

COMPANHIA DE SANEAMENTO BASICO DO ESTADO DE SAO PAULO-SABESP  
Form 20-F  
April 28, 2014

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

**FORM 20 F**

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

**OR**

**p ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2013**

**OR**

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

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

**OR**

**o 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, Brazil**  
(Address of principal executive offices)

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Rua Costa Carvalho, 300 05429 900 São Paulo, SP, Brazil

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

<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
Common Shares <sup>1</sup> , without par value	New York Stock Exchange <sup>2*</sup>
American Depositary Shares, evidenced by American Depositary Receipts, each representing one Common Share	New York Stock Exchange

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1 On April 22, 2013, our shareholders approved a stock split, following which each common share represented three new common shares.

2 Until January 23, 2013, each American Depositary Share represented two common shares. As of January 24, 2013, each American Depositary Share represents one Common Share.

\* 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.

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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.

683,509,869 Shares of Common Stock

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S - T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

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



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## PRESENTATION OF FINANCIAL AND OTHER INFORMATION

### General

We maintain our books and records in *reais*. We prepare our financial statements in accordance with International Financial Reporting Standards, or IFRS, as issued by the International Accounting Standards Board, or the IASB. Our financial statements as of December 31, 2013 and 2012 and for the three years ended December 31, 2013 have been audited, as stated in the report appearing herein, and are included in this annual report on Form 20-F.

We restated our financial statements as of and for the years ended December 31, 2012 and 2011 as a result of the adoption, as of January 1, 2013, of two new standards issued by the IASB: IAS 19 (Employee Benefits – as revised in 2011) and IFRS 11 (Joint Arrangements). These new standards were applied retrospectively to 2012 and 2011 pursuant to IAS 8 (Accounting Policies, Changes in Accounting Estimates and Errors) for comparison purposes. The adoption of these new standards impacted several line items of our financial statements. One of these impacts relates to the method of accounting for the results of joint-ventures, which are now recognized using the equity method of accounting instead of the proportional consolidation method we used prior to the adoption of the IFRS 11. See note 4.1 to our financial statements for a description of these standards and their impact on our financial statements.

### Convenience Translations

We have translated some of the *real* amounts contained in this annual report into U.S. dollars. The rate used to translate such amounts in respect of the year ended December 31, 2013 was R\$2.3426 to US\$1.00, which was the commercial rate for the purchase of U.S. dollars in effect on December 31, 2013, as reported by the Central Bank. The U.S. dollar equivalent information presented in this annual report is provided solely for the convenience of the reader and should not be construed as implying that the *real* amounts represent, or could have been or could be converted into, U.S. dollars at the above rate. See “Item 3.A. Selected Financial Data—Exchange Rates” for more detailed information regarding the Brazilian foreign exchange system and historical data on the exchange rate of the *real* against the U.S. dollar.

### Rounding

Some percentages and numbers included in this annual report have been subject to rounding adjustments. Accordingly, figures shown as totals in certain tables may not be an arithmetic aggregation of the figures that precede them.

### Other Information

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.

In addition, references to:

- “*real*,” “*reais*” or “R\$” are to the Brazilian *real*, the official currency of Brazil;
- “U.S. dollars” or “US\$” are to the United States dollar, the official currency of the United States;
- “Brazil” are to the Federative Republic of Brazil;

- “State” are to the State of São Paulo, which is also our controlling shareholder;
- “federal government” and “Brazilian government” are to the federal government of the Federative Republic of Brazil and “state government” are to the state government of the State of São Paulo;
- “São Paulo metropolitan region,” with respect to our operations, are to the area where the Metropolitan executive office operates, comprising 37 municipalities, including the city of São Paulo;

- “Regional systems” are to the area where the Regional systems executive office operates, comprising 326 municipalities in the interior and coastline regions of the State of São Paulo;
- “water coverage ratio” are to the ratio between the number of residences connected to the water supply network, divided by the number of urban residences in a certain area; and
- “sewage coverage ratio” are to the ratio between the number of residences connected to the sewage collection network, divided by the number of urban residences in a certain area.

Information in this annual report 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 investment in improvement programs has not been audited.

### ***Market Information***

We make statements in this annual report about our market share and other information relating to Brazil and the industry in which we operate. We have made these statements on the basis of information from third party sources and publicly available information that we believe is reliable, such as information and reports from the Brazilian Institute of Geography and Statistics (*Instituto Brasileiro de Geografia e Estatística*), or IBGE, and the State Data Analysis System Foundation (*Fundação Sistema Estadual de Análise de Dados*); or SEADE, among others. We have no reason to believe any of this information is inaccurate in any material respect.

References to urban and total population in this annual report are estimated based on a research prepared by 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*).

### ***Our contracts and the Municipalities We Serve***

Throughout this document, we refer to the 363 municipalities we serve and to our 365 water contracts. This difference results from the fact that we have two partial water contracts with the municipality of Mogi das Cruzes. These contracts are partial because pursuant to them we serve only two neighborhoods of this municipality and, as a result, do not include Mogi das Cruzes in the total of municipalities we serve.



## CAUTIONARY STATEMENTS ABOUT FORWARD LOOKING STATEMENTS

This annual report includes forward looking statements, mainly 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 factors:

- general economic, political, demographical and other conditions in Brazil and in other emerging market countries;
- changes in applicable laws and regulations, as well as the enactment of new laws and regulations, including those relating to environmental, tax and employment matters in Brazil;
- fluctuations in inflation, interest rates and exchange rates in Brazil;
- the interests of our controlling shareholder;
- our ability to collect amounts owed to us by our controlling shareholder and by municipalities;
- our ability to continue to use certain reservoirs under current terms and conditions;
- our capital expenditure program and other liquidity and capital resources requirements;
- droughts, water shortages, intensive rain and other climatic events;
- our exposure to probable increases in the frequency of extreme weather conditions;
- power shortages, rationing of energy supply or significant changes in energy tariffs;
- the effects of the agreement for provision of water and sewage services in the City of São Paulo, which we executed with the State and the City of São Paulo;
- the lack of formal agreements between our company and certain municipalities to which we provide water and sewage services, including cities comprising metropolitan regions, and the fact that the State and municipal governments share competency regarding these services;
- the municipalities' ability to terminate our existing concession agreements prior to their expiration date and our ability to renew such agreements;
- our ability to provide water and sewage services in additional municipalities and to maintain the right to provide the services for which we currently have contracts;
- the size and growth of our customer base;
- our ability to comply with the requirements regarding water and sewage service levels included in our agreements with municipalities;

- our level of debt and limitations on our ability to incur additional debt;
- our ability to access financing with favorable terms in the future;
- the costs we incur in complying with environmental laws and any penalties for failure to comply with these laws;
- the outcome of our pending or future legal proceedings;
- our management's expectations and estimates relating to our future financial performance;

- the regulations issued by the São Paulo State Sanitation and Energy Regulatory Agency, or ARSESP, regarding several aspects of our business, including limitations on our ability to set and adjust our tariffs;
- the impacts on our business of the water consumption reduction incentive program and of any other measures we may need to take until the level of our reservoirs is normalized and sufficient to supply the customers in the São Paulo metropolitan region;
- decisions by the São Paulo State Department of Water and Energy (DAEE) and the National Water Agency (ANA) limiting the volume of water that may be drawn from the Cantareira System, the main water system we use to serve the São Paulo Metropolitan Region, and the measures that we may be required to take to ensure the provision of water to our customers; and
- other risk factors as set forth under “Item 3.D. Risk Factors.”

The words “believe,” “may,” “estimate,” “continue,” “anticipate,” “plan,” “intend,” “expect” and similar words are intended to 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 any 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 an indication of future performance and involve risks.

## PART I

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

Not applicable.

### ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

### ITEM 3. KEY INFORMATION

#### A. Selected Financial Data

The following selected financial data should be read in conjunction with our financial statements (including the notes thereto), “Item 5. Operating and Financial Review and Prospects” and “Presentation of Financial and Other Information.”

The selected financial data as of December 31, 2013 and 2012 and for the years ended December 31, 2013, 2012 and 2011 have been derived from our financial statements, prepared in accordance with IFRS, and included in this annual report. As described above and in further detail in note 4.1 to our audited financial statements, our financial data as of and for the years ended December 31, 2012 and 2011 was restated as a result of the retrospective adoption of certain new accounting standards. The selected financial data as of and for the years ended December 31, 2010 and 2009 have been derived from our financial statements, prepared in accordance with IFRS, which is not included in this annual report. Because these financial statements, and the financial data derived therefrom, were not restated to reflect the adoption of the new standards described above, they are not comparable to our financial statements, and the financial data derived therefrom, as of and for the years ended December 31, 2013, 2012 and 2011 (see note 4.1 to our audited financial statements).

We have included information with respect to the dividends and/or interest attributable to shareholders’ equity paid to holders of our common shares since January 1, 2009 in *reais* and in U.S. dollars translated from *reais* at the commercial market selling rate in effect as of the payment date under the caption “Item 8. Financial Information—Dividends and Dividend Policy—Payment of Dividends.”

The following tables present our selected financial data as of and for each of the periods indicated.

#### IFRS Summary Financial Data

	Year ended December 31,				
2013	2013	2012 <sup>(3)</sup>	2011 <sup>(3)</sup>	2010 <sup>(4)</sup>	2009 <sup>(4)</sup>
(in millions of U.S. dollars)	(in millions of reais, except per share and per ADS <sup>(1)</sup> data)				

**Statement of operations data:**

Net operating revenues	4,830.3	11,315.6	10,737.6	9,927.4	9,231.0	8,579.5
Cost of sales and services	(2,909.7)	(6,816.3)	(6,449.9)	(6,018.7)	(5,194.5)	(5,087.3)
Gross profit	1,920.6	4,499.3	4,287.7	3,908.7	4,036.5	3,492.2
Selling expenses	(272.0)	(637.1)	(697.3)	(619.3)	(712.9)	(614.4)
Administrative expenses	(311.2)	(729.1)	(717.4)	(683.6)	(653.2)	(717.1)
Operating profit	1,339.9	3,138.8	2,843.3	2,512.0	2,672.2	2,120.3
Financial income (expenses), net	(206.3)	(483.2)	(295.7)	(633.0)	(379.4)	(10.0)
Net income	821.1	1,923.6	1,911.9	1,380.9	1,630.5	1,507.7
Earnings per share – basic and diluted <sup>(1)</sup>	1.20	2.81	2.80	2.02	2.39	2.21
Earnings per ADS – basic and diluted <sup>(*)</sup> (2)	1.20	2.81	2.80	2.02	2.39	2.21
Dividends and interest on shareholders' equity per share <sup>(2)</sup>	0.29	0.67	0.66	0.43	0.57	0.58
Dividends and interest on shareholders' equity per ADS <sup>(*)</sup> (2)	0.29	0.67	0.66	0.43	0.57	0.58
Weighted average number of common shares outstanding <sup>(2)</sup>		683,509,869	683,509,869	683,509,869	683,509,869	683,509,869

(1) American Depositary Shares, or ADSs.

(2) On April 22, 2013, our shareholders approved a stock split, following which each common share represented three new common shares. Therefore, per share information in the selected financial data has been revised to give effect to the stock split retrospective to all periods presented.

(3) Data for 2012 and 2011 have been restated in application of IAS 19 – Employee Benefits (as revised in 2011) and IFRS 11 – Joint Arrangements, as described in note 4.1 to our financial statements. With respect to IAS 19 – Employee Benefits, the principal adjustment is the change in the accounting record method of actuarial gains and losses, such that accumulated differences between actuarial estimates and actual obligations are recognized in Other Comprehensive Income when they occur. With respect to IFRS 11 – Joint Arrangements, the results of the joint-ventures Sesamm – Serviços de Saneamento de Mogi Mirim S/A, Águas de Andradina, Águas de Castilho, Saneaqua Mairinque, Aquapolo Ambiental and Attend Ambiental are recognized using the equity method of accounting in 2013, 2012 and 2011 rather than through proportional consolidation as previously.

(4) Data for 2010 and 2009 have not been restated in application of IAS 19 – Employee Benefits (as revised in 2011) and IFRS 11 – Joint Arrangements, described in note 4.1 to our financial statements. In particular, data for 2010 and 2009 reflect the results of the joint-ventures Sesamm – Serviços de Saneamento de Mogi Mirim S/A, Águas de Andradina, Águas de Castilho, Saneaqua Mairinque, Aquapolo Ambiental and Attend Ambiental through proportional consolidation in 2010 and 2009, as opposed to the equity method of accounting applicable in 2013, 2012 and 2011.

(\*) On January 10, 2013, the ratio of American Depositary Receipts (“ADRs”) to common shares changed from 1:2 to 1:1. We have adjusted the earnings per ADS and dividends and interest on shareholders’ equity per ADS for prior years for comparison purposes on the table above.

	2013 <i>(in millions of U.S. dollars)</i>	2013	As of December 31, 2012 <sup>(3)</sup> 2011 <sup>(3)</sup> <i>(in millions of reais)</i>		2010 <sup>(4)</sup>	2009 <sup>(4)</sup>
<b>Balance sheet data:</b>						
Property, plant and equipment	85.2	199.5	196.7	181.6	249.6	190.4
Intangible assets	10,179.4	23,846.2	21,967.5	20,125.7	18,546.8	16,917.5
Total assets	12,069.6	28,274.3	26,476.1	24,983.2	23,350.6	20,243.1
Current portion of long-term loans and financing	273.6	640.9	1,342.6	1,629.2	1,242.1	1,009.9
Long term loans and financing	3,760.4	8,809.1	7,532.7	6,794.1	7,022.5	5,548.0
Interest on shareholders' equity payable	195.1	457.0	414.4	247.5	354.3	365.4
Total liabilities	6,549.8	15,343.5	15,219.4	14,438.3	13,668.8	11,804.5
Equity	5,519.9	12,930.8	11,256.8	10,544.9	9,681.8	8,438.6
Capital stock	2,648.2	6,203.7	6,203.7	6,203.7	6,203.7	6,203.7
<b>Other financial information:</b>						
Cash generated from operating activities	1,185.5	2,777.2	2,343.2	2,698.6	2,083.0	2,072.5
Cash used in investing activities	(973.9)	(2,281.5)	(1,996.7)	(1,883.2)	(2,091.4)	(1,964.0)
Cash provided by (used in) financing activities	(268.8)	(629.7)	(572.7)	(661.3)	1,226.5	36.9
Purchases of intangible assets and property, plant and equipment as presented in our statement of cash flow	(997.1)	(2,335.8)	(2,026.1)	(2,068.8)	(1,901.5)	(1,982.4)

**Operating Data**

	As of and for the year ended December 31,				
	2013	2012	2011	2010	2009
Number of water connections (in thousands)	7,888	7,679	7,481	7,295	7,118
Number of sewage connections (in thousands)	6,340	6,128	5,921	5,718	5,520
Percentage of population with water connections (in percentages)	99	99	99	99	99
Percentage of population with sewer connections (in percentages)	84	83	82	81	80
Percentage of treated sewer <sup>(5)</sup> (in percentages)	78	77	76	75	74
Volume of water billed during period (in millions of cubic meters)	2,149	2,094	2,045	1,992	1,917
	24.4	25.7	25.6	26.0	26.0

Non-revenue water during period (average) (in percentages) <sup>(6)</sup>					
Water Loss Index during period (average) (in percentages) <sup>(6)</sup>	31.2	31.1	32.0	32.3	32.4
Water loss per connection per day (average) <sup>(7)</sup>	372	393	395	403	402
Number of employees	15,015	15,019	14,896	15,330	15,103

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(5) Treated sewage as a percentage of collected sewage.

(6) Includes both physical and non-physical water loss. Non-revenue water represents the quotient of (i) 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 that we exclude from our calculation of water loss (as described in the paragraph below), divided by (ii) the total amount of water produced. The Water Loss Index represents the quotient of (i) the difference between (a) the total amount of water produced by us less (b) the total amount of water micro-measured by us to customers minus (c) the volume of water set out below that we exclude from our calculation of water loss, divided by (ii) the total amount of water produced.

We exclude the following from our calculation of water loss: (i) water discharged for periodic maintenance of water transmission lines and water storage tanks; (ii) water supplied for municipal uses such as firefighting; (iii) water we consume in our facilities; and (iv) estimated water loss related to the supply of water to *favelas* (shantytowns).

(7) Measured in liters/connection per day, according to the method by which we measure water loss, based on worldwide market practice for the sector. See “Item 4.B. Business Overview—Description of Our Activities—Water Operations—Water Loss.”

## Exchange Rates

In the past, the Brazilian National Monetary Council (*Conselho Monetário Nacional*), or the CMN, has introduced changes to the Brazilian foreign exchange regime, such as unifying the Commercial and Floating Markets and easing the rules governing the ability of Brazilian residents to acquire foreign currency, among others. On March 24, 2010, the CMN and the Central Bank approved Resolution No. 3,844, which led to a series of measures to consolidate and simplify Brazilian foreign exchange market regulations.

The Brazilian foreign exchange system allows any person or legal entity to purchase or sell foreign currency and make international transfers of *reais*, regardless of the amount, subject to certain regulatory procedures.

The Brazilian currency has experienced frequent and substantial variations in relation to the U.S. dollar and other foreign currencies in recent decades. Between 2003 and mid 2008, the *real* appreciated significantly against the U.S. dollar with the exchange rate reaching R\$1.634 in August 2008. Primarily as a result of the global financial crisis, the *real* depreciated 32.0% against the U.S. dollar during 2008 and closed the year at R\$2.337 per US\$1.00. The *real* strengthened again by 25.5% in 2009 and 4.3% in 2010, but depreciated against the U.S. dollar by 12.6% in 2011, 8.94% in 2012 and 14.63% in 2013. On December 31, 2013, 2012 and 2011, the *real*/U.S. dollar exchange rate was R\$2.3426, R\$2.0435 and R\$1.8758 per US\$1.00, respectively.

The Central Bank sometimes intervenes in the market to combat instability 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 through a currency band system or other procedure. The *real* may fluctuate against the U.S. dollar substantially in the future. For further information on this risk, see “Item 3.D. Risk Factors—Risks Relating to Brazil—Exchange rate instability may adversely affect us and the market price of our common shares or ADSs.”



Exchange rate fluctuations will affect the U.S. dollar equivalent of the *real* price of our common shares on the São Paulo Stock Exchange (BM&FBOVESPA S.A. *Bolsa de Valores, Mercadorias e Futuros*), or the BM&FBOVESPA, as well as the U.S. dollar equivalent of any distributions we make in *reais* with respect to our common shares.

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

Year ended December 31,	Year end	R\$ per US\$1.00		
		Average <sup>(1)</sup>	High	Low
2009	1.7412	1.9935	2.4218	1.7024
2010	1.6662	1.7593	1.8811	1.6554
2011	1.8758	1.6746	1.9016	1.5345
2012	2.0435	1.9550	2.1121	1.7024
2013	2.3426	2.1605	2.4457	1.9528

Month ended	Period end	R\$ per US\$1.00		
		Average	High	Low
October 31, 2013	2.2026	2.1886	2.2123	2.1611
November 30, 2013	2.3249	2.2954	2.3362	2.2426
December 31, 2013	2.3426	2.3455	2.3817	2.3102
January 31, 2014	2.4263	2.3822	2.4397	2.3335
February 28, 2014	2.3334	2.3837	2.4238	2.3334
March 31, 2014	2.2630	2.3261	2.3649	2.2603
April 16, 2014	2.2342	2.2310	2.2811	2.1974

Source: Central Bank

(1) Average of the exchange rates on the last day of each month.

The following tables set forth the selling rate, expressed in *reais* per Japanese Yen (R\$/¥1.00):

Year ended December 31,	Year end	R\$ per ¥1.00		
		Average <sup>(1)</sup>	High	Low
2009	0.0188	0.0213	0.0268	0.0186
2010	0.0205	0.0201	0.0212	0.0183
2011	0.0243	0.0211	0.0249	0.0186
2012	0.0237	0.0245	0.0263	0.0211
2013	0.0223	0.0221	0.0248	0.0196

Month ended	Period end	R\$ per ¥1.00		
		Average	High	Low
October 31, 2013	0.0224	0.0224	0.0228	0.0219
November 30, 2013	0.0227	0.0229	0.0235	0.0225
December 31, 2013	0.0223	0.0227	0.0233	0.0223

January 31, 2014	0.0237	0.0229	0.0239	0.0224
February 28, 2014	0.0224	0.0233	0.0238	0.0228
March 31, 2014	0.0219	0.0277	0.0233	0.0219
April 16, 2014	0.0218	0.0217	0.0219	0.0215

Source: Central Bank

(1) Average of the exchange rates on the last day of each period.

## **B. Capitalization and Indebtedness**

Not applicable.

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

Not applicable.

## **D. Risk Factors**

### **Risks Relating to Brazil**

*The Brazilian government has exercised, and continues to exercise, significant influence over the Brazilian economy. This influence, as well as Brazilian political and economic conditions, could adversely affect us and the market price of our common 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, changes in interest rates, tax policies, price and tariff controls, currency devaluation or appreciation, capital controls and limits on imports. Our business, financial condition and results of operations, as well as the market price of our common shares or ADSs, may be adversely affected by changes in public policy at federal, state and municipal levels with respect to public tariffs and exchange controls, as well as other factors, such as:

- the regulatory environment related to our business operations and concession agreements;
- interest rates;
- exchange rates and exchange controls and restrictions on remittances abroad;
- currency fluctuations;
- inflation;
- liquidity of the Brazilian capital and lending markets;
- tax and regulatory policies and laws;
- economic and social instability; and
- other political, diplomatic, social and economic developments in or affecting Brazil.

For example, the Brazilian government may change its tax policy, such as changing tax rates or imposing temporary taxes. If overall taxes are increased, we may be unable to immediately recover the difference from our consumers, which may have an adverse effect on our financial condition and results of operations.

