales and services	60,738	32,188	92,926
	3,419,158	2,564,854	5,984,012
Taxes on sales and services	(241,885)	(214,794)	(456,679)
Net revenue from sales and services	3,177,273	2,350,060	5,527,333
Cost of sales and services and operating expenses	(2,460,178)	(1,263,178)	(3,723,356)
Income from operations before financial expenses, net	717,095	1,086,882	1,803,977

## Year Ended December 31, 2006

	Water system	Sewage System	Common assets and concession assets acquired	Consolidated
Depreciation and amortization charges				
BR CL	(361,675)	(280,496)	-	(642,171)
US GAAP	(411,959)	(319,493)	-	(731,452)
Additions to property, plant and equipment				
BR CL	349,708	430,305	24,934	804,947
US GAAP	349,708	453,949	24,934	828,591

## Year Ended December 31, 2005

	Water system	Sewage system	Consolidated
--	-----------------	------------------	--------------

Gross revenue from sales and services	2,771,633	2,256,857	5,028,490
Gross sales revenue - wholesale	241,209	-	241,209
Other sales and services	57,034	29,593	86,627
	3,069,876	2,286,450	5,356,326
Taxes on sales and services	(213,394)	(189,569)	(402,963)
Net revenue from sales and services	2,856,482	2,096,881	4,953,363
Cost of sales and services and operating expenses	(2,205,146)	(1,058,644)	(3,263,790)
Income from operations before financial expenses, net	651,336	1,038,237	1,689,573

F-85

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

Year Ended December 31, 2005

	Water system	Sewage System	Common assets and concession assets acquired	Consolidated
Depreciation and amortization charges				
BR CL	(336,450)	(259,531)	-	(595,981)
US GAAP	(392,449)	(302,728)	-	(695,177)
Additions to property, plant and equipment				
BR CL	301,815	345,426	30,995	678,236
US GAAP	301,815	376,560	30,995	709,370

**30. SUBSEQUENT EVENT****I Program Contracts:**

In certain Program Contracts that was signed in 2008, the Company assumed commitments to financially participate in social and environmental sanitation actions. These commitments are being amortized according to the effective period of the program contracts. On March 31, 2008 the total amount of these Intangible assets (net of amortization) was R\$ 57,710.

**II Granting of loans and financing****Executive Board of the Inter-American Development Bank (IADB)**

On April 30, 2008, the Executive Board of the Inter-American Development Bank (IADB) approved the granting of a loan to SABESP, in the amount of US\$250 million (AB loan). The funds will be used to refinance debts falling due and to implement a portion of the Company's investment plan. The agreement was signed on May 27, 2008, with the following characteristics:

	US\$ Trenches	Adjustment	Interest	Maturity date
C. 1983 A	100,000	LIBOR	2.375% p.a.	May/2023
C. 1983 B/BR - 1	100,000	LIBOR	2.075% p.a.	May/2020
C. 1983B/BR 2	50,000	LIBOR	1.875% p.a.	May/2018

Caixa Econômica Federal - CEF - Programa Saneamento para Todos (Sanitation Program) FGTS

Funds CEF granted a financing line totaling R\$626.91 million, for 71 water supply, sewage and integrated sewage systems projects, in municipalities of the São Paulo, Santos and Campinas metropolitan areas. On May, 2008, were signed 69 agreements in the amount of R\$ 619.34 million, and the disbursements should take place concurrently to the construction works, which will be completed within 48 months. The agreements were signed with the following characteristics:

Grace period	48 months
Repayment period	240 months
Interest rate	6.00% p.a.
Management fee	1.05% p.a.
Risk fee	0.30% p.a.

BNDES (National Bank for Economic and Social Development) - FAT (Workers Assistance Fund) funds

BNDES approved a financing line totaling R\$174.52 million, for 10 sewage systems projects in the São Paulo, Santos and Campinas metropolitan region. The financing agreement was signed in May 2008, and disbursements should take place concurrently to the construction works, which will be completed within 48 months. The agreements were signed with the following characteristics:

**COMPANHIA DE SANEAMENTO BÁSICO DO ESTADO DE SÃO PAULO - SABESP****NOTES TO THE FINANCIAL STATEMENTS**

AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2007, 2006 AND 2005

(Amounts in thousands of Brazilian reais-R\$, unless otherwise stated)

Grace period	36 months
Repayment period	120 months
Interest rate	2.15% p.a. + TJLP

**III Confidentiality agreement with EMAE:**

On May 30, 2008 SABESP published a Material Fact informing that it has entered into a confidentiality agreement with EMAE - Empresa Metropolitana de Águas e Energia S.A. ("EMAE") to carry out a valuation of this company, without any binding effects, aiming at an eventual acquisition of assets which, among other alternatives, may result in the corporate restructuring of EMAE or the acquisition of its capital by SABESP, currently held by the State of São Paulo, in accordance to the current legislation and conditions of operations of this nature.

**IV Public-Private Partnership agreement ( PPP )**

On June 2008, SABESP entered into a public-private partnership agreement ( PPP ) with Cab Spat, a special purpose company whose main shareholders are Cab Ambiental and Galvão Engenharia.

Cab Spat will be responsible for (i) expansion of Taiapuêba Plant water treatment capacity from 10 cubic meters per second to 15 cubic meters per second, (ii) construction of 17.7 kilometers of water transmission mains, (iii) construction of 4 water storage tanks with total capacity of 70,000 cubic meters, (iv) installation of boosters, and (v) construction of pumping stations. The total capital expenditure for these investments will amount to approximately R\$ 300 million.

Cab Spat shall also provide maintenance and operation services such as (i) dams maintenance, (ii) sludge treatment and disposal, (iii) maintenance of the civil works and electromechanical maintenance, (iv) complementary services of water transmission and supply.

The total amount expected to be paid by SABESP at the end of this contract is around of R\$ 1 billion, including services and investments.

Currently, Taiapuêba Plant produces and provides water to 3.1 million people. Its expansion will enable SABESP to supply water to an additional 1.5 million people. Therefore, this PPP is crucial to assure proper water supply in the large metropolitan area of the City of São Paulo.