Uncertainty over whether the Brazilian government will implement changes in policies or regulations affecting these factors or others may contribute to economic uncertainty in Brazil and to heightened volatility in the Brazilian securities market and in securities issued abroad by Brazilian issuers, which could have a material adverse effect on us and on our common 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 price of our common shares or ADSs.***

Brazil has experienced extremely high rates of inflation in the past. Inflation and the Brazilian government's measures to combat inflation have had significant negative effects on the Brazilian economy, contributing to economic uncertainty and heightened volatility in the Brazilian securities market. The Brazilian government's measures to control inflation have often included maintaining a tight monetary policy with high interest rates, thereby restricting the availability of credit and reducing economic growth. The Special Clearing and Settlement System (*Sistema Especial de Liquidação e Custódia*), or SELIC, the official overnight interest rate in Brazil, equaled 9.90%, 7.14% and 10.91% at the end of 2013, 2012 and 2011, respectively, in line with the target rate set by the Brazilian Committee on Monetary Policy (*Comitê de Política Monetária*).

The Brazilian annual inflation rates, as measured by the General Market Price Index (*Índice Geral de Preços—Mercado*), or IGP M index, were 5.51%, 7.81% and 5.1% during 2013, 2012 and 2011, respectively. Brazilian governmental actions, including interest rate decreases, intervention in the foreign exchange market and actions to adjust or fix the value of the *real*, may trigger increases in inflation. If Brazil experiences high inflation again, our costs and expenses may rise, we may be unable to increase our tariffs to counter the effects of inflation, and our overall financial performance may be adversely affected. In addition, a substantial increase in inflation may weaken investors' confidence in Brazil, causing a decrease in the market price of our common 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 price of our common shares or ADSs.

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

The Brazilian currency experienced frequent and substantial devaluations in relation to the U.S. dollar and other foreign currencies during the decades leading up to the mid-1990s. Throughout this period, the Brazilian government implemented various economic plans and exchange rate policies, including sudden devaluations, periodic mini devaluations (during which the frequency of adjustments ranged from daily to monthly), floating exchange rate systems, exchange controls and dual exchange rate markets. From time to time since that period, there have continued to be significant fluctuations in the exchange rate between the Brazilian *real* and the U.S. dollar and other currencies. For example, the *real* appreciated 13.8%, 9.5% and 20.7% against the U.S. dollar in 2005, 2006 and 2007, respectively. In 2008, primarily as a result of the global financial crisis, the *real* depreciated 32.0% against the U.S. dollar and closed the year at R\$2.337 per US\$1.00. The *real* strengthened again by 25.5% in 2009 and 4.3% in 2010, but depreciated against the U.S. dollar by 12.6% in 2011, 8.94% in 2012 and 14.63% in 2013. On December 31, 2013, 2012 and 2011, the *real*/U.S. dollar exchange rate was R\$2.343, R\$2.043 and R\$1.876 per US\$1.00, respectively. There can be no assurance that the *real* will not depreciate further against the U.S. dollar. As of April 16, 2014, the commercial selling rate as reported by the Central Bank was R\$2.2342 per US\$1.00.

Depreciation of the *real* against the U.S. dollar could create inflationary pressures in Brazil and cause increases in interest rates, which could negatively affect the growth of the Brazilian economy as a whole and harm our financial condition and results of operations, curtail our access to financial markets and prompt government intervention, including recessionary governmental policies. Depreciation of the *real* against the U.S. dollar could also lead to decreased consumer spending, deflationary pressures and reduced growth of the economy as whole.

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 because our tariff revenue and other sources of income are denominated solely in *reais*. In addition, because we have debt denominated in foreign currencies, any significant devaluation of the *real* will increase our financial expenses as a result of foreign exchange losses that we must record. We had a total foreign currency denominated debt of R\$3,698.6 million as of December 31, 2013 and we anticipate that we may incur additional amounts of foreign currency denominated debt in the future. In 2013, our results of operations were negatively affected by the 14.64% depreciation of the *real* against the U.S. dollar, and an appreciation of the *real* against the yen by 5.91% which led to a R\$267.8 million negative impact on our foreign exchange result, net. We do not currently have any derivative 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 common shares or ADSs.



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

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

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

**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 the interests of non-controlling, including holders of ADSs.***

As it owns the majority of our common shares, the State of São Paulo is able to determine our operating policies and strategy, control the election of a majority of the members of our board of directors and appoint our senior management. As of April 16, 2014, the State owned 50.3% of our outstanding common shares. Both through its control of our board of directors as well as by enacting State decrees, the State has in the past directed our company to engage in business activities and make expenditures that promoted political, economic or social goals but that did not necessarily enhance our business and results of operations. The State may direct our company to act in this manner again in the future. These decisions by the State may not be in the interests of our non-controlling, including holders of ADSs. See "Item 5.A. Operating and Financial Review and Prospects—Certain Transactions with Controlling Shareholder."

Following the elections for State governor in 2010, the new governor appointed Ms. Dilma Seli Pena as our chief executive officer in 2011 at the meeting of the board of directors held on January 27, 2011. In late March 2014, Mr. Alberto Goldman temporarily assumed the position of chairman of the board of directors. The new chairman of the board of directors will be elected for a term of two years at the shareholders' meeting to be held on April 30, 2014. Future changes in policy by State government may cause changes in all or some of the members of our management, which may have a material adverse effect on our business and results of operations.

***The State and some State entities owe us substantial unpaid debts. We cannot assure you as to when or whether the State will pay us.***

Historically, the State and some State entities have delayed payment of substantial amounts owed to us related to water and sewage services. Additionally, the State also owes us substantial amounts related to reimbursements of 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, 2013, the State owed us R\$63.9 million for water and sewage

services. With respect to payment of pensions on behalf of the State, we had a non-contested reimbursement credit in the amount of R\$179.1 million as of December 31, 2013 for actuarial liability, and a contested credit amount of R\$1,412.5 million as of the same date. We do not record this contested amount as a reimbursement credit for actuarial liability due to the uncertainty of payment by the State. In addition, as of December 31, 2013, we had a provision for an actuarial liability in the amount of R\$1,780.3 million in respect of future supplemental pension payments the State does not accept responsibility for paying. The 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 the overdue amounts that relate to water and sewage services. For a detailed discussion of these agreements, see “Item 7.B. Related Party Transactions, Agreements with the State of São Paulo” and Note 9 of our financial statements.

We cannot assure you when or if the State will pay the remaining overdue amounts it owes us. Due to the State’s history of not paying us in a timely manner for water and sewage services, and not reimbursing us in a timely manner for the pension benefits we paid on its behalf, we cannot assure you that the amount of account receivables owed to us by the State and some State entities will not significantly increase in the future.

In addition, certain municipalities and other government entities also owe us money. See “Risks Relating to Our Business—We may face difficulties in collecting overdue amounts owed to us by municipalities to which we provide water on a wholesale basis and municipal government entities.”

***A state controlled company that has a concession to produce energy in the Guarapiranga and Billings reservoirs may require us to pay damages for the use of water from these reservoirs.***

Empresa Metropolitana de Águas e Energia S.A., or EMAE, may require us to financially compensate them for our use of water from the Guarapiranga and Billings reservoirs, which they view as a loss of electricity that could otherwise be generated and sold. As such, EMAE has requested compensation from us. In the event water from these reservoirs were no longer made available to us, we would have to bring water in from locations farther away, which would increase the risk of not being able to provide adequate service in the region and increase the costs of water transportation.

The majority shareholder of both EMAE and us, the State of São Paulo, may force a resolution regarding the dispute of water use from the Guarapiranga and Billings reservoirs, which may have an adverse effect on our business. Currently, this matter is under judicial review due to various actions brought by EMAE. On April 10, 2014, we issued an Announcement to the Market to communicate that we are negotiating with EMAE regarding a potential future agreement. However, no adjustment has been confirmed and no agreement has been executed by either party as of yet.

Additionally, in the event we are required to make payments and compensation, our cash position and overall liquidity may be adversely affected.

***We may be required to pay substantial charges for the use of reservoirs that are not our property.***

We use the Billings and Guarapiranga reservoirs in order to provide water services. We are entitled to withdraw water from these reservoirs under a grant from the State Department of Water and Energy (*Departamento de Águas e Energia Elétrica do Estado de São Paulo*), or DAEE. We are not currently charged for the use of these reservoirs and 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 one were imposed.

We may also be required to pay additional maintenance and operational costs for our use of reservoirs. If we were required to pay substantial charges or additional maintenance or operational costs for our use of these reservoirs, we could be materially and adversely affected.

## **Risks Relating to Our Business**

*Current regulatory uncertainty, especially with regard to implementation and interpretation of the Brazilian Basic Sanitation Law, may have an adverse effect on our business.*

The Basic Sanitation Law No. 11,445 went into effect in early 2007, and although in 2010 Federal Decree No. 7,217 (as modified by Federal Decree No. 8,211/14) implemented a first series of new principles under the Basic Sanitation Law, the full implementation of a number of its provisions remains subject to regulations that the federal government has not yet published. As a result, we cannot currently anticipate all the effects that the Basic Sanitation Law and the decree will have on our business and operations, if any.

The Basic Sanitation Law requires states to establish independent regulators with the responsibility of monitoring basic sanitation services and regulating tariffs, and in response São Paulo State established in 2007 the São Paulo State Sanitation and Energy Regulatory Agency (ARSESP), which regulates and supervises the basic sanitation services that we provide in municipalities that have agreed to come under ARSESP's jurisdiction.

In 2009, ARSESP enacted rules regarding the following: (i) general terms and conditions for water and sewage services; (ii) procedures for communication regarding any failure in our services; (iii) penalties for deficiencies in the provision of basic sanitation services; and (iv) procedures for confidential treatment of our customers' private information. The implementation of these and other more recent rules will particularly impact our commercial and operations processes, and may adversely affect us in ways we cannot currently predict. Implementation of these rules started in 2011 and is expected to continue for the next few years. For more information, see "Item 4.B. Business Overview—Government Regulation—ARSESP Rule Enactments".

In 2011, ARSESP altered the standard contract that we are required to use in our relationships with retail customers. This alteration requires that invoices be sent to the consumer of the service rather than the owner of the property. We estimate that this change will affect ongoing legal disputes, particularly those regarding collection procedures, as well as business discussions in general. However, since this change is still being implemented, we are not currently able to predict its impact on our business.

The Basic Sanitation Law also allows municipalities to create their own regulatory agencies rather than being regulated by ARSESP. As a result, a number of municipalities have created their own regulatory agencies. If other municipalities create new agencies or retain regulatory powers, we will be subject to their regulation and to any limitations on our services that such agencies may set. We are involved in legal proceedings that dispute the authority of these new agencies to regulate us. We cannot foresee any changes that any such new agencies may implement regarding our business. If any such changes are unfavorable, they could materially and adversely affect us.

For more information on ARSESP regulations, see "Item 4.B. Business Overview—Tariff Government Regulation—Tariff Regulation in the State of São Paulo" and "ARSESP Rule Enactments—Consumer Relations in the State of São Paulo."

***New joint entities have been, and may continue to be, set up to oversee basic sanitation services in metropolitan regions, including the São Paulo metropolitan region. We cannot predict how the shared management of these operations will be carried out in the São Paulo metropolitan region and other metropolitan regions we operate or what effect this may have on our business, financial condition or results of operations.***

There are some pending cases before the Brazilian Supreme Court regarding whether the right to execute concession and program agreements in metropolitan regions belongs to the State or the municipal government. On February 28, 2013, the Brazilian Supreme Court decided a pending case on this matter related to the State of Rio de Janeiro. A majority of the court held that the State of Rio de Janeiro and its municipal governments must set up new joint entities to oversee the planning, regulation and auditing of basic sanitation services in metropolitan regions. On March 6, 2013, the court ruled that this decision would come into effect after a 24-month period over the State of Rio de Janeiro. Such decision may be considered a relevant precedent on this matter and therefore similar decisions may be taken on other pending cases as well as on new cases that can be initiated. The Supreme Court has yet to clarify the effects and extension of its decision. The São Paulo metropolitan region (including the municipalities to which we provide water on a wholesale basis), one of which new decisions on such pending or new cases may apply, accounted for 73.2% of our gross revenue from services in 2013 (excluding revenues relating to the construction of concession infrastructure). We cannot predict how the shared management of these operations could be carried out in the São Paulo metropolitan region and other municipalities we operate or what effect it may have on our business, financial condition or results of operation.

***The terms of our agreement to provide water and sewage services in the City of São Paulo could have a material adverse effect on us.***

The provision of water and sewage services in the City of São Paulo accounted for 53.6% of our gross operating revenues (excluding revenues relating to the construction of concession infrastructure) in the year ended December 31, 2013.

On June 23, 2010, the State and the City of São Paulo executed an agreement in the form of a *convênio*, to which we and ARSESP consented, under which they agreed to manage the planning and investment for the basic sanitation system of the City of São Paulo on a joint basis. The principal terms of this *convênio* were as follows:

- The State and the City of São Paulo would execute a separate agreement with us, granting us exclusive rights to provide water and sewage services in the City of São Paulo.
- ARSESP would regulate and oversee our activities regarding water and sewage services in the City of São Paulo, including tariffs.
- A management committee (*Comitê Gestor*) would be responsible for planning water and sewage services for the City and for reviewing our investment plans. The management committee consists of six members appointed for two-year terms. The State and the City of São Paulo have the right to appoint three members each. We may participate in management committee meetings but may not vote.

In application of the *convênio*, we executed a separate contract with the State and the City of São Paulo, also dated June 23, 2010, to regulate the provision of these services for the following 30 years. The principal terms of this contract are as follows:

- The total investment stated in the contract must be equal to 13% of gross revenues from the provision of services to the City of São Paulo, net of the taxes on revenues, which total approximately R\$600 million per year.
- We must transfer 7.5% of the gross revenues we derive under the *convênio*, and subtract (i) COFINS and PASEP taxes, and (ii) unpaid bills of publicly owned properties in the city of São Paulo, to the Municipal Fund for Environmental Sanitation and Infrastructure (*Fundo Municipal de Saneamento Ambiental e Infraestrutura*), established by Municipal Law No. 14,934/2009.
- Our investment plan must be compatible with the sanitation plans of the State, the City of São Paulo and, if necessary, the Metropolitan region.
- ARSESP will ensure that the tariffs will adequately compensate us for the services we provide and that tariffs may be adjusted in order to restore the original balance between each party's obligations and economic gain (*equilíbrio econômico financeiro*).

We currently have an investment plan in place that reflects these obligations and addresses their compatibility with the sanitation plans for municipalities in which we operate, including the City of São Paulo and the Metropolitan region. The investment plan is not irrevocable and will be reviewed by our management committee every four years, particularly with respect to the investments to be executed in the subsequent period.

Because we were not previously required to transfer 7.5% to the São Paulo Municipal Sanitation and Infrastructure Fund as described above, our existing tariff and adjustment formulas do not account for this requirement. Nonetheless, ARSESP is required to ensure that the tariffs will adequately compensate us for the services we provide, which includes the pass-through to tariffs.

- In April 2013, ARSESP issued Resolution No. 407 authorizing us to pass through to the service bill the 7.5% transfer to the São Paulo Municipal Sanitation and Infrastructure Fund as a legal charge, as defined by municipal legislation. Pursuant to the Program Contracts and the Sewage and Water Supply Service Contracts, this charge must

be considered in the tariff revision.

- In April 2013, ARSESP issued Resolution No. 413, which effectively suspended Resolution No. 407 until the tariff revision process is concluded, thereby postponing our authorization to pass the charge through to consumers on the service bill. The postponement of Resolution No. 407 was due to a request from the São Paulo State Government to analyze, among other things, methods of reducing the impact on consumers. Although Resolution No. 407 establishes the conclusion of the tariff review as the date for the implementation of the pass-through, we cannot be certain when Resolution No. 407 will be implemented.

- In April 2014, ARSESP issued Resolution No. 484, which establishes the conclusion of the tariff revision. No decision was made in relation to the 7.5% charge to our consumers, and we do not know when a final decision will be reached. We cannot know when we will be able to pass the 7.5% charge to consumers on the service bill.

Since 2010, we have transferred approximately R\$ 1.1 billion to the São Paulo Municipal Sanitation and Infrastructure Fund, as of December 2013. We cannot assure you when and how we will recover this amount.

We cannot assure you that this charge will eventually be passed through to customers or that the continued delay in passing on the charge to customers will not affect our financial condition. For further information on ARSESP regulations, see “Item 4.B. Business Overview—Government Regulation—Tariff Regulation in the State of São Paulo” and “Government Regulation—Public Consortia and Cooperation Agreement Law for Joint Management.”

***We currently lack formal agreements or concessions with 61 of the municipalities to which we provide service, and 38 of our existing concession agreements will expire between 2014 and 2034. We may face difficulties in continuing to provide water and sewage services in return for payment in these and other municipalities, and we cannot assure you that they will continue to purchase services from us on the same terms or at all.***

As of December 31, 2013, we held formal 30 year agreements with 265 municipalities (including the City of São Paulo) of the 363 municipalities we serve. We executed 7 of these agreements during 2013. The 265 municipalities with which we had formal agreements at year-end accounted for 72.9% of our total revenues for the year ended December 31, 2013, and 64.6% of our intangible assets as of December 31, 2013. Of the 61 served municipalities for which we lacked formal agreements at year-end, we were in the process of actively renegotiating with all municipalities, including the municipality of Santos. Together, these 61 municipalities accounted for 16.1% of our total revenues for the year ended December 31, 2013 and 25.1% of our intangible assets as of that same date. Between 2014 and 2034, 38 of our existing concession agreements will expire. These 38 concession agreements accounted for 9.0% of our total revenues for the year ended December 31, 2013 and 8.0% of our intangible assets as of that same date.

We may not be able to continue providing service on current terms, or at all, in the municipalities for which we do not have formal agreements, including the 61 for which we are renegotiating expired agreements. In particular, the lack of formal concessions or contractual rights in these municipalities means that we may not be able to enforce our right to continue to provide services and we may face difficulties in being paid on a timely basis, or at all, for the services that we provide. If we are successful in renegotiating the expired agreements, or executing formal agreements with the municipalities for which we have never had agreements, those agreements may not contain terms that are as favorable as those under which we currently operate. We cannot make any such assumption because the Basic Sanitation Law prevents us from planning, regulating and monitoring our services and it requires more stringent control by the municipalities or by ARSESP. The municipalities for which we do not have formal agreements may choose to start providing water and sewage services directly themselves, or may run public tenders to select another provider. They may set eligibility requirements for which we do not qualify and, if we do qualify and participate in these tenders, we may not win. In addition, our ability to continue operating without formal agreements may be modified or cancelled by federal, state or municipal governments, court decisions or other factors.

Any of these events could have a material adverse effect on our business, results of operations and financial condition. See “Item 4.B. Business Overview—Our Operations” and “Government Regulation—Public Consortia and

Cooperation Agreement Law for Joint Management.”

In the municipalities with which we did not have formal agreements by December 31, 2013, we continued operating with municipal approval or with judicial support.

***The municipalities may terminate our concessions before they expire in certain circumstances. The indemnification payments we receive in such cases may be less than the value of the investments we made.***

The municipalities have the right to terminate our concessions if we fail to comply with our contractual or legal obligations, or if the municipality determines in expropriation proceedings that early termination of the concession is in the public interest. If a municipality terminates our concession, we are entitled to be indemnified for the unamortized portion of our investments.



The Basic Sanitation Law provides that on early termination of a concession, the entity that provides sanitation services should carry out a valuation of the assets that relate to the services we provide, in order to calculate the unamortized portion of our investments. This valuation uses the criteria defined in the service contract or, in the absence of a contract, is based on customary practice with respect to the services for the preceding 20 years. The resulting indemnification payment may be less than the remaining value of the investments we made.

In addition, the São Paulo State constitution permits the municipalities to pay us this compensation in installments over 25 years. Receiving compensation over this extended period after termination of a significant concession would have a material adverse effect on our financial condition. The Brazilian Supreme Court suspended this deferred payment mechanism in a 1997 decision, but we cannot assure you that the mechanism will not be reinstated. This case is still awaiting a final decision, but on March 15, 2004 the Attorney General issued an opinion that this payment method is unconstitutional. The Basic Sanitation Law reduced the maximum time period for payment of indemnification in such cases to four years. This provision applies to concession agreements entered into prior to the enactment of the Basic Sanitation Law only to the extent that the concession agreement does not contain a contractual indemnification provision, or we have not otherwise entered into an agreement with the municipality with regard to such early termination. These provisions have not yet been tested by the courts and we are therefore unable to predict the effect of the Basic Sanitation Law on our rights to indemnification for the early termination of any particular concession.

In 1997, the municipality of Santos enacted a law in order to repossess our water and sewage systems in Santos. We have adopted the necessary judicial measures to contest this and continue to operate our services in Santos as of December 31, 2013. We filed an ordinary suit against the municipality of Santos, and our operation is still in place. The appellate court issued a decision that is favorable to us, and we consider the risk of loss as remote.

In 1995, the municipality of Diadema terminated its concession agreement with us. We commenced legal proceedings against the municipality, which were settled in 1996, but the municipality did not comply with the terms of the settlement. In December 2008, we entered into a memorandum of understanding with the State of São Paulo, the municipality of Diadema and the State Secretariat for Sanitation and Water Resources, previously known as the State Secretariat for Sanitation and Energy (*Secretaria de Saneamento e Energia do Estado de São Paulo*). Under this memorandum of understanding the parties agreed to conclude negotiations and settle all outstanding amounts, and we agreed to stay the collection proceedings we had filed against the municipality. In 2011, we and the municipality of Diadema agreed to develop shared infrastructure for water and sewage services through a mixed capital company to be called Companhia de Água e Esgoto de Diadema, or CAED. Studies regarding the establishment of CAED have been discontinued, and on March 18, 2014, we executed a contract to resume direct supply of water and sewage services to the municipality of Diadema. Concurrently, we entered an agreement with Diadema to resolve water supply-related debt and indemnities. Guarantees are in place if the municipality of Diadema breaches its agreement with us.

Other municipalities may seek to terminate their concession agreements before the contractual expiration date. If this occurs and we do not receive adequate indemnification for our investments, or the indemnification is paid over an extended period, we may suffer material harm to our financial position.

***We may face difficulties in collecting overdue amounts owed to us by municipalities to which we provide water on a wholesale basis and municipal government entities.***

As of December 31, 2013, our total accounts receivable was R\$4,372.2 million. Of this amount, certain municipalities to which we provide water on a wholesale basis owed us R\$1,917.9 million, and certain municipal government

entities owed us R\$679.6 million. Of the total amount owed by municipalities, R\$205.2 million was overdue by between 30 and 360 days and R\$1,645.3 million was overdue by over 360 days.

The Brazilian courts are entitled to obligate us to continue to supply water to these municipalities, even when we have not received payments due to us. We have no way of ensuring that negotiations with these municipalities or legal action taken against the municipalities will result in payments being made. Some entities associated with municipal governments for which we provide services also do not make regular payments. We cannot guarantee if or when these entities will make payments on a regular basis or pay the amounts owed to us. If the municipalities and related entities do not pay the amounts owed to us, we may suffer material harm to our financial position.

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

Our capital expenditure program will require resources of approximately R\$12.8 billion in the period from 2014 through 2018. In 2013 we recorded R\$2.7 billion in capital expenditures.

We have funded these capital expenditures with cash generated by our operations as well as borrowings in Brazilian *reais* and foreign currencies, and we intend to continue to fund our capital expenditures from these sources. A significant portion of our financing needs has been provided by the Brazilian federal public government banks. We have obtained long term financing at attractive interest rates from multilateral agencies and domestic and international governmental development banks. If the Brazilian government changes its policies regarding the financing of water and sewage services, or if we fail to obtain long term financing at attractive interest rates from domestic and international multilateral agencies and development banks in the future, we may not be able to meet our obligations or finance our capital expenditure program, which could have a material adverse effect on our business and financial condition.

Governmental agencies, institutional lenders and multilateral agencies constitute our main sources of financing in addition to cash generated by our operations and issuances of debt securities in the domestic and international capital markets. Brazilian financial institutions are legally limited up to a certain percentage of their shareholder's equity to provide loans to public sector entities, such as us. These limitations could adversely affect our ability to continue our capital expenditure program.

Our debt includes financial covenants that impose indebtedness limits on us, which could have a material adverse effect on us. For further information on these covenants, see "Item 5.B. Liquidity and Capital Resources—Capital Sources—Indebtedness Financing—Financial Covenants." Our failure to comply with these covenants could seriously impair our ability to finance our capital expenditure program, which could have a material adverse effect on us.

***Compliance with environmental laws and environmental liability payments could have a material adverse effect on us.***

We are subject to extensive Brazilian federal, state and municipal laws and regulations relating to the protection of human health and the environment. These laws and regulations set potable water standards and limit or prohibit the discharge or spillage of effluent produced in our operations, particularly raw sewage. We occasionally suffer accidents such as leakages or breaks in pipes that could lead to liability for damages under environmental law. We could be subject to various types of criminal, administrative and civil proceedings for non compliance with environmental laws and regulations, which could expose us to penalties and criminal sanctions, such as fines, closure orders and significant indemnification obligations. The scope and enforcement of environmental laws in Brazil are becoming more stringent, and our capital expenditures and environmental compliance costs may increase substantially as a result. These expenses may lead us to reduce expenditure on strategic investments, which could harm our business. In addition, Brazilian courts are enforcing environmental laws more stringently than in the past, which may result in fines or liability for damages that are significantly higher than those we currently anticipate. We are party to various environmental proceedings that could have a material adverse impact on us, including civil processes and investigations relating to the release of untreated sewage into waterways and the disposal of sludge generated by treatment plants. Any unfavorable judgment in relation to these proceedings, or any material unforeseen environmental liabilities, may have a material adverse effect on us. For further information on these proceedings, see "Item 8.A. Financial Information – Financial Statements and Other Financial Information – Legal Proceedings." For further information on investments in environmental programs, see "Item 4.A - Main Projects of our Capital Expenditure Program," "Item 4.B – Business Overview – Sewage Treatment and Disposal," "Item 4.B – Business Overview -

Environmental Matters” and “Item 4.B – Business Overview - Environmental Regulation.”

*New laws and regulations relating to climate change and changes in existing regulation, as well as the physical Effects of Extreme Weather Events, may result in increased liabilities and increased capital expenditures, which could have a material adverse effect on us.*

Current federal, state and municipal laws and regulations on climate change establish global goals, which we intend to meet, concerning greenhouse gas emissions and this may require us to increase our investments in order to comply with these laws. Currently, however, if we increase our capital expenditures for this purpose, we may be required to reduce expenditures on other strategic investments.

In addition, climate change may lead to increases in extreme weather events such as droughts or torrential rain, which may affect our ability to deliver our services and require us to take action such as:

- investing in seeking new water sources located further from major consumer centers;
- investing in new technologies;
- improvement of water conservation practices and demand management alternatives such as economic mechanisms or educational programs; and
- increasing our reserve capacity.

An increase in sea levels could cause additional intrusion of salt water in the river estuaries where we abstract water for treatment, which could generate problems in our water treatment in coastal areas by damaging our collection networks. Additionally, increases in air temperature could affect demand for water. Climate change may also reduce water levels in the reservoirs that power hydroelectric plants in Brazil, which may cause energy shortages and increase electricity prices, which may adversely affect our costs and operations.

We cannot predict all of the Effects of Extreme Weather Events, which makes it difficult to predict necessary investments. We have not provisioned any funds for climate change events as current technology and scientific understandings of climate change make it difficult to predict potential expenses and liabilities.

We may be required to adopt new norms to improve our energy use efficiency and minimize the release of greenhouse gases when we renew the environmental licenses for the systems already in operation or when we obtain environmental licenses for new enterprises.

We may need to make substantial new expenditures, either to comply with new environmental regulations linked to climate change or to prevent or correct the physical Effects of Extreme Weather Events, any of which could have a material adverse effect on our results of operations.

For more information, see “Item 4.B. Business Overview—Environmental Matters—Climate Change Regulations: Reduction of Greenhouse Gases (GHG).”

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

Our industry is affected by the following additional risks relating to the provision of water and sewage services:

- The state and federal government agencies that manage water resources impose substantial charges for the abstraction of water from bodies of water and the discharge of sewage. We may not be able to pass these charges on to our customers. See “Item 4.B. Business Overview—Government Regulation—Water Usage.”
- The increasing degradation of watershed areas may affect the quantity and quality of water available to meet demand from our customers. See “Item 4.A. History and Development of the Company—Capital Expenditure Program” and “—Main Projects of Our Capital Expenditure Program.”
- In addition to the risks discussed under “—The terms of our new agreement to provide water and sewage services in the City of São Paulo could have a material adverse effect on us,” we may not be able to increase our tariffs

on a timely basis, or at all, in order to pass on increases in inflation or operating expenses, including taxes, to our customers. These constraints may have an adverse effect on our ability to fund our capital expenditure program and financing activities, and to meet our debt service requirements. See “Item 5.A. Operating and Financial Review and Prospects—Factors Affecting Our Results of Operations—Effects of Tariff Increases.”

- In addition to the risks discussed under “— New laws and regulations relating to climate change and changes in existing regulation, as well as the physical Effects of Extreme Weather Events, may result in increased liabilities and increased capital expenditures, which could have a material adverse effect on us,” we are exposed to various weather-related risks, since our financial performance is closely linked to climate patterns. The expected increase in the frequency of extreme weather conditions in the future may adversely affect both the quality and quantity of waters available for abstraction, treatment, and supply. Droughts could adversely affect the water supply systems, resulting in a decrease in the volume of water distributed and billed as well as in the revenue derived from water supply services. An increase in heavy rainfall could impact water quality and the regular operation of water sources, including abstraction of waters from our dams, due to increased soil erosion, silting, pollution and eutrophication of aquatic ecosystems. See “Item 5.A. Operating and Financial Review and Prospects—Factors Affecting Our Results of Operations—Effects of Extreme Weather Events – Drought.”
- We are dependent upon energy supplies to conduct our business. Any shortages or rationing of energy may prevent us from providing water and sewage services, and may also cause material damage to our water and sewage systems when we resume operations. Also, we may not be able to pass on any significant increases in energy tariffs to our customers. See “Item 4.B. Business Overview—Energy Consumption.”
- We depend on a usage rights grant from ANA and DAEE to extract water in the Cantareira System. In 2013, the Cantareira system accounted for 47.1% of the water that we supplied to the São Paulo metropolitan region (including the municipalities to which we supplied water on a wholesale basis), which represented 73.2% of our gross operating revenues (excluding revenues relating to the construction of concession infrastructure) for the year. The Cantareira System usage rights grant was renewed in 2004 and will expire in August 2014. We are working to renew this grant for a period of 30 years and to maintain the same withdrawal supply rights of 33 m<sup>3</sup>/s granted in 2004. Due to current climate conditions, particularly the severe drought, the renewal process is temporarily suspended. In addition, the current drought may provide a new context for definition of the rules related to the grants for the right to use water and we cannot guarantee that we will be able to renew the grant in accordance with the conditions we requested.

Any of the above may have a material adverse effect on us.

***Droughts, the water consumption reduction program or other measures may result in a significant decrease in the volume of water billed and the revenues from services we provide, which may have a material adverse effect on our company.***

We experience decreases in our water supply from time to time due to droughts. Part of the southeastern region of Brazil, particularly the southern region of Minas Gerais State and the Piracicaba river basin (from which we extract the water used in the Cantareira System), and the northern area of the São Paulo metropolitan region experienced below average rainfall in 2012. The drought worsened in late 2013 and early 2014, with rainfall being significantly below average, which resulted in lower reservoir water levels in the Cantareira System during the rainy season, from October 2013 to March 2014. This was particularly the case for the Cantareira System, the largest system of the Metropolitan Region of São Paulo.

In order to minimize the effects of this drought, in February 2014 we approved a water consumption reduction incentive program based on a bonus system, pursuant to which customers served by the Cantareira System who achieve a 20% reduction in water consumption are entitled to a 30% discount on their service bill. Initially, this incentive program was scheduled to last seven months from February 1, 2014 or until the water level in the reservoirs is normalized and sufficient to supply the customers in the São Paulo metropolitan region served by the Cantareira System. However, in April 2014 the incentive program was extended for the entire São Paulo metropolitan region until the end of 2014 or until the water level in the reservoirs is normalized. As a result of the drought and low water volume in the Cantareira System, the São Paulo State Department of Water and Energy (DAEE) and the National Water Agency (ANA) determined that, as of March 10, 2014, we must temporarily restrict the flow of water from the Cantareira System from 33 m<sup>3</sup>/s to 27.9 m<sup>3</sup>/s. In order to continue to meet consumer demand with a restricted water supply, we are increasing our use of other water systems. This may lead to an increase in our costs to serve customers in the São Paulo metropolitan region. If the situation in the reservoirs affected by the drought does not improve, we may be obligated to take more drastic measures.



As a result of this drought and of the measure imposed by the DAEE and ANA, our volume of water and sewage billed may decrease throughout 2014. In addition, our operating costs may increase as a result of additional capital expenditures required to mitigate the effects of this drought on our water production systems. We cannot assure you that the consumption reduction incentive program will be the only mitigating measure we take to address the severe drought. Although we expect our billing amount to decrease, due to volume decrease and bonus payments, we cannot estimate the impact of this program on our revenues. In addition, we cannot assure you that any continuous drought in the future will not have any impact on our covenant clauses or any material and adverse effects on our water supply and thus our business and results of operations.

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

We are party to a number of legal proceedings involving significant monetary claims. These legal proceedings include, among others, civil, tax, labor, corporate and environmental issues. As of December 31, 2013, the total value of all outstanding claims against us was R\$38,604.6 million (net of R\$323.4 million in court deposits). A substantial monetary judgment against us in one or more of these legal proceedings may have a material adverse effect on our financial condition. We have provisioned a total aggregate amount of R\$1,180.4 million (net of court deposits) as of December 31, 2013 to cover probable losses related to legal proceedings. This provision does not cover all legal proceedings involving monetary claims filed against us and it may be insufficient to cover our liabilities related to these claims. Any unfavorable judgment in relation to these proceedings may have a material adverse effect on us. For more information, see “Item 8.A. Financial Information—Financial Statements and Other Financial Information—Legal Proceedings.”

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

***We may not always be in a position to pay dividends or interest on shareholders’ equity and ADSs.***

Depending on our future results, our shareholders may not receive dividends or interest on own capital if we do not generate a profit. Despite the requirement to distribute a minimum of 25% of our annual net income to shareholders, our future financial position may not permit us to distribute dividends or pay interest on own capital.

***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 from emerging markets such as Brazil involves greater risk than investing in securities of issuers in major securities markets, and these investments are often considered to be more speculative in nature. The Brazilian securities market is substantially smaller, less liquid, more concentrated and can be more volatile than major securities markets. Accordingly, although you are entitled to withdraw the common shares underlying the ADSs from the depositary at any time, your ability to sell the common shares underlying the ADSs at a price and time at which you wish to do so may be substantially limited. There is also significantly greater concentration in the Brazilian securities market than in major securities markets. The ten largest companies in terms of market capitalization represented approximately 51.2% of the aggregate market capitalization of the BM&FBOVESPA as of December 31, 2013. The top ten stocks in terms of trading volume accounted for approximately 41.3%, 43.0% and 47.2% of all shares traded on the BM&FBOVESPA in 2013, 2012 and 2011, respectively.

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

The Brazilian custodian for the common shares underlying our ADSs must obtain a certificate of registration from the Central Bank in order to be entitled to remit U.S. dollars abroad for payments of dividends and other distributions relating to our common shares or upon sales of our common shares. If an ADR holder decides to exchange ADSs for the underlying common shares, the holder will be entitled to continue to rely on the custodian's certificate of registration for five business days from the date of exchange. After that period, the holder may not be able to obtain and remit U.S. dollars abroad upon sale of our common shares, or distributions relating to our common shares, unless he or she obtains his or her own certificate of registration or registers under Resolution No. 2,689, dated January 26, 2000, of the CMN, which entitles registered foreign investors to buy and sell on a Brazilian stock exchange. If the holder does not obtain a certificate of registration or register under Resolution No. 2,689, the 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. The custodian's certificate of registration or any foreign capital registration obtained by a holder may be affected by future legislative changes, and additional restrictions applicable to the holder, the disposition of the underlying common shares or the repatriation of the proceeds of disposition may 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 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 more difficulty 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, since the State may only be able to pay a judgment if it is provided for in its budget in a subsequent fiscal year. None of the public property of our controlling shareholder is available for seizure or attachment, either prior to or after judgment.

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

Under our bylaws, any disputes among us, our shareholders and our management with respect to the *Novo Mercado* rules, Law No. 6,404 of December 15, 1976, as amended ("Brazilian Corporate Law") and Brazilian capital markets regulations will be resolved by arbitration conducted pursuant to the BM&FBOVESPA Arbitration Rules in the Market Arbitration Chamber. Any disputes among shareholders and ADR holders, and any disputes between us and our shareholders and ADR holders, will also be submitted to arbitration. As a result, a court in the United States might require that a claim brought by an ADR holder predicated upon the U.S. securities laws be submitted to arbitration in accordance with our bylaws. In that event, a purchaser of ADSs would be effectively precluded from pursuing remedies under the U.S. securities laws in the U.S. courts.

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

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

***Holders of our ADSs do not have the same voting rights as our shareholders.***

Holders of our ADSs do not have the same voting rights as holders of our shares. Holders of our ADSs are entitled to the contractual rights set forth for their benefit under the deposit agreements. ADS holders exercise voting rights by providing instructions to the depositary, as opposed to attending shareholders meetings or voting by other means available to shareholders. In practice, the ability of a holder of ADSs to instruct the depositary as to voting will depend on the timing and procedures for providing instructions to the depositary, either directly or through the holder's custodian and clearing system. The deposit agreement also provides that if the depositary does not receive any instructions from a holder of ADRs, the ADR holder may be deemed to have given a discretionary proxy to a person designated by our company and the underlying shares may be voted by such person. However, we chose not to designate any person to exercise these deemed proxy rights with respect to the annual general meeting held to approve our financial statements for 2013, and ADSs for which no specific voting instructions were received by the Depositary were therefore not voted at that meeting.

## ITEM 4. INFORMATION ON THE COMPANY

### A. History and Development of the Company

#### Overview

Companhia de Saneamento Básico do Estado de São Paulo – SABESP is a mixed capital company (*sociedade de economia mista*) with limited liability. We were incorporated on September 6, 1973 under the laws of the Federative Republic of Brazil. We are registered with the Commercial Registry of the State of São Paulo (*Junta Comercial do Estado de São Paulo*) under registration number NIRE 35300016831. 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. We are allowed to operate, in a subsidiary form, in other Brazilian locations and abroad. See “Item 4.B. Business Overview—Government Regulation—Public Consortia and Cooperation Agreement Law for Joint Management.”

We believe we are one of the largest water and sewage service providers in the world (based on the number of customers in 2012, according to the 14<sup>th</sup> edition of the *Pinsent Masons Water Yearbook 2012-2013*). We operate water and sewage systems in the State of São Paulo, which includes the city of São Paulo, Brazil’s largest city. According to the 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. For the year ended December 31, 2013, we generated net revenue of R\$11,315.6 million and net income of R\$1,923.6 million. Our total assets amounted to R\$28,274.3 million and our total shareholders’ equity amounted to R\$12,930.8 million as of December 31, 2013.

As of December 31, 2013, we provided water and sewage services to a broad range of residential, commercial, industrial and governmental customers in 363 of the 645 municipalities in the State of São Paulo, including the city of São Paulo. Substantially all of our concessions or program agreements have 30 year terms. At year-end 2013 we lacked formal agreements for 61 of the municipalities we serve, each of which we are in the process of actively renegotiating, including in the municipality of Santos. From January 1, 2014 through 2034, 38 further concessions will expire, and we will seek to replace them with program agreements. In addition to the 363 municipalities we served, we also provided water service to the municipality of Mogi das Cruzes, pursuant to two partial water contracts under which we service only certain neighborhoods of that municipality. See “Presentation of Financial and Other Information—Other Information—Our Contracts and the Municipalities We Serve.”

We also supply water on a wholesale basis to 6 municipalities in the São Paulo metropolitan region in which we do not operate water distribution systems (together covering a total estimated urban population of approximately 3.5 million). Five of these municipalities also utilize our sewage treatment services. For the year ended December 31, 2013, the São Paulo metropolitan region (including the municipalities to which we provide water on a wholesale basis) accounted for 73.2% of our gross operating revenue (excluding revenues relating to the construction of concession infrastructure), while the Regional Systems accounted for 26.8%.

As of December 31, 2013, we provided water services through 7.9 million water connections to approximately 24.6 million people, representing approximately 59% of the urban population of the State of São Paulo, and had a water coverage ratio of approximately 99% in respect of all regions. As of that date, we provided sewage services through

6.3 million sewage connections to approximately 21.5 million people and had an effective sewage coverage ratio of 84%. As of December 31, 2013, we operated using 69,619 kilometers of water pipes and water transmission lines and 47,103 kilometers of sewer lines.

We also provide water and/or sewage services to 4 other municipalities through special purpose companies. In addition, we provide consulting services regarding the rational use of water and commercial and operational management in Panama and Honduras through a partnership with Latin Consult. In addition we set up two new activities in partnership with other companies: Aquapolo Ambiental S.A., a joint venture with a private sanitation services operator, which commenced operations in the second half of 2012 and operates the largest water recycling facility in the southern hemisphere, with capacity to supply up to 1,000 liters per second to industries in the Capuava petrochemical cluster in the São Paulo metropolitan region; and Attend Ambiental, a joint venture with Estre Ambiental S.A., which is constructing a pre-treatment plant for non-domestic effluent in the São Paulo metropolitan region that is expected to commence operations in the first half of 2014.

The State of São Paulo, our controlling shareholder, is required by law to own at least 50% plus one of our common shares. As of April 16, 2014, the State owned 50.3% of our outstanding common shares. As a mixed capital company, we are an integral part of the State governmental structure. Our strategy and major policy decisions are formulated in conjunction with the State Secretariat for Sanitation and Water Resources as part of the State's overall strategic planning. The majority of the members of our board of directors and our board of executive officers are nominated by the State government.

In addition, our capital expenditure budget is subject to approval by the State legislature and is approved in conjunction with the budget of the State Secretariat for Sanitation and Water Resources 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 derive from the following strengths:

***Well established business with significant size, scale and know how to operate in complex urban settings.*** We believe we are one of the largest water and sewage service providers in the world. We provide water services directly to approximately 24.6 million people and supply water on a wholesale basis to an additional urban population of approximately 3.5 million people. As of December 31, 2013, we had an effective water coverage ratio of approximately 99% in respect of all regions in which we operate. We also provide sewage services directly to approximately 21.5 million people, achieving an effective sewage coverage ratio of 84% in respect of all regions in which we operate as of December 31, 2013. During the year ended December 31, 2013, our net operating revenues (including revenues relating to the construction of concession infrastructure) increased by 5.4% as compared to 2012. Our significant size and scale have required us to operate in complex urban settings such as *favelas* (shantytowns) and environments without urban planning, which has enabled us to develop skill in operating in adverse conditions, well trained personnel and a specialized structure that we believe our competitors lack.

***Operations in Brazil's most populous and wealthy state.*** The State of São Paulo, which is located in the most developed and economically active region of Brazil, is the most populous state in Brazil, with an estimated total population of 44 million as of December 31, 2013. The city of São Paulo had an estimated total population of 11 million as of the same date, while the São Paulo metropolitan region had a total population of 21 million. 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\$1.3 trillion in 2011, representing approximately 33% of Brazil's total GDP. The State of São Paulo generates more revenue from water and sewage services than any other Brazilian state.

***Strong Base of Contracted Business.*** Between January 1, 2007 and December 31, 2013, we executed 30 year agreements with 266 of the 363 municipalities we serve, including an agreement with the City of São Paulo in June 2010. For the year ended December 31, 2013, income from these 30 year agreements accounted for 72.9% of our gross operating revenues (including revenues relating to the construction of concession infrastructure).

***Access to low cost and diverse sources of financing.*** Our strong cash flow generation from operations and our role as an essential public service provider places us in a privileged position in our industry to obtain low cost, long term financing from Brazilian public banks, and domestic and international multilateral agencies and development banks. We do not depend on a limited number of sources of financing, but instead have access to various funding alternatives in the Brazilian and international markets to fund our working capital needs and our capital expenditure programs.



***Strong corporate governance practices.*** In 2002, we joined the *Novo Mercado* segment of the BM&FBOVESPA, which is the listing segment in Brazil with the highest corporate governance requirements. As a result, we are committed to certain corporate governance standards that are not otherwise required by Brazilian law, which provides heightened protection to our shareholders and enhances the quality of information we disclose to the market. On December 1, 2007, we became part of the BM&FBOVESPA Corporate Sustainability Index, or ISE, which reflects our high degree of commitment to sustainable environmental and social practices.

***High quality operations.*** We believe that we adhere to high standards of service and employ the best available technology in the sanitation business to control the quality of the water we abstract, process and distribute. All of our water quality control laboratories operate in accordance with the ABNT NBR ISO 9001 standard, the highest international water quality standard. In addition to our central laboratory, 12 of our regional laboratories are accredited by the National Institute of Metrology, Standardization and Industrial Quality, or INMETRO, and comply with the ABNT NBR ISO IEC 17025 standard, thereby assuring the quality and accuracy of our test results. Moreover, our 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.

## **Our Strategy**

Our mission is to provide water and sewage services, contributing to improvements in quality of life and the environment. To this end, our strategic objectives are based upon the guiding principles of growth, quality, universalization of sanitation services, social, economic and environmental sustainability, human capital as a competitive strength and innovation, while focusing on reaching excellence in customer service. Our strategic objectives also focus on our political and institutional relationships as well as on our commitment to the market to increase shareholder value. We seek to implement these guiding principles through the following strategies:

***Continue to seek growth while improving our financial results by reducing operating costs, increasing productivity and profitability and prudently managing our levels of indebtedness.*** We aim to apply our principles of financial growth and sustainability to each business unit, assigning goals and setting clear responsibilities to each unit so as to strengthen our financial results. To achieve this goal, we intend to use our best efforts to reduce operating costs and increase productivity and profitability. We plan to improve the management of our assets, as well as to continue to reduce our total operating expenses by automating some of our facilities, streamlining operational processes, implementing integrated planning and further investing in internal technological research and development. We also plan to continue our efforts to improve our collection of overdue accounts receivable from municipalities to which we provide services, from the State and from other governmental entities, including by exploring opportunities to offset these outstanding debts against certain possessory or property rights over utilities relating to water and sewage systems. We intend to continue to fund our working capital needs and estimated capital expenditure programs with diversified sources of financing, such as domestic and international development banks and multilateral agencies. We will continue to seek market opportunities for low cost financing and restructuring of our indebtedness if and when advantageous and appropriate.

***Improve operating efficiency and reduce water loss.*** We seek to reduce both physical water loss, which results mainly from leakage; non physical water loss, which results primarily from inaccurate water meters installed at customers' premises and at our water treatment facilities; and clandestine and illegal water use. In order to achieve more consistent long term results, we have developed a comprehensive 12 year program to reduce our water loss rate. The first four years of the program from 2009 to 2012 were funded by BNDES. From 2013 to 2017 the program will be funded by a loan granted by the government of Japan through the Japan International Cooperation Agency, or

JICA. The program focuses on renewing our water distribution infrastructure and improving the pressure control and the maintenance and control services as a means of reducing physical water loss. We are also seeking to reduce physical water loss by creating smaller water supply districts through the construction of district metering areas, which reduce system pressure and pipe bursts, and allow leaks to be detected and repaired more efficiently. The program also seeks to reduce non physical water loss by upgrading and replacing inaccurate water meters and through inspections of non authorized water consumption in water service connections.

***Ensure the quality and availability of our services in our existing service area.*** Our goal is to maintain an effective water coverage ratio of around 100%, coupled with a high standard of quality and availability, and meet the expected population growth by adding 1.17 million water connections between 2014 and 2020. We also intend to increase our sewage coverage ratio to 95% by 2020 by adding 1.65 million sewage connections. In addition, we are also developing short, medium and long term marketing strategies, such as client segmentation and tailor made solutions for different types of clients, which we believe will help us increase our customer base. We also seek to improve our customer support strategies by modernizing our telephone and internet based customer support and to continuously measure the level of satisfaction of our clients.

***Maintain and continue to expand our existing service areas.*** We intend to maintain and expand our operating base by executing new agreements. To this end, we are actively seeking to develop closer relationships with the municipal governments that we currently serve in order to increase customer loyalty and thereby renew all or substantially all our concession agreements as they expire. In June 2010, we entered into a 30 year agreement with the State and city of São Paulo for the provision of water and sewage services in the city of São Paulo, which in the year ended December 31, 2013 accounted for 51.8% of our gross operating revenues (excluding revenues relating to the construction of concession infrastructure). Between January 1, 2007 and December 31, 2013, we entered into agreements with 265 municipalities (including our services agreement with the city of São Paulo), of which seven were entered into in 2013. These 265 municipalities accounted for 72.9% of our total revenues for the year ended December 31, 2013 and 64.6% of our intangible assets as of the same date. As of December 31, 2013, 61 of our concessions had expired and are currently being renegotiated. These 61 municipalities accounted for 16.1% of our total revenues for the year ended December 31, 2013 and 25.1% of our intangible assets as of the same date. From January 1, 2014 through 2034, 38 concession agreements, accounting for 9.0% of our revenues for the year ended December 31, 2013 and 8.0% of our intangible assets as of the same date, will expire.

Our investment plan will include the investment of R\$12.8 billion between 2014 and 2018, 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, in order to encourage these customers to continue using our services. We also regularly explore the possibility of executing agreements for the provision of water and sewage services in municipalities in the State of São Paulo in which we currently have no operations or to which we currently supply water and provide sewage treatment solely on a wholesale basis, which together represent a total population of approximately 17 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.

***Expand our water and sewage services.*** We had an effective sewage coverage ratio of 84% as of December 31, 2013 and plan to increase this ratio to 95% by 2020 by adding over 1.65 million sewage connections. In addition, there are municipalities in the State of São Paulo representing a total population of approximately 17 million to which we currently do not provide water or sewage services, or to which we currently supply water solely on a wholesale basis. Our strong presence in the State and experience in providing water and sewage services places us in a privileged position to expand our sewage services to these additional municipalities in the State of São Paulo, as well as to other Brazilian states and abroad. Further, we seek to deepen our relationships with strategic clients that consume high volumes of water (more than 500 cubic meters per month) by applying special tariffs to these clients.

***Seek selective opportunities to expand our business.*** Our activities comprise water supply, sanitary sewage services, urban rainwater management and drainage services, urban cleaning services, solid waste management services. We are looking into related activities, including the planning, operation, maintenance and commercialization of energy,

and the commercialization of services, products, benefits and rights that directly or indirectly arise from our assets, operations and activities. We are allowed to act, in a subsidiary form, in other Brazilian locations and abroad. Since 2008, we have expanded into activities that complement water and sewage services in which we may leverage our know how, size, scale and profitability. For example:

- We are planning to install small hydroelectric power plants in our water treatment plants in Guaraú and Cascata in conjunction with the Servitec/Tecniplan consortium. We expect to start construction of the first two plants, with capacities of 4 and 2 MW, in the second half of 2014.

- We worked with the basic sanitation company of the state of Alagoas to transfer technology for the reduction of water loss in the city of Maceió. Under this type of contract, we are remunerated based on our success rate, or more specifically, we profit based on the reduction of water loss achieved in city of Maceió.
- In partnership with the consultancy firm Latin Consult, we are providing consulting services to the *Instituto de Acueductos y Alcantarillados Nacionales*, the company responsible for water and sewage services in the central provinces of Panama, in the field of sustainable water use and to implement a new model for commercial, financial and operational planning and management.
- Also in partnership with Latin Consult, we are providing consulting services to seven municipalities in Honduras to implement a new commercial and operational management model.
- We have set up Attend Ambiental, a joint venture with Estre Ambiental S.A., which is constructing a pre treatment and processing plant for non-domestic effluent in the São Paulo metropolitan region that is expected to commence operations in the first half of 2014.
- We are looking into the production and distribution of bio methane from gas generated in our sewage treatment processes.

***Establish efficient and competitive ways of attracting, retaining and motivating our personnel.*** We intend to become a reference in human resource management, providing our personnel with growth opportunities and recognition. We seek to raise workplace satisfaction levels by establishing programs for the professional and personal development of our employees, setting competitive benefit packages and creating a healthy and collaborative work environment.

***Streamline internal processes.*** We are implementing plans to increase our speed and productivity in responding to regulatory changes; strengthen and streamline our financial, commercial and administrative structure; and increase the efficiency of our operations; while also reducing costs. To this end, in 2012 we began implementing an enterprise resourcing planning (ERP) system to replace our commercial and management information systems. We contracted through a bidding process the Águas Claras Consortium, which consists of companies Accenture and Engineering and which will provide us with SAP's ERP system and the Net@suite system. We estimate that the ERP will be implemented in 2014, and the Net@suite in 2015.

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, while strengthening our results of operations and our financial condition and creating 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 also includes the States of Minas Gerais, Espírito Santo and Rio de Janeiro, and which is, according to IBGE, the most developed and economically active region of Brazil. The State of São Paulo is located on the Atlantic coast of Brazil and is bordered by the States of Rio de Janeiro and Minas Gerais to the north, the State of Paraná to the south and the State of Mato Grosso do Sul to the west.

The State of São Paulo occupies 3.0% of Brazil's land mass and encompasses an area amounting to approximately 96,000 square miles. According to the SEADE, the State of São Paulo had an estimated total population of 44 million as of December 31, 2013. The city of São Paulo, capital of the State of São Paulo, had an estimated total population of 11 million, with a total population of 21 million inhabitants in the São Paulo metropolitan region, as of December 31, 2013. The São Paulo metropolitan region encompasses 39 municipalities and is the largest metropolitan region in the Americas and the sixth largest metropolitan region in the world, according to the United Nations' World Urbanization Prospects, 2011 Revision, with approximately 47% of the total population of the State of São Paulo as of December 31, 2013.

According to the IBGE, the GDP of the State of São Paulo was approximately R\$1.3 trillion in 2011, representing approximately 33% of Brazil's total GDP, and making it the largest economy of any state in Brazil based on GDP. According to the IBGE, the State of São Paulo is also the leading Brazilian state in terms of manufacturing and industrial activity, with a strong position in car manufacturing, pharmaceuticals, computer manufacturing, steel making and plastics, among other activities, as well as a leading position in the banking and financial services industries. The State of São Paulo is the leading export 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 nineteenth century, water and sewage services in the State of São Paulo were generally provided by private companies. In 1875, the Province of São Paulo granted a concession for the provision of water and sewage services to *Companhia Cantareira de Água e Esgotos*. In 1893, the government of the Province of São Paulo assumed responsibility for the provision of water and sewage services from *Companhia Cantareira de Água e Esgotos* and formed the Office of Water and Sewers (*Repartição de Água e Esgotos*), a government 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 directly by the municipalities, 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 carry out the administration of public services where the government deems that a decentralized administrative and financial structure would be advantageous.

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 Water Company of the São Paulo metropolitan Region (*Companhia Metropolitana de Água de São Paulo*), or the COMASP, the purpose of which was to provide potable water on a wholesale basis for public consumption in the various municipalities of 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 State government created the Superintendence of Water and Sewers of the city of São Paulo (*Superintendência de Água e Esgoto da Capital*), or the SAEC, to distribute water and collect sewage in the city of São Paulo. All assets relating to water services previously owned by the Department of Water and Sewers were transferred to the SAEC. Also in 1970, the State created the Basic Sanitation Company of the São Paulo metropolitan Region (*Companhia Metropolitana de Saneamento de São Paulo*), or the SANESP, to provide sewage treatment services for the São Paulo metropolitan region. All assets relating to sewage services previously owned by the Department of Water and Sewers were transferred to the SANESP. The Department of Water and Sewers was subsequently closed.

On June 29, 1973, pursuant to State Law n. 119, COMASP, the SAEC and the 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*). We were incorporated under the laws of Brazil as a limited company (*sociedade anônima*), for indefinite duration. 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 our company. The State has always been our controlling shareholder, as required by State Law No. 119. We have therefore been integrated into the State governmental structure and our strategies have been formulated in conjunction with the strategies of the State Department of Water Resources and Sanitation. Additionally, a majority of the members of our board of directors and our management are appointed by the State Government.

Our capital expenditure budget is subject to approval by the State legislative chamber. This approval is obtained simultaneously with the approval of the budgets of the Department of Sanitation, of the Department of Energy and of the State of São Paulo. We are also subject to supervision from the Court of Audit of the State of São Paulo (“*Tribunal de Contas do Estado de São Paulo*”), with regard to our accounting, financial and budgetary activities and our operating assets.



We provide water and sewage services directly to a large number of residential, commercial and industrial private consumers, as well as to a variety of public entities, in 363 of the 645 municipalities in the State, including in the city of São Paulo. We also supply water on a wholesale basis to 6 municipalities in the São Paulo metropolitan region in which we do not operate water distribution systems, and five of these municipalities also utilize our sewage treatment services. Currently, we are the fifth largest water and sewage service company in the world in terms of number of clients, according to the 14<sup>th</sup> edition of the *Pinsent Masons Water Yearbook* (2012-2013).

In 1994, we were registered with the CVM as a publicly-held company and are therefore subject to the CVM's rules, including those relating to the periodic disclosure of extraordinary facts or relevant events. Our common shares have been listed on the BM&FBOVESPA under the ticker "SBSP3" since June 4, 1997.

In 2002, we joined the *Novo Mercado* segment of the BM&FBOVESPA, which is the listing segment in Brazil with the highest corporate governance requirements. In the same year, we registered our common shares with the Securities and Exchange Commission, or SEC, and started trading our shares in the form of American Depositary Receipts – level III ("ADRs") on the New York Stock Exchange, or NYSE.

In 2004, the State of São Paulo carried out a secondary offer of common shares of our company in the Brazilian and international markets. On December 1, 2007, we became part of the BM&FBOVESPA ISE, which reflects our high degree of commitment to sustainable environmental and social practices.

In December 2007, Law No. 1,025, which provided for the creation of regulatory agencies for the supervision of water and sewage services, created ARSESP, the regulatory agency that regulates and supervises the services we provide.

## **Corporate Organization**

We currently have six management divisions, each of which is supervised by one of our executive officers.

Our board of directors allocates responsibilities to our executive officers following an initial proposal made by our Chief Executive Officer, in accordance with our bylaws. 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, including the coordination, evaluation and control of all functions related to the Chief Executive Officer's office and staff, integrated planning, business management and corporate organization, communication, audit, ombudsman, and negotiation of concessions. The Chief Executive Officer represents our company before third parties and certain powers can be granted to attorneys in fact. The executive officers described below report to the Chief Executive Officer:

- the Corporate Management Officer, who is responsible for marketing (commercial processes), human resources, quality and social responsibility, legal affairs, information technology, asset management, supplies and contracts;
- the Chief Financial Officer and Investor Relations Officer, who is responsible for financial planning, costs and tariffs, raising capital and allocating financial resources to divisions of our company, conducting capital markets and other debt incurrence transactions and managing debt levels, financial controls, accounting, corporate governance and investor relations. Moreover, the Chief Financial Officer is part of the committee on regulatory matters and is responsible for implementing the committee's guidelines with the support of our division responsible for regulatory matters;

- the Technology, Enterprises and Environment Officer is responsible for environmental management, technological and operational development, quality control of water and sewage, the development, coordination and execution of special investment programs, projects, research and innovation, and
- the Chief Operating Officer for the São Paulo metropolitan region Division and the Chief Operating Officer for the Regional Systems Division, who are responsible for managing the operation, maintenance, execution of planning and works for water and sewage supply systems (including for the services that we provide on a wholesale basis), sales and call center services, and have overall responsibility for the financial and operational performance of their divisions. Moreover, the Chief Operating Officers are part of the committee on regulatory matters and they implement the committee's guidelines in their respective management team, with the support of our division responsible for regulatory matters. The Chief Operating Officers are also responsible for sanitation advisory services to autonomous municipalities and for mediation and negotiation with communities and local governments, aimed at aligning our interests with the interests of our 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 with respect to the municipalities we serve:

- (i) to continue to meet the maximum demand for treated water;
- (ii) to expand the percentage of households connected to our sewage system;
- (iii) to increase the treatment of sewage collected; and
- (iv) to increase operating efficiency and reduce water loss.

Our capital expenditures from 2011 through 2013 totaled R\$7.7 billion. We have budgeted investments in the total amount of R\$12.8 billion from 2014 through 2018. We invested R\$2.7 billion, R\$2.5 billion and R\$2.4 billion in 2013, 2012 and 2011, respectively.

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

	<b>Planned Capital Expenditures</b>					<b>Total</b>
	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	
Water	1,139	1,129	1,087	956	974	5,284
Sewage Collection	1,092	1,069	889	893	1,107	5,051
Sewage Treatment	411	478	553	647	339	2,428
<b>Total</b>	<b>2,642</b>	<b>2,676</b>	<b>2,529</b>	<b>2,496</b>	<b>2,420</b>	<b>12,763</b>

Our capital expenditure program from 2014 through 2018 will continue to focus on achieving our targets by making regular investments to maintain and expand our infrastructure and to reduce water loss in the 363 municipalities we served as of December 31, 2013.

## Main Projects of Our Capital Expenditure Program

The following is a description of the main projects in our capital expenditure program.

### *Metropolitan Water Program*

Demand for our water services has grown steadily over the years in the São Paulo metropolitan region and has at times exceeded the capacity of our water systems. As a result, prior to September 1998, a portion of our customers in this region received water only on alternate days of the week. We refer to this as “water rotation.” In order to remedy this situation, we implemented the (*Programa Metropolitano de Água*) to improve regular water supply to the entire São Paulo metropolitan region. This program terminated in 2000 and the water rotation measure was eliminated, but we have maintained our investment plans for the region.



The second phase of the Metropolitan Water Program, projected to result in an increase of 13.2 m<sup>3</sup>/s in water production capacity, started in 2006 and is expected to run through 2014. Within this phase, there has been an increase of 5.5 m<sup>3</sup>/s in water production capacity (of which 5 m<sup>3</sup>/s through the Alto do Tietê Public Private Partnership (PPP) concluded in 2011), and there is a plan to increase another 1 m<sup>3</sup>/s in 2014. Total investments made from 2006 to December 31, 2013, amounted to R\$1.6 billion, including our own funds and financing from *Caixa Econômica Federal* and *Banco Nacional de Desenvolvimento Econômico e Social* (“BNDES”), as well as the investments from the Alto Tietê Public Private Partnership. In 2013, we invested approximately R\$128 million in this program.

In 2013, the goals of the Program were revised, and we initiated the Program’s third phase. We plan to increase water production capacity by 9.5 m<sup>3</sup>/s in the São Paulo Metropolitan Region by 2018, including the new São Lourenço System. This new system alone will increase water production capacity by 4.7 m<sup>3</sup>/s. The projected investments in the Program’s third phase may reach R\$4.4 billion, including the investments in the São Lourenço PPP. For information on Public Private Partnerships, see “—Business Overview—Public Private Partnerships.”

#### Alto Tietê Public Private Partnership

In June 2008 we formed the Alto Tietê PPP with a special purpose company known as Cab Spat, whose main shareholders are Cab Ambiental and Galvão Engenharia S.A. The Alto Tietê PPP is part of the second phase of the Metropolitan Water Program and aims to improve the reliability, flexibility and availability of the integrated water system that serves the São Paulo metropolitan region. Through this PPP, Cab Spat carried out certain infrastructure works, which were completed in December 2011, and expanded the Alto Tietê System nominal capacity from 10 cubic meters per second to 15 cubic meters per second.

Cab Spat has also undertaken to perform maintenance on the Alto Tietê System’s dams on an ongoing basis. This maintenance work consists of civil engineering, electromechanical and operational services, as well as sludge treatment, water adduction and water supply.

The total estimated cost for this project, including the investments and the System’s maintenance, is R\$1.0 billion. We intend to complete payment for these by 2024. For information on Public Private Partnerships, see “—Business Overview—Public Private Partnerships.”

#### São Lourenço Project

The metropolitan region suffers from a water shortage, which requires us to obtain water from increasingly distant sources. In order to remedy this situation, we are currently developing a new supply system called São Lourenço, which will expand our production capacity by 4.7 m<sup>3</sup>/s and should be able to benefit a population of almost 1.5 million people. The PPP contract was executed in August 2013 and the works will begin in the first semester of 2014. Sistema Produtor São Lourenço S.A. is a Special Purpose Company (SPC) consisting of the construction companies Camargo Correa and Andrade Gutierrez. The new system is expected to begin operating in 2018. For information on Public Private Partnerships, see “Business Overview—Public Private Partnerships.”

The contract is in the amount of approximately R\$6 billion (including the investment in the construction of R\$2.2 billion and the system’s operation and maintenance) and it has a 25-year term, four years of which will be dedicated to the construction, while the other 21 years will be dedicated to service delivery. These services include the operation and maintenance of the sludge treatment system of the water treatment station and disposal of the waste thus generated; electromechanic and civil maintenance of the untreated water pumping stations, of the water treatment station and the untreated water pipeline; preservation and cleaning, surveillance and property security.

Tietê Project

The Tietê river crosses the São Paulo metropolitan region and receives most of the region's runoff and wastewater. The environmental status of the river reached a critical level in 1992. In an effort to reverse 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 carried out the first phase of the program between 1992 and 1998.

In the first phase of the Tietê Project, we completed the construction of three additional sewage treatment facilities in June 1998. This involved total investment of US\$1.1 billion, of which US\$450 million was financed by the Inter American Development Bank, or IADB, approximately US\$100 million by Caixa Econômica Federal, and approximately US\$550 million by us.

The second phase of the project, which was carried out from 2000 through 2008, involved installing 290,000 sewage connections and more than 1,500 kilometers of sewage collection networks, branch collectors and interceptors. Total investments in this phase amounted to approximately US\$500 million, of which US\$200 million was financed by the IADB, R\$60 million by BNDES directly, and R\$180 million by BNDES through another financial institution.

The main objective of the second phase was to continue expanding and optimizing the sewage system in the São Paulo metropolitan region, focusing primarily on improvements to expand the delivery of raw sewage to the sewage treatment facilities that were built in the first phase. Upon the conclusion of the second phase of the project in 2008, we were able to collect approximately 5,000 liters of raw sewage per second and send it to the five sewage treatment plants in our integrated system for treatment. As part of the second phase of the Tietê Project, we implemented a 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.

The first and second phases of the Tietê Project contributed to an increase from 70.0% to 84.0% in the sewage collection rate and an increase from 24.0% to 70.0% in the treatment of sewage collected in the São Paulo metropolitan region. As a result, the sewage collection system covered a total of 15.8 million people (5.1 million more than the number of people served when the Tietê Project was initiated), and the sewage treatment system covered 11.1 million people (8.5 million more than the number of people served when the Tietê Project was initiated). 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 16 cubic meters of sewage per second. We plan to build additional collection lines to direct more raw sewage to our treatment facilities.

The third phase of the Tietê Project, initiated in 2010, aims to remediate the water quality in the Tietê river basin by expanding collection levels to 87.0% and sewage treatment levels to 84.0% in the São Paulo metropolitan region. The total estimated cost of the third phase is approximately US\$2 billion, of which US\$600 million will be financed by a loan from the IADB entered into in September 2010 and approximately R\$ 1.35 billion by a loan from BNDES entered into in February 2013. The third phase consists principally of the following items:

- improvements to the effluent collection system through collection networks and home connections;
- removal and transport of effluent for treatment through branch collectors and interceptors; and
- the construction of new sewage treatment plants in the São Paulo metropolitan region.

Approximately 76% of the work for the third phase is under construction, and a further 7% is in the process of public tender. Following completion of the third phase of the Tietê Project, the sewage collection system will serve an additional 1.5 million people and the sewage treatment system will serve an additional 3 million people. We have invested R\$1.1 billion in the third phase, R\$358 million of which during 2013.

Continuing our efforts to eliminate the disposal of in natura sewage, in the bodies of water of the São Paulo Metropolitan Region, by the areas we serve, we are currently structuring the fourth phase of the Tietê Project, which is

expected to begin in 2014 with investments estimated at US\$2 billion. We have been seeking financing sources from the Federal Government and international institutions, similarly to what happened in the earlier phases of the program.



### Corporate Program for Reduction of Water Loss

The objective of the Corporate Program for Reduction of Water Loss (*Programa Corporativo de Redução de Perdas de Água*) is to reduce water loss efficiently by integrating and expanding existing initiatives in our business units.

This program has a 12 year term that began in 2009. We have invested R\$1.5 billion in this project so far, including R\$424 million invested in 2013, and anticipate total investments of approximately R\$5.9 billion throughout the term of the program. Funding for the program will come from our own resources as well as from credit facilities provided by JICA, Caixa Econômica Federal and BNDES. The program aims to reduce the incidence of water loss from 436 liters per connection per day in December 2008 to 280 liters per connection per day in 2020, which is equivalent to reducing the Non-Revenue Water Index from 27.6% in December 2008 to 18% in 2020. This is equivalent to reducing the water loss index (based on metered consumption) from 34.1% in December 2008 to 25.7% in 2020.

Since the beginning of the program, we reduced the Non-Revenue Water Index by 3.2%, reaching 24.4% in December 2013. Regarding the utilization of water sources, the drop in real water loss (water physically lost, which corresponds to about 65% of the Water Loss Index) dropped from 22.2% in December 2008 to 20.3% in December 2013.

### Mananciais/New Life Program

The *Mananciais/New Life Program (Programa Vida Nova)* consists of various projects that focus on the preservation and improvement of water reserves in the São Paulo metropolitan region, especially in the Guarapiranga and Billings reservoirs. The resources will be mostly invested in the creation of infrastructure to collect sewage and transport it to treatment plants in order to reduce the discharge of effluent into water sources. The program also includes the protection of green spaces and the urbanization of *favelas* (shantytowns) and is expected to directly benefit 58,000 families by 2015.

The State government, local authorities and the federal government are expected to invest approximately R\$1.6 billion in this program by the end of 2015. To implement this program, we estimate we will invest R\$335 million. As of December 31, 2013, the total amount of cumulative investments in this program reached R\$117 million, R\$48.4 million of which was invested in 2013.

### Clean Stream Program

The Clean Stream Program (*Programa Córrego Limpo*), a partnership between the State, acting through our company, and the municipality of São Paulo, aims to decontaminate urban streams in the city of São Paulo by eliminating the discharge of sewage into streams and rainwater runoff routes, cleaning streams and banks, and removing and relocating of properties located on the banks of streams.

Total investments made in this program amounted to R\$730.3 million as of December 31, 2013, of which we had invested R\$130 million. 146 urban streams have been decontaminated since 2007, benefiting approximately 2 million people. In 2013, 30 urban streams have been decontaminated and we had invested R\$20 million in this Program. Part of the investment related to the Tietê Program benefit the Clean Stream Program.

In 2013, we began the fourth phase of the Clean Stream Program, and we expect to completely or partially decontaminate more than 20 large streams by the end of 2014, with investments of approximately R\$100 million.

### *Regional Systems Investment Programs*

We currently have a number of projects in progress and planned for our Regional Systems. These relate to the abstraction of water as well as to the collection, removal and disposal of sewage. We invested approximately R\$1.1 billion per year in these projects in 2013, 2012 and 2011, and we have budgeted for additional capital expenditures of approximately R\$3.7 billion from 2014 through 2018.

#### Clean Wave Program

The main goals of the Clean Wave Program (*Programa Onda Limpa*) are to improve and expand the sewage systems in the municipalities comprising the Baixada Santista metropolitan region, increasing the sewage collection rate to 95%, and treating 100% of the collected sewage, thereby improving bathing water quality at 82 beaches in the region by the end of the decade. This project is being carried out in two phases, the first of which has started and the second of which is in the planning phase. The first phase is expected to be completed by 2016, aiming at increasing the sewage collection rate to 88%. The funds will come from our own resources as well as from loan agreements entered with JICA and from the Government Severance Indemnity Fund for Employees (*Fundo de Garantia por Tempo de Serviço*), or FGTS.

As of December 31, 2013, we had invested approximately R\$1.9 billion in this program, of which R\$75.5 million was invested during 2013. As a result, sewage collection increased from 53% to 72%, and the treatment of collected sewage rose from 96% to 100%.

After completing the construction of sewage treatment plants and installation of networks, we are prioritizing the connection of customers to the sewage collection system. As of December 31, 2013, we had completed 84 thousand connections.

Additionally, complimentary works of the first phase shall be executed between 2013 and 2016, including an addition of 33 thousand sewage connections, which refer to connections that were not executed in the first phase. We expect to evaluate the service of sewage collection rate by 88% by the end of this phase. These works have an approximated investment value of R\$400 million.

Still in the first stage, we will work until 2017 on the system of oceanic sewage disposal in the city of Praia Grande, which is an important city in the Baixada Santista region, on the coast of São Paulo state. This will involve investments of approximately R\$300 million.

The second phase is in planning for the period between 2015 and 2020. We estimate investments in the amount of R\$1 billion, in order to enlarge and implement sewage collection and treatment systems and complete 50 thousand new connections. This phase of the Clean Wave Program aims at universalizing sewage services in the Metropolitan Region of Baixada Santista.

#### Northern Coast Clean Wave Program

The Northern Coast Clean Wave Program (*Programa Onda Limpa Litoral Norte*) aims at expanding the collection and treatment of sewage on the northern coast of the State of São Paulo, intending to benefit 600 thousand people, including the local population as well as tourists that visit the region each year. The program aims to increase the sewage collection rate in the region from 36.0% in 2008 to 85.0% in 2016, thereby improving the health and well being of the population and stimulating economic development through an increase in tourism. As of 2013, the sewage collection rate was 56%.

Within this program, in 2013, we implemented collection networks, sewage connections and disposal systems, and built two Sewage Treatment Stations on beaches on the northern coast of São Paulo state.

The funds in the amount of R\$510 million that are necessary to conclude this program until 2016 will come from our own resources, as well as from loan agreements entered with BNDES and Caixa Econômica Federal. As of December 31, 2013, we had invested R\$144 million in this program, of which R\$18 million was invested during 2013.

#### Coastal Water Program

The Coastal Water Program (*Programa Água no Litoral*) combines various long term activities to expand water production capacity in the Baixada Santista metropolitan region and the southern coast of the State of São Paulo. The program aims to benefit approximately three million people, including both the local population and tourists. It aims to increase the level of reliability of the local systems, eliminating existing and potential deficiencies and irregularities in the water supply. Through this program we aim to increase the availability of treated water and improve the quality of water available to the population. The fund will come from our own funds and financing from Caixa Econômica

Federal.

During the first phase of this program, we have focused mainly on increasing water production in order to satisfy demand and improve water quality in the Baixada Santista metropolitan region. In order to reach this goal, we built two water treatment stations, which started operations in 2013: Mambu/Branco, with water treatment capacity of 1.6 m<sup>3</sup>/s, and Jurubatuba, with water treatment capacity of 2 m<sup>3</sup>/s.

As of December 31, 2013, we had invested R\$858 million in this program, of which R\$100 million was invested during 2013. The total investment estimated in this phase is R\$1.1 billion.

The second phase of the program is in planning, with the goal of increasing even further the availability of treated water for the local population and tourists and improving the quality of the water available to the population in the Baixada Santista metropolitan region in the coming years.

### ***New Policies and Programs***

#### *Nossa Guarapiranga*

In December 2011, we launched the Nossa Guarapiranga project, the main objective of which is to remediate the water quality in the Guarapiranga basin, which is a water source for the São Paulo metropolitan region. The basin serves one million people directly in the areas near Guarapiranga, and indirectly serves a further two million people who consume the water from the basin. We installed 11 drains to collect residue from rivers in the Guarapiranga basin, and since July 2012, we have developed diagnosis and control services for the withdrawal of water plants that obstruct water extraction and deposit garbage at the bottom of the basin's dam. The total amount invested from our own funds was R\$12.2 million as of March 2014. These actions will continue through 2014-2015 during which another R\$4.3 million will be invested.

#### *Pró Conexão*

In December 2011, Municipal Legislative Assembly of the city of São Paulo approved a project to subsidize connections to the sewage system for low income families. Initially intended to last 8 years, the project involves capital expenditures of up to R\$349.5 million of which 80% will be provided by the State government and 20% by us. In this period we expect that this program will create 192 thousand new connections benefiting approximately 800 thousand people.

By December 2013 we completed approximately 15 thousand connections. We believe that this program will increase the efficiency of our sewage collection programs and help improve water quality in the region's rivers and basins, as well as improving quality of life for low income families.

#### *Water is Life*

The Water is Life program, established in November 2011, aims to provide water and sewage services to low income and isolated communities in the regions of Alto Paranapanema and Vale do Ribeira. In the first phase of the program, we expect to cover 81 communities of 30 municipalities, benefiting approximately 15 thousand people. In this project we are responsible for supplying water, and the municipalities, with financing from the state government, are responsible for installing Individual Sanitary Units (*Unidades Sanitárias Individuais*), which is a technology designed for low income and isolated communities. Regarding the supply of water, we invested approximately R\$6.5 million in well drilling and infrastructure projects (reservoirs, equipment, networks and pipelines). We expect to invest approximately R\$15 million by 2015.

In 2013, we executed almost 64 kilometers of networks and pipelines to serve the program. A large part of these works were executed by our own personnel, which considerably reduced the need for investment. We also started

operating 20 new wells and have studies and projects for 18 others. We estimate that by the end of the program we will reach 220 kilometers of network and pipelines and 45 wells.

An amount of approximately R\$6 million was estimated for sewage infrastructure construction, to be financed by the State Government. This amount is negotiated between the municipalities and the State Government, and we only indicate the technical solution that is most adequate for each region.

## **B. Business Overview**

### **Our Operations**

As of December 31, 2013, we provided water and sewage services to 363 municipalities in the State of São Paulo under concession agreements, program agreements, other forms of legal arrangements or without formal agreements. We also supply treated water on a wholesale basis to six municipalities located in the São Paulo metropolitan region. Article 2 of our bylaws permits us to carry out the following activities: provision of water supply and sewage services, urban rain water management and drainage services, urban cleaning services and solid waste management services. In addition, our bylaws authorize us to carry out other related activities, including the planning, operation and maintenance of production systems, the storage, preservation and trading of energy, and the trading of services, products, benefits and rights that, directly or indirectly, result from our assets, projects and activities, and the right to operate a subsidiary anywhere in Brazil or abroad to provide the services mentioned above.

Following the enactment of the Basic Sanitation Law, which regulates the basic sanitation industry in Brazil, we currently operate under two different contractual environments: (i) for concession agreements that have expired, we are currently renegotiating or will negotiate new agreements that follow the terms and conditions of the Basic Sanitation Law, known as “program agreements”; and (ii) for concession agreements that have not expired, we will continue to operate under the terms and conditions of the existing concession agreements, except in circumstances where the Basic Sanitation Law applies even though the concession agreement is still in force. For further information on this topic, see “Government Regulation—Public Consortia and Cooperation Agreement Law for Joint Management.”

As of December 31, 2013, 61 of our agreements or concessions were still in the process of being regularized through formal agreements. See “3.D. Risk Factors—Risks Relating to Our Business—We currently lack formal agreements or concessions with 61 of the municipalities to which we provide service, and 38 of our existing concession agreements will expire between 2014 and 2034. We may face difficulties in continuing to provide water and sewage services in return for payment in these and other municipalities, and we cannot assure you that they will continue to purchase services from us on the same terms or at all.”

### ***Regulation of Concessions***

Pursuant to 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.

According to the Basic Sanitation Law, existing concessions will remain in effect until payment of indemnification is made based on the valuation of investments. The Basic Sanitation Law provides that our new concession agreements be planned, supervised 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.

As of December 31, 2013, we provided water and sewage services to 363 municipalities. The majority of these concessions have 30 year terms. Due to court orders, we temporarily suspended our services in five other

municipalities (Cajobi, Iperó, Álvares Florence, Macatuba and Embaúba) that accounted for less than 0.1% of our gross operating revenues and our intangible assets as of December 31, 2013. For more information, see “Item 8.A. Financial Information—Financial Statements and Other Financial Information—Legal Proceedings—Concession Related Legal Proceedings.” Between January 1, 2007 and December 31, 2013, we entered into agreements with 265 municipalities (including our services agreement with the city of São Paulo) in accordance with the Basic Sanitation Law, of which seven were entered into in 2013. As of December 31, 2013, these 265 municipalities accounted for 72.9% of our gross operating revenues (including revenues relating to the construction of concession infrastructure). In addition to the contracts that have 30 year terms, the municipalities entered into cooperation contracts with the State of São Paulo, delegating the regulation and monitoring of the provision of services to ARSESP. As of December 31, 2013, 61 of our agreements or concessions had expired but we continued to provide water and sewage services to these 61 municipalities and were in negotiations with these municipalities to execute program agreements to substitute the expired concessions. From January 1, 2014 through 2034, 38 concessions will expire.



Following the increase in the demand for regulatory work, we created a regulatory affairs department, which focuses on regulatory matters and has centralized communication with the regulatory agencies, driving business to the new regulatory regime and proposing matters in which we have an interest to ARSESP.

In April 2011, we created a specific area in our Financial, Economic and Investor Relations Office responsible for costs and tariffs, given the subject's importance to the continuation of our business. We also created a statutory Regulatory Affairs Committee. The committee is composed of our Chief Executive Officer, our Chief Financial Officer and Investor Relations Officer, our Metropolitan Officer and our Regional Systems Officer and is responsible for defining the guidelines, strategies and regulatory recommendations for our Company and coordinating the work of the Regulatory Affairs Department.

The current concessions are based on a standard form of agreement between us and the relevant municipality. Each agreement received the prior approval of the legislative council of each municipality. The assets comprising the existing municipal water and sewage systems are transferred from the municipality to us in order for us to provide the contracted services. 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 from the date of acquisition of the concession, assuming a discount of at least 12%. For reference purposes, ARSESP has set the discount rate for concession contracts at 8.06% since 2011.

The main provisions of our existing concession agreements are as follows:

- we assume all responsibility for providing water and sewage services in the municipality;
- according to the municipal laws authorizing the concession, we are permitted to collect tariffs for our services and tariff readjustments follow the guidelines established by the Basic Sanitation Law and ARSESP;
- as a general rule, to date, we are exempt from municipal taxes, and no royalties are 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 water transmission lines, and sewage lines; and
- upon termination of the concession, for any reason, we are required to return the assets that comprise the municipality's water and sewage system to the municipality and the municipality is required to pay us the non-amortized value of the assets relating to the concession.

These assets have been considered to be intangible assets since January 2008. See Note 3.8 to our financial statements. Under concession agreements executed prior to 1998, the reimbursement for the 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 agreement.

In Brazil, there are three federal legal regimes for contracting water and sewage services: (i) public concessions, regulated by Law No. 8,987/1995, which require a prior public bidding process; (ii) administration of public services through cooperation agreements between the federal government and local public authorities at State and municipal level without the need for a public bidding process, regulated by the Public Consortia and Cooperation Agreement Law; and (iii) public private partnerships, regulated by Law No. 11,079/2004, used to grant concessions to private companies to provide public services and used in relation to construction works associated with the provision of public services. Until 2005, we had adopted the regime for public concessions. Following the entry into force of the Public Consortia and Cooperation Agreement Law, we adopted the administration of public services through cooperation agreements, which can be used alongside the other two regimes.

Since 1998, our contracts with municipalities have been regulated by the Federal Concessions Law No. 8,987/1995. Generally, these contracts have a 30 year term, and the total value of the concession is set by the discounted cash flow method. Under this method, when the expected contractual cash flow is reached, the total value of the concession and assets is 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 term, thereby interrupting the normal contractual cash flow, we are paid an amount equal to the present value of the expected cash flow over the years remaining in the concession, adjusted for inflation.

Federal Law No. 11,107, or the Federal Public Consortia and Cooperation Agreement Law, established the legal basis for the administration of public service contracts, giving greater rights and obligations to municipalities who are responsible for sanitation services and setting out more clearly the provision of services and the responsibilities of the parties. New agreements entered into following the expiry of concession agreements under the previous law will follow this new model. See “—Government Regulation—Public Consortia and Cooperation Agreement Law for Joint Management.”

Our new agreement model follows the provisions of the Basic Sanitation Law. Its main contractual provisions include the joint execution of planning, supervision and regulation of services, the appointment of a regulatory authority for the services, and periodic disclosure of financial statements.

Furthermore, the economic and financial formulas in new agreements must be based on the discounted cash flow methodology and on the revaluation of returnable assets. Pursuant to the Basic Sanitation Law, the preexisting assets will be returned to the grantor of the concession. We will carry out all new investments and the municipalities will record them as assets. The municipalities will then transfer possession of these assets to us for our use and management and will also record a credit in the same amount of the assets recorded in our favor. According to Article 42 of the Basic Sanitation Law and the new agreement model, 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 operation of the services. These receivables may also be used as guarantees in funding operations.

Another important development was that the new agreement model includes exemptions from municipal taxes applicable on our operational areas and the possibility of the revaluation of our assets that existed prior to the execution of the program agreements 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 Mauá terminated our concession with our consent. The municipality of Diadema terminated our concession without our consent after asserting that we did not provide adequate water and sewage services. In 2011, we and the municipality of Diadema agreed to develop shared infrastructure for water and sewage services through a mixed capital company to be called Companhia de Agua e Esgoto de Diadema, or CAED. According to the agreement, the amount owed to us by Diadema would be repaid through the issuance of shares in CAED. Studies regarding the establishment of CAED have been discontinued, and on March 18, 2014, we executed a contract to resume direct supply of water and sewage services to the municipality of Diadema. Concurrently, we entered an agreement with Diadema to resolve water supply-related debt and indemnities. Guarantees are in place if the municipality of Diadema breaches its agreement with us.

The receivables owed to us by Mauá and Diadema total R\$85.9 million and R\$60.3 million, and have not been recognized in our financial statements due to the uncertainty of our ability to collect them, as of December 31, 2013. For further information on these matters, see Note 8 to our financial statements included elsewhere in this annual

Edgar Filing: COMPANHIA DE SANEAMENTO BASICO DO ESTADO DE SAO PAULO-SABESP - Form 20-F report. Despite these developments, we currently supply water on a wholesale basis to both Diadema and Mauá.

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. However, we cannot be certain that other municipalities will not seek to terminate their concessions in the future. See “Item 3.D. Risk Factors—Risks Relating to Our Business—The municipalities may terminate our concessions before they expire in certain circumstances. The indemnification payments we receive in such cases may be less than the value of the investments we made.”

In addition, we are currently involved in litigation with respect to municipalities that intend to expropriate our water and sewage systems, or to terminate concession agreements before paying us any indemnification. For a detailed discussion on these proceedings, see “Item 8.A. Financial Information—Financial Statements and Other Financial Information—Legal Proceedings.”

### ***Operations in the City of São Paulo and Certain Metropolitan Regions***

As of December 31, 2013, 61 concessions had expired which jointly accounted for 16.1% of our gross revenues. We entered into seven agreements in the year ended December 31, 2013, bringing the total number of agreements entered into between 2007 and 2013 to 266. These seven new agreements accounted for 1.2% of our total revenues and 1.6% of our intangible assets as of December 31, 2013.

On June 23, 2010 the State and the City of São Paulo executed an agreement in the form of a *convênio*, to which we and ARSESP consented, under which they agreed to manage the planning and investment for the basic sanitation system of the city of São Paulo on a joint basis. The principal terms of this *convênio* were as follows:

- The State and the City of São Paulo would execute a separate agreement with us, granting us exclusive rights to provide water and sewage services in the city of São Paulo.
- ARSESP would regulate and oversee our activities regarding water and sewage services in the city of São Paulo, including tariffs.
- A management committee (*Comitê Gestor*) would be responsible for planning water and sewage services for the city and for reviewing our investment plans. The management committee consists of six members appointed for two-year terms. The State and the City of São Paulo have the right to appoint three members each. We may participate in management committee meetings but may not vote.

In application of the *convênio*, we executed a separate contract with the State and the city of São Paulo, also dated June 23, 2010, to regulate the provision of these services for the following 30 years. The principal terms of this contract are as follows:

- The total investment stated in the contract must be equal to 13% of gross revenues from the provision of services to the city of São Paulo, net of the taxes on revenues, which total approximately R\$600 million per year.
- We must transfer 7.5% of the gross revenues we derive under the *convênio*, and subtract (i) COFINS and PASEP taxes, and (ii) unpaid bills of publicly owned properties in the city of São Paulo, to the Municipal Fund for Environmental Sanitation and Infrastructure (*Fundo Municipal de Saneamento Ambiental e Infraestrutura*), established by Municipal Law No. 14,934/2009. In April 2013, ARSESP postponed the application of such municipal charges until the conclusion of the tariff revision process, based on a request from the São Paulo State Government to analyze, among other things, methods to reduce the impact on consumers.

- Our investment plan must be compatible with the sanitation plans of the State, the City of São Paulo and, if necessary, the Metropolitan region.
- ARSESP will ensure that the tariffs will adequately compensate us for the services we provide and that tariffs may be adjusted in order to restore the original balance between each party's obligations and economic gain (*equilíbrio econômico financeiro*).

We currently have an investment plan in place that reflects these obligations and addresses their compatibility with the sanitation plans for the 363 municipalities in which we operate, that include, the City of São Paulo and, if necessary, the Metropolitan region. The investment plan is not irrevocable and will be reviewed by our management committee every four years, particularly with respect to the investments to be executed in the subsequent period.

### ***Wholesale Operations***

#### *Wholesale Water Services*

We provide water services on a wholesale basis to six municipalities located in the São Paulo metropolitan region (Diadema, Mauá, Santo André, São Caetano do Sul, Guarulhos and Mogi das Cruzes). Agreements to provide water services on a wholesale basis must comply with the Basic Sanitation Law, which designates these services as “interdependent activities” and regulates each stage of the service. The law requires that the service be supervised by an independent agency, stipulates registration of the cost of the service, and requires assurance of payment among the several service providers in order to continue the provision of the services, in accordance with the rules to be published by ARSESP. Our agreements currently comply with the provisions of the Basic Sanitation Law. In 2013, the revenues from wholesale water services were R\$208.7 million. For further information, see “Regulation of Concessions” above.

#### *Wholesale Sewage Services*

We provide sewage services on a wholesale basis to the municipalities of Mogi das Cruzes, Santo André, São Caetano, Mauá and Diadema. Our agreement with Santo André for these services was executed with the intervention of the Public Prosecution Office. Our agreements with the other municipalities resulted from our environmental efforts and municipal authorities’ awareness of environmental issues. Through these agreements, in 2013 we treated approximately 38 million cubic meters of sewage from these municipalities. We believe this illustrates our commitment to social and environmental responsibility. In 2013, our revenues from wholesale sewage services were R\$26.1 million.

In December 2008, we entered into a five year agreement for the collection and treatment of 20% of the sewage generated by the city of Guarulhos. We have not yet started to provide these services, and such services will only commence when the works on linking the Guarulhos sewage to our sewage system are finalized. These works are the responsibility the Guarulhos sanitation company.

### **Description of Our Activities**

As set forth in Article 2 of our bylaws, we are permitted to render basic sanitation services with the goal of providing basic sanitation services to the entire population in the municipalities where we conduct our activities without harming our long term financial sustainability. Our activities comprise water supply, sanitary sewage services, urban rainwater management and drainage services, urban cleaning services, solid waste management services and related activities, including the planning, operation, maintenance and commercialization of energy, and the commercialization of services, products, benefits and rights that directly or indirectly arise from our assets, operations and activities. We are allowed to act in a subsidiary form in other Brazilian locations and abroad. See “—Government Regulation—Public Consortia and Cooperation Agreement Law for Joint Management.” For a description of our operating segments please see Note 23 to our financial statements as of and for the year ended December 31, 2013.

Operating segments are presented in our annual report in a manner consistent with the internal reporting provided to management, comprised of the board of directors and the board of executive officers, pursuant to IFRS 8. Under Brazilian GAAP, prior to our conversion to IFRS, the financial information for construction services was not separately presented and construction costs related to concessions were capitalized within property, plant and equipment. As a result, our management did not review the results of this business. Following our conversion to IFRS, our management decided to continue to exclude the construction results from the management reporting of our revenues and expenses, thus not basing his decisions on discrete financial information for that business. The characteristics described in paragraph 5(b) of IFRS 8 for separate operating segments are thus not fulfilled for this particular business. Nonetheless, after our conversion to IFRS and for IFRS financial statement purposes only, we started to record such results separately as construction revenue and costs under IFRIC 12. Although such information is available discretely, however, it is not analyzed by our management as such and is not the basis for operational decisions.



We set forth below a description of our activities.

### ***Water Operations***

Our supply of water to our customers generally involves abstraction of water from various sources, subsequent treatment and distribution to our customers' premises. In 2013, we produced approximately 3,053 cubic meters of water. The São Paulo metropolitan region (including the municipalities to which we supply water on a wholesale basis) currently is, and has historically been, our core market, accounting for approximately 66% of water invoiced by volume in 2013.

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>2013</b>	<b>2012</b>	<b>2011</b>
	<i>(in millions of cubic meters)</i>		
Produced:			
São Paulo metropolitan region	2,220.6	2,235.3	2,182.8
Regional systems	832.0	823.5	809.2
<b>Total</b>	<b>3,052.6</b>	<b>3,058.8</b>	<b>2,992.0</b>
Invoiced:			
São Paulo metropolitan region	1,206.9	1,181.9	1,150.6
Wholesale	299.0	297.5	297.3
Regional systems	628.1	614.0	596.8
Reused water	0.4	0.4	0.3
Effluents	14.7	-	-
<b>Total</b>	<b>2,149.1</b>	<b>2,093.8</b>	<b>2,045.0</b>

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 Loss” below. In addition, we do not invoice:

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

### ***Seasonality***

Although seasonality does not affect our results in a significant way, in general, higher water demand is observed during the summer and lower water demand during the winter. The summer coincides with the rainy season, while the winter corresponds to the dry season. The demand in the coastal region is increased by tourism, with the greatest

demand occurring during the Brazilian summer holiday months.

*Water Resources*

We can abstract water only to the extent permitted by DAEE pursuant to water usage rights granted by it. Depending on the geographic location of the river basin or if the river crosses more than one state (federal domain), the approval of the National Water Agency (*Agência Nacional de Águas*), or ANA, a federal agency under the Ministry of the Environment is 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 the flow from nearby rivers, or by a combination of both methods. For more information on water usage regulation, see “—Water Usage” below.

In order to supply water to the São Paulo metropolitan region, we rely on 20 reservoirs of non treated water and 405 reservoirs of treated water, which are located in the areas under the influence of the eight water producing systems comprising the interconnected water system of the São Paulo metropolitan region. The capacity of the water sources available for treatment in this area is 72 cubic meters per second. Total current installed capacity is 73.2 cubic meters per second, which can be treated from the interconnected water system of the São Paulo metropolitan region. Average verified production during 2013 on the interconnected water system of the São Paulo metropolitan region was 69.1 cubic meters per second. The Cantareira, Guarapiranga and Alto Tietê systems, as a whole, supplied 84.3% of the water we produced for the São Paulo metropolitan region in 2013.

In 2013, the Cantareira system accounted for 47.1% of the water that we supplied to the São Paulo metropolitan region (including the municipalities to which we supplied water on a wholesale basis), which represented 73.2% of our gross operating revenues (excluding revenues relating to the construction of concession infrastructure) for the year. The Cantareira System usage rights grant was renewed in 2004 and will expire in August 2014. We are working to renew this grant for a period of 30 years and to maintain the current withdrawal basin condition which is of 33 m<sup>3</sup>/s. Due to current climate conditions, particularly the strong drought, next steps in the renewal process are temporarily suspended. For further information on droughts see “Item 3.D Risk Factors—Risks Relating to Our Business—Droughts, the water consumption reduction program or other measures may result in a significant decrease in the volume of water billed and the revenues from services we provide, which may have a material adverse effect on our company.”

Water basin committees are authorized to charge both for water usage and the dumping of sewage into water bodies. We participate in the decentralized and integrated management of water resources established by the National Policy on Water Resources. We are represented by 150 employees on the 21 Committees on State Water Basins, on the four Federal Committees that act in the State of São Paulo and in the National and State Councils on Water Resources. In 2013, the State Committees and part of the Federal Committees renewed their management for the next two years, and we kept our representation.

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

<b>Water production system:</b>	<b>Production Rate<sup>(1)</sup></b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
	<i>(in cubic meters per second)</i>		
Cantareira	32.6	32.7	31.5
Guarapiranga	13.6	13.7	12.6
Alto Tietê	12.1	12.4	13.0
Rio Claro	4.8	3.7	4.0
Rio Grande (Billings reservoir)	3.9	4.7	4.6
Alto Cotia	1.2	1.2	1.2
Baixo Cotia	0.8	0.9	0.9
Ribeirão da Estiva	0.1	0.1	0.1
<b>Total</b>	<b>69.1</b>	<b>69.4</b>	<b>67.9</b>

(1) Average of the twelve months ended December 31, 2013, 2012 and 2011.



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. We accepted, on a temporary basis, the reservoirs in the Alto Tietê System as part of the payment until the State transfers the property rights with respect to the reservoirs to us. We are unable to assure you whether and when these reservoirs will be transferred to us because the Public Prosecution Office of the State of São Paulo filed a civil public action alleging that a transfer to us of ownership of the Alto Tietê System reservoirs is illegal.

In January 2009, we began operating, monitoring and maintaining the reservoirs in the Alto Tietê system, formed by the Ponte Nova, Paraitinga, Biritiba, Jundiá and Taiapuêba reservoirs. In the cities of the interior region of São Paulo, our principal source of water consists of surface water from nearby rivers and 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. We installed 226,421, 212,775 and 207,840 new water connections in 2013, 2012 and 2011, respectively.

The interconnected water system of the São Paulo metropolitan region serves 30 municipalities, of which 24 are operated directly by us under this system. Through this system, we serve the other six municipalities on a wholesale basis, and the distribution is made by other companies or departments related to each municipality.

In order to reach the final customer, the water is stored and transported through a complex and interconnected system. This water system requires permanent operational supervision, engineering inspection, maintenance, and 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\$4.5 billion (including the investment in the São Lourenço PPP) from 2014 to 2018 to increase our water production and distribution capacities as well as to improve the water supply systems. In 2013, our total investment in water supply systems amounted to R\$1.1 billion.

#### *Water Treatment*

We treat all water at our water treatment facilities prior to placing it into our water distribution network. We operate 232 treatment facilities, of which the eight largest, located in the São Paulo metropolitan region, account for approximately 73% of all water we produced in 2013. 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.

#### *Water Distribution*

We distribute water through our own networks of water pipes and water transmission lines, ranging in size from 2.5 meters to 75 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. The following table sets forth the

total number of kilometers of water pipes and water transmission lines and the number of connections in our network as of the dates indicated.

	<b>As of December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
Water distribution pipes and water transmission lines (in kilometers)	69,619	67,647	66,389
Number of connections (in thousands)	7,888	7,679	7,481

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

As of December 31, 2013, our water distribution pipes and water transmission lines included: (i) 36,334 kilometers in the São Paulo metropolitan region; and (ii) 33,285 kilometers in the Regional systems.

As of December 31, 2013, we had 405 storage tanks in the São Paulo metropolitan region with a total capacity of 2 million cubic meters, and 1,879 storage tanks in the Regional systems. As of that date, we had 126 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 transmission lines that require maintenance are cleaned and their lining is replaced. 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 water transmission lines in the São Paulo metropolitan region to be adequate as of the date of this annual report. Due to age, external factors such as traffic, the dense population, and commercial and industrial development, water pipes and water transmission lines in the São Paulo metropolitan region are somewhat more susceptible to degradation than those in the Regional systems. To counter these effects, we have a maintenance program in place for water pipes and water transmission lines that is intended to address anticipated fractures and clogs due to brittleness and encrustation, and to help ensure water quality in the region. The new customers are responsible for covering part of the costs of connecting to our water distribution network that is related to the connection of customers water pipes that are more than 20 meters away from the water transmission lines. Thereafter, the customer must cover the costs of connecting to the network from the customer's premises, including costs of purchasing and installing the water meter and related labor costs. 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.

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

	<b>in thousands</b>							<b>2014</b>
	<b>2014</b>	<b>2015</b>	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>	<b>2020</b>	<b>2020</b>
São Paulo metropolitan region	103	99	94	85	84	76	76	617
Regional systems	77	78	78	79	80	82	82	556
<b>Total</b>	<b>180</b>	<b>177</b>	<b>172</b>	<b>164</b>	<b>164</b>	<b>158</b>	<b>158</b>	<b>1,173</b>

#### *Water Loss*

The difference between the amount of water produced and the amount of water invoiced generally represents both physical and non physical water loss. The Non-Revenue Water Index represents the quotient of (i) 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 loss, divided by (ii) the total amount of water produced by us.

We exclude the following from our calculation of water loss: (i) water discharged for periodic maintenance of water transmission lines and water storage tanks; (ii) water supplied for municipal uses such as firefighting; (iii) water we

consume in our facilities; and (iv) estimated water loss associated with water we supply to *favelas* (shantytowns).

Among the principal indicators utilized to measure rates of water loss are the following:

- Non-Revenue Water (NRW), in %;
- Water Loss Index (based on metered consumption) (WLI); and
- Index of total loss per connection, (TLDC) in liters/connection per day.



These indicators are calculated by applying the following formulas:

$$\text{NRW} = \frac{V_{\text{produced}} - (V_{\text{billed}} + V_{\text{used}})}{V_{\text{produced}}}$$

$$\text{WLI} = \frac{V_{\text{produced}} - (V_{\text{micromeasured}} + V_{\text{used}})}{V_{\text{produced}}}$$

$$\text{TLDC} = \frac{V_{\text{produced}} - (V_{\text{micromeasured}} + V_{\text{used}})}{N_{\text{connection}} \times \text{No. of days of a given period}}$$

Where:

**V<sub>produced</sub>**: corresponds to the volume of water produced at a given period;

**V<sub>billed</sub>**: corresponds to the volume of water billed at a given period;

**V<sub>micromeasured</sub>**: corresponds to the volume of water micromeasured at a given period;

**V<sub>used</sub>**: corresponds to the volume of water used for operational, public, private and social needs (supply shantytown areas) at a given period; and

**N<sub>connections</sub>**: corresponds to the average number of active water connections.

Since 2005, we have used a method of measuring our water loss based on worldwide market practice for the industry. According to this measurement method, average water loss is calculated by dividing (i) average annual water loss by (ii) the average number of active water connections multiplied by the number of days of the year. The result of this calculation is the number of liters of water lost per connection per day.

Using this calculation method, as of December 31, 2013, we experienced 446 liter/connection per day of water loss in the São Paulo metropolitan region and 261 liter/connection per day in the Regional systems, averaging 372 liter/connection per day. We plan to reduce total water loss to around 280 liters/connection, Non-Revenue Water to 18% by 2020 and the Water Loss Index to 25.7% by 2020.

Our strategy to reduce water loss has two approaches:

- reduction in the level of physical loss, which results mainly from leakage. To this end we are primarily replacing and repairing water transmission lines and pipes, and installing probing and other equipment, including strategically located pressure regulating valves; and
- reduction of non physical loss, which results 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. To this end we are upgrading and replacing inaccurate water meters and expanding our anti fraud personnel.

We are taking measures to decrease physical loss by reducing response time to fix leakages and by better monitoring non visible water transmission lines fractures. Among other initiatives, we have adopted the following measures to reduce physical water loss:

- the introduction of technically advanced valves to regulate water pressure throughout our water transmission lines in order to maintain appropriate water pressure downstream. 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 transmission lines and the resulting stress on the network can cause significant water loss through cracks and an increase in ruptures of the pipes. The technically advanced valves are equipped with probes programmed to feed data to the valve in order to reduce or increase pressure to the water transmission lines as water usage fluctuates. As of December 31, 2013, we had installed 1,912 valves at strategic points in the network, with 1,141 valves being installed in the São Paulo metropolitan region and 771 in the Regional systems;

- 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 to reduce overall water loss;
- 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, billed at a lower rate;
- preventing fraud with the use of new, more sophisticated water meters that are more accurate and less prone to tampering;
- installing water meters where none are present; and
- conducting 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 are similar to the standards set in the United States of America and Europe. Pursuant to the Brazilian Ministry of Health (*Ministério da Saúde*) regulations, 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 water quality from underground or surface water sources. However, high rates of population growth, increased urbanization and disorganized occupation of some areas of the São Paulo metropolitan region has reduced the quantity and quality of water available to serve the population 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 water transmission lines and invest in improvements of our treatment systems to ensure the quality and availability of water for the upcoming years.

Water quality is monitored at 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, as required by our standards and those set by statute. Our laboratories analyze an average of 50,000 samples 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 the ABNT NBR ISO 9001 certification and our central laboratory and 12 of our regional laboratories have obtained the ABNT NBR ISO IEC 17025 accreditation (accreditation for general requirements for the competence of testing and calibration laboratories) awarded by the INMETRO.

All chemical products used for water treatment are analyzed and follow strict specifications set out in recommendations made by the National Health Foundation (*Fundação Nacional de Saúde*), or NHF, the Brazilian Association of Technical Rules (*Associação Brasileira de Normas Técnicas*), or the ABNT, and the American Water Works Association, to eliminate toxic substances that are harmful to human health. 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: (i) fighting algae growth at the water source and (ii) using advanced treatment processes at the water treatment facilities, which involve the use of powdered activated carbon and oxidation by potassium permanganate. The algae growth creates significant additional costs for water treatment because of the higher volumes of chemicals used to treat the water. In 2013, we did not detect significant algae growth. We participate in *Mananciais/New Life*, together with other organizations engaged in the promotion of urban development and social inclusion to mitigate the pollution problem in the São Paulo metropolitan region. In addition, we also participate in the Clean Stream Program to clean up important streams in the city of São Paulo. Other initiatives also aimed at improving the water quality in our water sources located in the metropolitan region of São Paulo are *Nossa Guarapiranga* and *Pró-Conexão*. See “—Main Projects of Our Capital Expenditure Program—Metropolitan Water Program—*Mananciais/New Life* Program,” “—Clean Stream Program,” and “—New Policies and Programs—*Nossa Guarapiranga*.”

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 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, removal, treatment and final disposal of sewage. As of December 31, 2013, we collected approximately 87% and 77% of all the sewage produced in the municipalities in which we operate in the São Paulo metropolitan region and in the Regional systems, respectively. During 2013, we collected approximately 84% of all the sewage produced in the municipalities in which we operated in the State of São Paulo. We installed 236,647, 240,687 and 246,441 new sewage connections in 2013, 2012 and 2011, respectively.

#### *Sewage System*

The purpose of our sewage system is to collect and treat sewage and to adequately dispose of the treated sewage. As of December 31, 2013, we were responsible for the operation and maintenance of 47,103 kilometers of sewage lines, of which approximately 25,085 kilometers are located in the São Paulo metropolitan region and 22,018 kilometers are located in the Regional systems, respectively.

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

	<b>As of December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
Sewage lines (in kilometers)	47,103	45,778	45,073
Sewage connections (in thousands)	6,340	6,128	5,921

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 sewage lines made of cast iron.

The public sewage system operated by us was structured in order to receive, in addition to household effluents, a portion of non-domestic effluents (such as industrial sewage and sewage from other non domestic sources) for treatment together with household effluents. Non-domestic effluents have characteristics that are qualitatively and quantitatively different from household effluents. As a result, the discharge of non-domestic effluents into the public sewage system is subject to compliance with specific legal demands with the purpose of protecting the sewage collection and treatment systems, the health and safety of operators and the environment. The current environmental legislation establishes standards for the discharge of these effluents into the public sewage system and stipulates that

such effluents be subject to pre-treatment. These standards are defined in State Decree No. 8,468 dated September 8, 1976, as amended.

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 us and the effluent producer. Failure to comply with these conditions can lead to the application of penalties by us. In extreme cases, the environmental protection agency (Companhia Ambiental do Estado de São Paulo), or CETESB, is notified in order for the applicable measures to be taken. Effluents from our treatment facilities must comply with limitation guidelines for release of effluents into receiving water bodies. Additionally, the quality of the water in the receiving water body must not be impaired by the release of such effluents, as established by State Decree No. 8,468/76 and Conama Resolutions 357/2005 and 430/2011.

We considered the condition of the sewage lines in the São Paulo metropolitan region to be adequate as of the date of this annual report. Due to a greater volume of sewage collected, a higher population and more extensive commercial and industrial development, the sewage lines in the São Paulo metropolitan region are more deteriorated than those of the Regional systems. To counter the effects of deterioration, we maintain an ongoing program for the maintenance of sewage lines intended to address anticipated fractures arising from obstructions caused by system overloads.

Unlike the São Paulo metropolitan region, the interior region of São Paulo State does not generally suffer obstructions caused by sewage system overload. The coastal region, however, experiences obstructions in its sewage lines primarily due to infiltration of sand, especially during the rainy season in the summer months. In addition, the sewage coverage ratio in the coastal region is lower than in the other regions served by us, with approximately 60% of all residences in the coastal region currently connected to our sewage network as of December 31, 2013.

New sewage connections are made on substantially the same basis as connections to water lines: we assume the cost of installation for the first 20 meters of sewage lines from the sewage network to all customers' sewage connections and the customer is responsible for the remaining costs.

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

	2014	2015	2016	2017	2018	2019	2020	2014-2020
São Paulo metropolitan region	124	135	135	125	117	105	121	862
Regional systems	111	111	108	118	118	123	101	790
<b>Total</b>	<b>235</b>	<b>246</b>	<b>243</b>	<b>243</b>	<b>235</b>	<b>228</b>	<b>222</b>	<b>1,652</b>

### *Sewage Treatment and Disposal*

In 2013, approximately 68% and 95% of the sewage we collected in the São Paulo metropolitan region and the Regional systems, respectively, or 78% 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 rivers and the Atlantic Ocean, in accordance with applicable legislation. Though we have not yet reached universalization of sewage collection and treatment services in the regions where we operate, we are making efforts to reach this goal.

We currently operate 500 sewage treatment facilities and 9 ocean outfalls, of which the five largest, located in the São Paulo metropolitan region, have treatment capacity of approximately 18 cubic meters of sewage per second.

In the São Paulo metropolitan region, the treatment process used by most treatment facilities is the activated sludge process.

Sewage treatment in the Regional systems will vary according to the particularities of each area. In the interior region of São Paulo State, treatment consists largely of stabilization ponds. There are 407 secondary treatment facilities in the interior region of São Paulo State that have treatment capacity of approximately 14 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 also into the Atlantic Ocean through our ocean outfalls, in accordance with applicable legislation. We have 74 sewage treatment facilities in the coastal region.



We are a party to a number of legal proceedings related to environmental matters. See “Item 8.A. Financial Information—Financial Statements and Other Financial Information—Legal Proceedings.” In addition, our capital expenditure program includes projects to increase the amount of sewage that we treat. See “Item 4.A. History and Development of the Company—Capital Expenditure Program” and “4.B Business Overview—Government Regulation—Environmental Regulation—Sewage Requirements.”

### *Sludge Disposal*

The creation of sludge is inherent to the sanitation cycle. The treatment of water and sewage produces residue which needs to be disposed of appropriately to prevent harm to the environment. Sludge removed from the treatment process typically contains water and a very small proportion of solids. We use filter presses, belt presses, drying beds and centrifugation machines, among other processes, to abstract the water from the sludge.

Currently, the sludge generated through our activity goes mainly to landfills. In turn, we treat the slurry generated in these landfills.

Current legislation and the population at large demand advances in the search for alternative technologies that minimize the generation of and find beneficial uses for sludge. In light of these demands, we work on several fronts, seeking innovative approaches to the destination and final disposal of sludge.

Part of the R\$6.4 million invested in research and development in 2013 was used for approached to the disposal and beneficial use of sludge, in order to meet the Principles for Cleaner Production. Our partnerships with the Brazilian Innovation Agency (FINEP) and the São Paulo State Foundation for Research Support (Fapesp) cover projects to use of sludge to help recover of degraded areas, cover landfills and yield sand for construction works.

Sludge disposal must comply with State and Federal law requirements, such as Resolution No. 375 of August 29, 2006 of the CONAMA, Federal Law No. 12,305/2010, Federal Decree No. 7,404/2010, State Law No. 12,300/2006 and State Decree No. 54,645/2009.

### **Principal Markets in Which We Operate**

As of December 31, 2013, we operated water and sewage systems in 363 of the 645 municipalities in the State of São Paulo. In addition, we currently supply water on a wholesale basis to six municipalities located in the São Paulo metropolitan region with an urban population of approximately 3.5 million.

The following table provides a breakdown of gross revenues from water supply and sewage services by geographic market for the periods indicated.

	<b>Year ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
	<i>(in millions of R\$)</i>		
São Paulo metropolitan region	6,984.4	6,625.0	6,144.7
Regional systems	2,555.7	2,301.7	2,160.4
<b>Total</b>	<b>9,540.1</b>	<b>8,926.7</b>	<b>8,305.1</b>

The following table provides a breakdown of gross revenues from water supply and sewage services by category of activity for the periods indicated.

	<b>Year ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
		<i>(in millions of R\$)</i>	
Water supply	5,276.1	4,944.2	4,607.2
Sewage services	4,264.0	3,982.5	3,697.9
<b>Total</b>	<b>9,540.1</b>	<b>8,926.7</b>	<b>8,305.1</b>

## **Competition**

In the State of São Paulo, there are approximately 276 municipalities that operate their own water and sewage systems and that collectively have a total population of approximately 13.7 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.

The competition for municipal concessions arises mainly from the municipalities, as they may 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—Regulation of Concessions.” In the past, municipal governments have terminated our concessions agreements before the expiration date. Furthermore, 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—Financial Statements and Other Financial Information—Legal Proceedings.” We negotiate expired concession agreements and concession agreements close to expiration with the municipalities in an attempt to maintain our existing areas of operations. In the State of São Paulo we face competition from private and municipal water and sewage service providers.

In recent years, we have also experienced an increasing level of competition in the market of water supply to large customers. Several large industrial customers located in municipalities served by us use their own wells to supply themselves with water. In addition, competition for the disposal of non residential, commercial and industrial sludge in the São Paulo metropolitan region has increased in recent years as private companies offer stand alone solutions inside the facilities of their customers. We have also established new tariff schedules for commercial and industrial customers in order to assist us in retaining these customers. For this group of customers, we have a special authorization from ARSESP to establish different tariffs than the ones that agency establishes for regular consumers.

## **Billing Procedures**

The procedure for billing and payment of our water and sewage services is largely the same for all customer categories. 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 loss resulting from faulty water meters. Sewage billing is included as part of the water bill and is based on the water meter reading.

The majority of the bills for water and sewage services are delivered to our customers in person, mainly through one of our employees or through independent contractors who are also responsible for reading water meters. The remainder, by judicial determination, is sent by mail. 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 after deducting average banking fees ranging from R\$0.29 to R\$1.21 per transaction 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 2013, 2012 and 2011, we received payment of 95.2%, 94.7% and 94.8%, respectively, of the amount billed to our retail customers, and 95.0%, 95.5% and 94.7%, respectively, of the amount billed to those customers other than State entities, within 30 days after the due date. In 2013, 2012 and 2011, we received 100.5%, 100.7% and 96.0%, respectively, of the amount billed to the State entities. Amounts in excess of 100.0% reflect our recovery of amounts billed in prior years. With respect to wholesale supply,

in 2013, 2012 and 2011, we received payment of 45.8%, 50.1% and 54.7%, respectively, of the amount billed within 30 days.

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. Part of the water meter monitoring for billing purposes is carried out by our own personnel, trained and supervised by us, and part of it is carried out by third party contractors that employ and train their own personnel whose training we supervise.

## Tariffs

Tariff adjustments follow the guidelines established by the Basic Sanitation Law and ARSESP. The guidelines also establish procedural steps and the terms for the annual adjustments. The adjustments have to be announced 30 days prior to the effective date of the new tariffs, which used to take effect in September. Pursuant to the most recent tariff revision, both the base date and future adjustments will now take place in April.

Tariffs have historically been adjusted once a year and for periods of at least 12 months. See “—Government Regulation—Tariff Regulation in the State of São Paulo” for additional information regarding our tariffs.

With the publication of the Basic Sanitation Law, the regulation of basic sanitation services, including tariff regulation, became the responsibility of an independent regulator. To exercise this assignment, the State of São Paulo created ARSESP, which regulates and supervises the services we provide to the State and also to the municipalities that have agreed to its jurisdiction through a cooperation agreement.

In regards to municipalities that have not explicitly selected ARSESP as their regulator, the Basic Sanitation Law allows the municipality to create other regulatory agencies of their own. In 2007, the municipality of Lins decided to create its own regulatory authority, although it revised this decision in 2010, transferring to ARSESP the regulation of the water activities performed in Lins, including for the setting of tariffs. The municipality of Lins has reserved, however, the power to ultimately approve the tariff set by ARSESP.

In addition, in 2011 municipalities in which the hydrographic basins of the Piracicaba, Capivari and Jundiá rivers are located created a consortium (ARES/PCJ) for the regulation and supervision of our activities in those areas. As a result of the creation of the ARES/PCJ, we are currently involved in legal proceedings in which ARES/PCJ is claiming that it has jurisdiction over the regulation and supervision of our activities in two municipalities (Piracicaba and Mombuca). In the municipality of Piracaia, ARSESP is the entity responsible for applying the state tariff policy (Decree 41,446/96) which is in force due to an existing concession agreement. In the municipality of Mombuca, the regulation and supervision of basic sanitation services was delegated to the State of São Paulo, so that ARSESP could exclusively execute these services. We cannot predict the outcome of this case or how it may impact our business. See” Risk Factor – Risk Relating to Our Business - Current regulatory uncertainty, especially with regard to implementation and interpretation of the Brazilian Basic Sanitation Law, may have an adverse effect on our business.”

In 2012 and 2011, we readjusted our prices by 5.15% and 6.83% starting on September 11, 2012 and on September 11, 2011, respectively. On April 22, 2013, ARSESP approved a preliminary tariff rate of 2.3509% to be applied equally on all customer tariffs. These adjustments were valid for all municipalities served by us, except for the municipalities of Lins and Magda, which have different rules and readjustment dates. We adjusted the tariffs in the municipality of São Bernardo do Campo pursuant to a different methodology due to the difference between the tariffs charged in that municipality when we assumed the service and the tariffs we were charging in other metropolitan municipalities we serve. The adjustments in São Bernardo do Campo were set so that in September 2012 the tariff charged in this municipality and the tariff charged in the other municipalities of the region became the same. Since then, the tariff adjustments in this municipality follow the adjustment calendar of the São Paulo metropolitan region. With respect to the municipality of Lins, we adjust our tariff in January according to the variation of the IPCA for the last twelve month period ended November 30. In Magda, the tariffs will equal the tariffs in the region by July 2014. In the municipalities of Glicério and Torrinha, the tariffs will equal the tariffs in the region in 2017.

On November 1, 2013, ARSESP issued Resolution No. 435 which authorizes us to implement a tariff adjustment. Initially, this adjustment considered an inflation rate of 6.2707% as measured by the IPCA for the period of August

2012 to July 2013. From this number, ARSESP deducted the Efficiency Factor (X Factor) of 0.4297% for the period, and this resulted in an adjustment of 5.8410%. Additionally, ARSESP estimated the gain that we had with a tariff revision of 2.3509% beginning in April 2013, and this resulted in a further discount of 0.9249% in the indicator.

Moreover, ARSESP also estimated our loss of 0.6538% resulting from the delay in the reposition of the IPCA and added that estimated amount. The product of these movements and considerations resulted in a linear increase of 3.1451% in tariffs beginning December 11, 2013.

Regarding the tariff structure, ARSESP Resolution No. 463, published in January 2014, established April 10, 2014, as a deadline for publication of the timetable for implementation of our new tariff structure. However, in April 17, 2014, ARSESP issued Resolution No. 484, which maintains the current Tariff Structure and does not set a date for implementation of the new tariff structure. Until the new tariff structure is approved by ARSESP, we will continue to use our current tariff structure. As such, we currently divide tariffs into two categories: residential and non residential. The residential category is subdivided into standard residential, 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: (i) commercial, industrial and public customers; (ii) "not for profit" entities that pay 50.0% of the prevailing non residential tariff; (iii) government entities that have entered into a water loss reduction agreement with us and pay 75.0% of the prevailing non residential tariff; and (iv) public entities that have entered into program agreements, for municipalities with a population of up to 30,000 and with half or more classified according to their degree of social vulnerability by the Social Vulnerability Index of São Paulo (*Índice Paulista de Vulnerabilidade Social*) 5 and 6, of the SEADE, obtained through the analysis of the 2000 Census figures, and start to receive tariff benefits, in accordance with our normative ruling, for the category of public use, at the municipality level. The tariffs are equal to those offered to the commercial/entity of social assistance and that corresponds to 50.0% of the public tariffs without contractual provisions referred to in item (iv) above.

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 fixed demand agreements (take or pay) with us for at least one year terms. In October 2007, the minimum volume for entering into these agreements was reduced from 5,000 cubic meters per month to 3,000 cubic meters per month. We believe this tariff schedule will help prevent our commercial and industrial customers from switching to the use of private wells. Since 2008, we have been authorized by ARSESP to establish tariffs for non residential customers, such as industrial and commercial customers, that consume more than 3,000 cubic meters per month, with a maximum tariff equal to the tariffs applicable to non residential customers that consume more than 50 cubic meters per month. In 2010, ARSESP authorized a reduction in the minimum volume of consumption for customers that enter into demand agreements with us to a minimum of 500 cubic meters per month.

We establish separate tariff schedules for our services in each of the São Paulo metropolitan regions and each of the interior region of São Paulo State 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 exceed our costs of providing 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 region of São Paulo State and coastal regions.

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 São Paulo State region, sewage tariffs are approximately 20.0% 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 (i) customer category and class and (ii) volume of water consumed, charged in cubic meters during the years and period stated in the São Paulo metropolitan region.



<b>Customer Category Consumption</b>	<b>As of December 11, 2013<sup>(5)</sup></b>	<b>As of April 22, 2013<sup>(4)</sup></b>	<b>As of September 11, 2012<sup>(3)</sup></b>	<b>As of September 11, 2011<sup>(2)</sup></b>
Residential				
Standard Residential:				
0 10 <sup>(1)</sup>	1.68	1.63	1.59	1.52
11 20	2.63	2.55	2.49	2.37
21 50	6.57	6.37	6.22	5.92
Above 50	7.24	7.02	6.86	6.52
Social:				
0 10 <sup>(1)</sup>	0.57	0.55	0.54	0.51
11 20	0.99	0.96	0.94	0.89
21 30	3.48	3.37	3.29	3.13
31 50	4.97	4.82	4.71	4.48
Above 50	5.49	5.32	5.20	4.95
<i>Favela</i> (shantytown):				
0 10 <sup>(1)</sup>	0.44	0.42	0.41	0.39
11 20	0.50	0.48	0.47	0.45
21 30	1.64	1.59	1.55	1.47
31 50	4.97	4.82	4.71	4.48
Above 50	5.49	5.32	5.20	4.95
Non Residential				
Commercial/Industrial/Governmental:				
0 10 <sup>(1)</sup>	3.38	3.28	3.20	3.04
11 20	6.57	6.37	6.22	5.92
21 50	12.59	12.21	11.93	11.35
Above 50	13.12	12.72	12.43	11.82
Social Welfare Entities:				
0 10 <sup>(1)</sup>	1.69	1.64	1.60	1.52
11 20	3.29	3.19	3.12	2.97
21 50	6.32	6.13	5.99	5.70
Above 50	5.56	6.36	6.21	5.91
Government entities that employ the Rational Use of Water Program ( <i>Programa de Uso Racional da Água</i> ), or PURA, with reduction agreement:				
0 10 <sup>(1)</sup>	2.53	2.40	2.28	2.14
11 20	4.92	4.66	4.43	4.15
21 50	9.47	8.97	8.53	7.98
Above 50	9.84	9.32	8.86	8.29

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

(2) From September 11, 2011 through September 10, 2012.

- (3) From September 11, 2012 through April 21, 2013.
- (4) From April 22, 2013 through December 10, 2013.
- (5) Since December 11, 2013

In 2013, 2012 and 2011, the average tariff calculated for the Regional systems was approximately 30% below the average tariff of the São Paulo metropolitan region.

The Basic Sanitation Law requires states to establish independent regulators with the responsibility of monitoring basic sanitation services and regulating tariffs. Federal law No. 11,445/07 and São Paulo State Law No. 1,025/07 established the ARSESP, which regulates and supervises the basic sanitation services that we provide in municipalities that have agreed to come under ARSESP's jurisdiction. For the municipalities that have not yet agreed to come under ARSESP's jurisdiction for which we currently provide basic sanitation services, we determine tariffs based on State Decree 41,446/96. ARSESP has proposed or enacted a number of regulatory changes, including the following:

- In 2009, ARSESP opened the methodology for tariff revisions for public discussion and hearings. In 2010, ARSESP issued Resolution No. 156. This resolution established the methodology and general criteria for the valuation of our regulatory asset base to be used for purposes of tariff review processes and auditing. During 2011 and 2012 ARSESP held further public consultations regarding the methodology for tariff revisions, which was finally specified and disclosed in April 2012. In November 2012, ARSESP published a preliminary technical note for public consultation, proposing a preliminary initial maximum average tariff (P0) and efficiency gains factor (X Factor), based on a preliminary evaluation of assets held by us. Following further public consultations, in March 2013 ARSESP published two resolutions, Resolution No. 406 and Resolution No. 407.
- Resolution No. 406 sets out the following: (i) an initial maximum average tariff (P0) and a preliminary asset base value to apply until the conclusion of an external audit of our asset base, resulting in a tariff revision of 2.3509%; (ii) authorizes the pass-through to consumers of the regulation and supervision rate of 0.5% immediately after the conclusion of the operational adjustments necessary for the inclusion of this rate in the bills in the municipalities where it will be charged; (iii) ARSESP also establishes an annual tariff adjustment formula, to be implemented during the second tariff cycle, consisting of the IPCA variation (a consumer price index) for the period, adjusted by an efficiency factor designed to transfer a portion of our productivity gains to consumers, which was implemented on November 1, 2013 and further adjusted to reflect changes in service quality to be defined and applied as of the third year of the tariff cycle. According to ARSESP's timetable the final maximum average tariff (P0) would be announced in August 2013 after an audit of the asset base value presented by us. However, it was postponed to April 2014.
- A tariff revision of to a rate of 2.3509% was implemented in April 2013 pursuant to Resolution No. 406. Additionally, we will pass an inspection fee of 0.5% to consumers immediately after the conclusion of the operational adjustments necessary for the inclusion of this rate in the bills to municipalities where it will be charged. The adaptation of internal processes to accommodate this charge has not been finalized yet, and it should be finalized in 2014.
- In April 2013 ARSESP issued Resolution No. 407 authorizing us to pass through to the service bill the 7.5% transfer to the São Paulo Municipal Sanitation and Infrastructure Fund as a legal charge, as defined by municipal legislation. Pursuant to the Program Contracts and the Sewage and Water Supply Service Contracts, this charge must be considered in the tariff revision.
- In April 2013, ARSESP issued Resolution No. 413, which effectively suspended Resolution No. 407 until the tariff revision process is concluded, thereby postponing our authorization to pass the charge through to consumers on the service bill. The postponement of Resolution No.407 was due to a request from the Government of the State of São Paulo to analyze, among other matters, methods of reducing the impact on consumers. Although Resolution No.407 establishes the conclusion of the tariff review as the date for the implementation of the pass-through, we cannot be certain when Resolution No. 407 will be implemented. In April 2014, ARSESP issued Resolution No. 484, which establishes the conclusion of the tariff revision. No

decision was made in relation to the 7.5% charge to our consumers, and we do not know when a final decision will be reached. We cannot know when we will be able to pass the 7.5% charge to consumers on the service bill.

- In July 2013, ARSESP announced that due to a lack of quorum by its board of directors to deliberate on the tariff revision process, the process would be postponed until a quorum could be formed. Three directors are necessary so that ARSESP may deliberate on any matter and, at that time, it only had two directors.

- Resolution No. 427, published by ARSESP on August 1, 2013, maintained suspension of our tariff revision and required that we reevaluate 19 points of our Regulatory Asset Base. We requested 90 days to assess, clarify and make the adjustments necessary to the Regulatory Asset Base. A revised Regulatory Asset Base was filed in December 2013, in compliance with the schedule.

- In October 2013, ARSESP's officers fulfilled the minimum requirement quorum necessary to deliberate on subjects related to the tariff adjustment and/or revision that had been paralyzed since August 2013. On November 1, 2013, ARSESP issued Resolution No. 435, authorizing us to implement a tariff adjustment. Initially, this adjustment considered an inflation rate of 6.2707% as measured by the IPCA for the period of August 2012 to July 2013. From this number, ARSESP deducted the Efficiency Factor (X Factor) of 0.4297% for the period, and this resulted in an adjustment of 5.8410%. Additionally, ARSESP estimated the gain that we had with a tariff revision of 2.3509% beginning in April 2013, and this resulted in a further discount of 0.9249% in the indicator. Moreover, ARSESP also estimated our loss of 0.6538% resulting from the delay in the repositioning of the IPCA and added that estimated amount. The product of these movements and considerations resulted in a linear tariff adjustment of 3.1451% beginning December 11, 2013.
- ARSESP Resolution No. 463 published in January 2014 established a new timetable for the development of our tariff revision phases and established April 10, 2014, as the date for release of the definitive Initial Maximum Price (P0) and the Efficiency Factor (X Factor) for the tariff cycle initiated on August 10, 2012. The phases of our tariff revision were determined as follows:
  - February 11, 2014 – ARSESP released Technical Note RTS 001/2014, which presents its proposals for the definitive Initial Maximum Price (P0) and Efficiency Factor (X Factor) and start of the public consultation and call for a public hearing. With Technical Note RTS 001/2014, ARSESP determined the Final Tariff Level, which consists of: (i) the definition of the Final P0, which refers to December 2012, with the definitive initial Net Regulatory Asset Base, or RAB, (ii) the quantification of the compensatory adjustments for retroactive application to the beginning of the cycle, and (iii) the tariff amounts to be applied on services rendered as from April 11, 2014.
  - March 12, 2014 – public hearing and the end of the public consultation;
  - April 10, 2014 – release and publication of the results related to the definitive Initial Maximum Price (P0) and Efficiency Factor (X Factor) and the consolidated reports on contributions from the public consultation; and publication of the timetable for implementation of our new tariff structure. However, on April 10, 2014, ARSESP suspended the publication of this timetable.
  - April 17, 2014 – ARSESP issued Resolution No. 484, which, among other things: (i) establishes that, as of May 11, 2014, a tariff repositioning index of 5.4408% in relation to our current tariffs and an annual Efficiency Factor (X Factor) of 0.9386%, which will be deducted in the upcoming annual tariff adjustments, shall be applied to water services bills, (ii) allows us to apply the repositioning index arising from the tariff revision at a more opportune future date, when we shall proceed with a recalculation and monetary adjustment of the applicable amounts, in order to ensure our economic and financial balance, taking into account the atypical situation in our market due to the lack of rainfall and our measures to encourage water savings in order to ensure supply, (iii) establishes that the next annual tariff adjustments will occur on April 11, 2015 and April 11, 2016, with the next tariff revision on April 11, 2017, and (iv) ratifies the readjustment rules set forth on Resolution No. 406 (described above) and updated the X Factor for the tariff cycle from 0.836% to 0.9386%. The current tariff structure will be kept with respect to our services until the new structure is approved by ARSESP and implemented. Considering what has been established by Resolution No. 484, we decided to postpone the application of the repositioning index to an opportune date no later than the end of December 2014.

In August 2012, ARSESP issued Resolution No. 346, which established the principle that users should be compensated for any interruptions in water supply. Implementation of this regulation has been suspended pending further technical discussions. In 2013, ARSESP held public consultations that resumed technical discussions on the subject, but the new resolution that will replace Resolution No. 346 has not yet been published.

### **Marketing Channels**

As of December 31, 2013, we were the concessionaire for the provision of water supply and collection, treatment and disposal of sewage services directly to end consumers for 363 municipalities of the State of São Paulo. We also supply water on a wholesale basis to six municipalities located in the São Paulo metropolitan region. It is the responsibility of these municipalities to then distribute the water to end consumers. We provide sewage services to five of these municipalities. Because of our distribution infrastructure, end consumers to whom we offer water services on a wholesale basis cannot alternatively acquire such services directly from us. For more information on service concessions, see “—Wholesale Operations.”

### **Energy Consumption**

Energy is essential to our operations, and as a result we are one of the largest users of energy in the State of São Paulo. In the year ended December 31, 2013, we used 1.78% of the total energy consumption in the State of São Paulo. 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. See “Item 3.D. Risk Factors—Risks Relating to Our Business—We are exposed to risks associated with the provision of water and sewage services.”

Energy prices have a significant impact on our results of operations. In 2013, 42.6% of our total energy consumption occurred within the “free market,” where we can more efficiently negotiate the supply of energy. In October 2012, we entered into long term contracts with AES Tiête (39%) and Tractebel Energia S.A. (61%) to provide these services until 2015.

## **Insurance**

We maintain insurance covering, among other things, fire or other damage to our property and 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 by means of public bids involving major Brazilian and international insurance companies that operate in Brazil. As of December 31, 2013, we had paid a total aggregate amount of R\$5.6 million in premiums. In addition, we paid R\$1.4 million for a D&O insurance policy, covering R\$4.1 billion in 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 of our activities. 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 our type of business.

## **Intellectual Property**

### *Trademarks*

We have secured registration of our logo and composite trademark at the Brazilian Institute of Industrial Property (Instituto Nacional da Propriedade Industrial), or INPI. We have registered with the INPI the following trademarks: “Sabesp”, “Sabesp Soluções Ambientais”, “Projeto Tietê”, “Programa Córrego Limpo”, “Programa Onda Limpa”, “Prol – Programa de Reciclagem do Óleo De Fritura”, “Revista DAE”, “Ligação Sabesp”, “Agente da Gente – Sabesp na Comunidade”, “PURA – Programa de Uso Racional da Água”, “Sabesp Inteligência Ambiental”, “Reúso da Água”, “Uso Racional da Água”, “Parque da Integração”, “Clubinho Sabesp”, “Cauã”, “Denis”, “Gabi”, “Gotucho”, “Gota Borradeira”, “D”, “Iara”, “Ratantan”, “Sayuri”, “Cadu” and “SuperH2O.” Cauã, Denis, Gabi, Gotucho, Gota Borradeira, Dr. Gastão, Iara, Sayuri, Ratantan, Cadu and Super H2O are some of the characters of our children’s club (Clubinho SABESP), which is a tool for environmental education directed to children through our website.

We have also filed applications with the INPI for registration of the following trademarks: “Eu Sou Guardiã das Águas Sabesp Eu Não Desperdiço”, “Parque Da Integração”, “Programa de Recuperação Ambiental”, “Signos Sistema De Informação Geográfica No Saneamento”, “Signos Net Sistema De Informação Geográfica No Saneamento”, “Scorpion”, “Sabesp Semana do Meio Ambiente”, “Água de Reúso Sabesp”, “Água Sabesp Aquífero Guarani”, “Água Sabesp Estação Cantareira”, “Contrato de Fidelização Sabesp”, “Esgotos não Domésticos Sabesp”, “Cine Sabesp”, “Ecoposto Sabesp”, “PEA – Programa de Educação Ambiental”, “Projeto Tietê”, “Sabesp Abraço Verde”, “Super H2O”, “Programa Córrego Limpo” and the following character of the Clubinho SABESP: “Cadu”.

### *Patents*

We have a patent granted by the INPI for a constructive device in a building hydraulic simulator used for didactic purposes. We have also filed patent requests for the following additional devices:

- a water consumption measurement unit;

- a biofilter odor control unit;
- a device for the removal of supernatants in the treatment of sewage;
- a mobile device for the calibration of hydrometers;
- rotary devices used to clean water reservoirs transported by trucks with high-pressure hydrojetting systems; and
- portable metrological test equipment.



We are currently awaiting responses to our patent requests from the INPI. While the requests are under consideration, we are granted the exclusive right to use these devices.

### **Software**

We have adopted an internal policy that provides for an active and effective audit and prevention of unauthorized software. We have acquired the software licenses for all our workstations.

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 “CSI– *Sistema Comercial, Serviços e Informações*,” “AQUALOG (Control Water Treatment Plants),” “SGL (Bid Management System),” “SCORPION (Software to Operational Control),” “Electronic Price Quotation” (*Cotação Eletrônica de Preços*), “PREGÃO SABESP ONLINE,” “SISDOC – *Sistema de Controle de Documentos*,” “*Sistema de análise do comportamento metrológico de hidrômetros*,” “*Modelo padronizado de Laudo técnico MPLT*,” and “SGH” hydrometry management system (*Sistema de Gestão de Hidrometria*), “SIA – *Sistema de Informações de Auditoria*,” “SAN – *Sistema de Apoio à Navegação*,” online software for managing specific articles published in the DAE magazine, Dashboard and Online Control of Water Losses. We have also secured registration of these programs at the INPI.

AQUALOG is a Brazilian software designed to monitor water treatment through the employment of artificial intelligence. In 2001, we completed the first rendering of services based on the AQUALOG software to a third party with the automation of a water treatment plant in the city of Jaguará do Sul, State of Santa Catarina. We have entered into an agreement to license the software to Sanesul, in the state of Mato Grosso do Sul and to Teuto’s drugs factory, in the city of Anapólis, state of Goiás. We currently have a temporary license for the AQUALOG software and are awaiting its final registration with the INPI.

SGL is an electronic price quotation system that allows us to view and control all bid and acquisition proceedings in real time.

### **Domain Names**

We own the domain names described below which have been registered with the relevant entity in Brazil, Registro.br:

- [www.sabesp.com.br](http://www.sabesp.com.br);
- [www.corregolimpo.com.br](http://www.corregolimpo.com.br);
- [www.projetotiete.com.br](http://www.projetotiete.com.br);
- [www.revistadae.com.br](http://www.revistadae.com.br);
- [blogdasabesp.com.br](http://blogdasabesp.com.br);
- [blogsabesp.com.br](http://blogsabesp.com.br);
- [sustentabilidadesabesp.com.br](http://sustentabilidadesabesp.com.br);

- [clubinhosabesp.com.br](http://clubinhosabesp.com.br); and
- [superh2o.com.br](http://superh2o.com.br).

### **Environmental Matters**

Our environmental policy establishes environmental management directives that allow us to become a contributing force to environmental sustainability and excellence. These directives are based on a systematic approach to the environment, which allows us to develop a plan that integrates economic, environmental and social dimensions of our work with sustainable use of natural resources.

We have the following ongoing environmental management programs:

- implementation of an Environmental Management System, or EMS, in our water and sewage treatment stations (“WTS” and “STS”). The EMS is present in 95 stations and we have a plan of progressive extension until 2020. Additionally, we pursue the ISO 14001 certification for our strategic plants. As of December 31, 2013, we have ISO 14001 certification for 50 STSs;
- participation in the Carbon Disclosure Project since 2006;
- development of the Corporate Greenhouse Gas Management Program (*Programa Corporativo de Gestão de Emissões de Gases de Efeito Estufa*), in line with the guidelines from the São Paulo State Climate Change Policy (PEMC), including the creation of inventories of greenhouse gases, totaling six inventories concluded since 2007;
- continuation of the actions set forth in the corporate programs for obtaining and maintaining environmental licenses and grants for the right to use water;
- the implementation of the Environmental Education Program (*PEA SABESP*), including over one hundred environmental education actions and projects involving the community and other stakeholders;
- management of our institutional representation in the State and National Systems of Water Resources, including training of company representatives to participate in: (i) the creation of criteria for water usage charges, (ii) the monitoring of water basin plans (*Planos de Bacias*), (iii) review of water bodies’ classifications, and (iv) analysis of legislation regarding the protection of water sources; and
- implementation of the SABESP 3 Rs Program (*Programa SABESP 3Rs*) for the reduction, re use and recycling of waste of administrative activities, in partnership with the Catadores Cooperatives (*Cooperativas de Catadores*) and which includes employee training enabling them to act as multipliers in the roll-out of the program.

In addition to corporate environmental management initiatives, we have several projects and initiatives underway to benefit the environment by engaging the population at large. In 2013, we invested R\$32.5 million in environmental programs and projects.

#### ***Climate Change Regulations: Reduction of Greenhouse Gases (GHG)***

We are required to comply with laws and regulations related to climate change, including international agreements and treaties to which Brazil is a signatory.

The São Paulo State Climate Change Policy (Law No. 13,798), enacted on November 9, 2009, aims to reduce global emissions of carbon dioxide by 20.0% by 2020 compared with 2005 levels. Brazil’s Climate Change Policy (Law

No. 12,187), enacted on December 29, 2009, establishes a voluntary national commitment to reduce Brazil's currently projected GHG emissions for 2020 by a percentage between 36.1% and 38.9%. Such targets have not been established for the sanitation sector yet. We are currently developing a Corporate Greenhouse Gas Management Program, aimed at reducing the amount of greenhouse gases released into the atmosphere, including the creation of an inventory to record releases of greenhouse gases.

In 2013, we concluded the corporate inventories of greenhouse gases for 2011 and 2012, thus totaling six inventories since 2007. We noted that the trend observed in the previous inventories persists, specifically that activities regarding sewage collection and treatment remain our largest sources of greenhouse gas release, representing approximately 91% of CO<sub>2</sub> release. Electric energy represents approximately 8% and administrative activities represent approximately 1% of greenhouse gas release.

We participate in initiatives that may potentially reduce the amount of greenhouse gases we release into the atmosphere, such as installing a small hydroelectric power plant. The use of biogas generated in the treatment of sewage, recycling sewage sludge and covering lagoons, among other actions, are other initiatives related to this matter.

At this point, it is still not possible to predict if climate change policies will provide opportunities or generate new costs for us. Reducing our emissions of carbon dioxide will involve costs and expenses related to implementing more stringent control mechanisms, adopting pollution prevention measures and actions to minimize the generation of GHGs. We may not receive financial incentives to offset all or part of these costs. In addition, if limitations in GHG emissions affect our supply chain and increase our costs, we may not be able to pass on these costs to our end consumers. See “—Tariffs.”

#### *Carbon Disclosure Project*

- *Carbon Disclosure Project Investors.* We participate in the Carbon Disclosure Project, a global initiative focused on the financial risks related to climate change. Through this project, main international institutional investors ask the world’s largest companies to demonstrate that they are managing carbon effectively. We have received and responded to the project’s questionnaires since 2006.

#### *Physical Effects of Extreme Weather Events*

Since our financial performance is closely linked to climate patterns that influence the availability of water (in terms of quantity and quality of water resources), extreme weather conditions may adversely affect our business and operations. If long term climate change causes significant alterations in environmental conditions, such as an increase in the frequency of extreme weather conditions, this could affect the quality and quantity of water available for abstraction, treatment and supply, which could affect the costs of services and tariffs.

An increase in heavy rainfall can impact water quality and the regular operation of water sources, including abstraction of water from our dams, through increased soil erosion, silting, pollution and eutrophication of aquatic ecosystems. In addition, increased flows of rainwater into sewage systems may overwhelm the capacity of sewage treatment plants. We may need to implement new production systems, build larger reservoirs, or increase operational capacity by further automating our existing equipment. To increase automation, we would need to purchase and operate new equipment to measure dam levels and volumes, river output and the rain in hydrographic basins, create mathematical models for real time operations, and train technicians to operate these systems.

In the case of prolonged periods of drought, for example, reduced water levels in dams can cause an increase in the concentration of plant matter by increasing eutrophication and, consequently, increasing water treatment costs and operational complexity. In such cases our production costs may increase, affecting our financial margins and the quality of water we produce. Droughts also lower reservoir levels available for hydroelectric plants, which may lead to power shortages, particularly since hydroelectric power accounts for most of Brazil’s electric power supply. Lack of electric energy could lead to instability in water supply and sewage collection and treatment services, which could damage our reputation. In addition, because we are one of the largest consumers of electricity in the State of São Paulo, a potential increase in electricity tariffs due to a shortage of hydroelectric power could have a significant economic impact on us.

We are also the concessionaire for water and sewage services for all the coastal municipalities of the State of São Paulo. A rise in the sea level could result in increased salinity in the river estuaries where we abstract water, which could affect water treatment in these areas. Rising sea levels could also cause damage in our sewage collection network.

Extreme climate events may also affect the extraction, production and transportation of the materials necessary for our operations, such as water treatment materials, and may lead to an increase in the cost of these materials. A rise in air

temperature could also increase consumer demand for water, increasing the need to expand both water supply and sewage treatment.

In this context, our strategy calls for identifying mitigating actions, enlarging their coverage and managing possible operational risks related to climate change, as well as identifying opportunities to increase our effectiveness and to implement new technologies. The use of biogas generated in the treatment of sewage is an example of some of our initiatives related to this matter. With regards to the risk of reduced water availability, we are working to adapt to a new scenario of water scarcity due to climate change through initiatives such as the Corporate Programs for Loss Reduction, the Program for Rational Water Usage and the expansion of the planned reutilization of effluents for urban and industrial purposes.

See “Item 3.D. Risk Factors—Risks Relating to Our Business—New laws and regulations relating to climate change and changes in existing regulation, as well as the physical Effects of Extreme Weather Events, may result in increased liabilities and increased capital expenditures, which could have a material adverse effect on us.”

Regarding the drought that affected the Cantareira System in late 2013 and early 2014, see “Item 3.D. Risk Factors—Risks Relating to Our Business— Droughts, the water consumption reduction program or other measures may result in a significant decrease in the volume of water billed and the revenues from services we provide, which may have a material adverse effect on our company” and “Item 5.A. Operating and Financial Review and Prospects—Factors Affecting Our Results of Operations—Effects of Extreme Weather Events—Drought.”

### **Government Regulation**

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

- the granting of concessions to provide water and sewage services;
- the development 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 agreement 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 by the service provider;
- minimum requirements for 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 joint 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 rendering 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 render these services directly or through a concession granted to a third party.

In Brazil, there are three federal legal regimes for contracting water and sewage services: (i) public concessions, regulated by Law No. 8,987/1995, which require a prior public bidding process; (ii) administration of public services through cooperation agreements between the federal government and local public authorities at State and municipal level without the need for a public bidding process, regulated by the Public Consortia and Cooperation Agreement Law; and (iii) public private partnerships, regulated by Law No. 11,079/2004, used to grant concessions to private companies to provide public services and used in relation to construction works associated with the provision of public services. Until 2005, we had adopted the regime for public concessions. Following the entry into force of the Public Consortia and Cooperation Agreement Law, we adopted the administration of public services through cooperation agreements, which can be used alongside the other two regimes.



The Public Consortia and Cooperation Agreement Law and the Basic Sanitation Law 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 and sewage services, serving approximately 59% of the State's population and providing sanitation services through concession agreements, the Consortium Law affects us on the expiry of our concession agreements entered into in the 1970s 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 service providers, most notably in mixed capital companies, such as us, because of the implementation of the program agreements as a substitute for concession agreements.

In addition, the Basic Sanitation Law in its role as a general guideline for the development of the Brazilian sanitation industry, addresses the conditions for the delegation of water and sewage services, the exercise of ownership by the granting authority and the regulatory conditions for the industry. The 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 expiration date and the reversibility conditions for 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, Federal Law No. 11,445, or the Basic Sanitation Law, was enacted, establishing nationwide guidelines for basic sanitation and seeking to create appropriate solutions for the situation 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. On June 21, 2010, the federal government enacted Federal Decree No. 7,217 (as amended by Federal Decree No. 8,211/14), regulating the Basic Sanitation Law. See "Item 3.D. Risk Factors—Risks Relating to our Business—Current regulatory uncertainty, especially with regard to implementation and interpretation of the Brazilian Basic Sanitation Law, may have an adverse effect on our business."

The 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. It 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 and, 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).

Federal Decree No. 7,217, which was enacted on June 21, 2010, (as modified by Federal Decree No. 8,211 of March 21, 2014) and Law 11,445 implemented a first series of new principles under the Basic Sanitation Law, including the following:

- for public public partnership contracts (or program contracts), public hearings must be held with respect to bid announcements, and technical and economic viability studies must be carried out;

- the rights and obligations of customers and service providers, including penalties, are determined by the owner of the public service, not by the regulatory agency (since its function is to ensure full compliance of legislative and contractual conditions);
- the regulatory agency's function is to ensure compliance with the law and with the contractual conditions;

- the technical and financial viability of the provision of water and sewage services should be determined based on (i) capital contributions necessary to offer the services and (ii) expected revenues from the provision of the service; and
- when a regulated service is to be provided by different service providers, those providers must execute an agreement regulating their respective activities.

In addition, the 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 Basic Sanitation 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.

The Basic Sanitation Law also 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 Basic Sanitation Law provides the basis for calculating the amount of an indemnity due, which must be calculated by a specialized institution chosen by mutual agreement between the parties.

Pursuant to the Basic Sanitation Law, the parties of the concession may enter into an agreement with respect to the payment of the indemnification due to the concessionaire. However, in the absence of an agreement, the Basic Sanitation Law establishes that the indemnification must be paid in no more than four equal and successive annual installments, with the first installment payable by the last business day of the fiscal year in which the assets are reversed.

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

The tariffs for our services are subject to Federal and State regulation.

On December 16, 1996, the governor of the State of São Paulo 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 equality” 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 of consumption; and
- social and economic conditions of residential customers.

With the enactment of the Basic Sanitation Law and Federal Consortium Law, we are prohibited from planning, overseeing and regulating services, which includes determining the tariff policy to be adopted. Such activities are to be exercised by the owner of the concession. Other than the responsibility for planning, the remaining activities may not be delegated.

The current tariff structure maintains different tariff schedules, depending upon whether a customer is located in the São Paulo metropolitan region or the Regional Systems. There are four levels of volume consumed for each category of customer, except for the residential social and *favelas* (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. Customers are billed on a monthly basis. 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 nonphysical loss resulting from faulty water meters. Sewage billing is included as part of the water bill and is based on the water meter reading. We are also authorized to enter into individual contracts with certain customers, such as municipalities, to supply water or sewage services on a wholesale basis.

Furthermore, since Law No. 11,445 permits municipalities to create their own regulatory agencies rather than being subjected to overview by ARSESP, a number of municipalities created their own regulatory agencies. The municipality of Lins, which decided in 2007 to create its own regulatory authority, revisited this decision in 2010 and transferred the regulation of water activities, including the setting of tariffs, to ARSESP. The municipality of Lins has retained, however, the power to ultimately approve the tariff set by ARSESP.

In addition, in 2011 municipalities in which the hydrographic basins of the Piracicaba, Capivari and Jundiá rivers are located created a consortium (ARES/PCJ) for the regulation and supervision of our activities in those areas. As a result of the creation of the ARES/PCJ, we are currently involved in legal proceedings in which ARES/PCJ is claiming that it has jurisdiction over the regulation and supervision of our activities in two municipalities (Piracicaba and Mombuca). In the municipality of Piracaia, ARSESP is the entity in charge of applying the state tariff policy (Decree 41,446/96) which is in force due to an existing concession agreement. In the municipality of Mombuca, the regulation and supervision of basic sanitation services was delegated to the State of São Paulo, so that ARSESP could exclusively execute these services. We cannot predict the outcome of this case or how it may impact our business. See” Risk Factor – Risk Relating to Our Business - Current regulatory uncertainty, especially with regard to implementation and interpretation of the Brazilian Basic Sanitation Law, may have an adverse effect on our business”

### ***ARSESP Rule Enactments***

In 2009 ARSESP enacted rules regarding the following:

- general terms and conditions for water and sewage services;
- procedures for communication regarding any failure in our services;
- penalties for deficiencies in the provision of basic sanitation services; and
- procedures for confidential treatment of our customers’ private information.

### ***Consumer Relations in the State of São Paulo***

In 2011 ARSESP altered the standard contract that we are required to use in our relationships with retail customers, requiring that invoices be sent to the consumer of the service rather than the owner of the property. We estimate that this change will affect ongoing legal disputes, particularly those regarding collection procedures, as well as business discussions in general. Since this change is still being implemented, we are not currently able to predict its impact on

our business.

Regarding changes to the communication process for the reporting of failures, ARSESP has modified the rules and standards for supervision and reporting of incidents. We have implemented these requested changes. Currently, part of the reporting of incidents occurs online, through the Incident Reporting System (“*Sistema de Comunicação de Incidentes*”) established by ARSESP, which introduces greater transparency and control to our operations.

In 2013, we established procedures for communicating scheduled interruptions in the provision of water services by developing the Communication of Scheduled Interruptions of Basic Sanitation – SISCIP-S.

We are currently evaluating the enforceability and legality of some of these rules. Implementation of these rules started during 2011, is currently ongoing, and is expected to continue for the next few years. The implementation of these rules will impact our commercial and operations processes, and may adversely affect us in ways we cannot currently predict.

We are attentive to these regulatory changes, have been working toward meeting ARSESP’s requirements and recommendations, and have presented technical, legal and factual reasons for any conduct that ARSESP may find irregular. As a result, we are subject to few regulatory infractions and to limited fines. See “Risk Factors—Risks Relating to Our Business—“Current regulatory uncertainty, especially with regard to implementation and interpretation of the Brazilian Basic Sanitation Law, may have an adverse effect on our business.”

### *Regulation of 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. 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 agreement.

A municipality that chooses to assume the direct control of its water and sewage services must terminate the current relationship by duly compensating 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 any concession and assume any corresponding 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 Basic Sanitation Law reduced the maximum time period for payment of indemnification in such cases to four years. See “Item 3.D. Risk Factors—Risks Relating to Our Business—The municipalities may terminate our concessions before they expire in certain circumstances. The indemnification payments we receive in such cases may be less than the value of the investments we made.”

The Federal Concessions Law No. 8,987/1995 and the State Concessions Law No. 7,835/1992 require that the granting of a concession by the government be preceded by a public bidding process. However, the Federal Public Bidding Law No. 8,666/1993, which establishes the rules for the public bidding process, provides that a public bidding process can be waived under 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 Public Bidding Law, as amended by the Public Consortia and Cooperation Agreement Law, provides that the program contracted can be executed with waiver of a public bidding process.

In the majority of municipalities where we operate, the new contracts have been formalized pursuant to the provisions of the Federal Public Bidding Law that allows the public bidding process to be waived under certain circumstances. In addition, there are pending cases before the Brazilian Supreme Court regarding whether the right to execute

concession and program agreements in the metropolitan regions belongs to the State or the municipal government. On February 28, 2013 the Brazilian Supreme Court decided a pending case on this matter related to the State of Rio de Janeiro. A majority of the court held that the State and municipal governments must set up new joint entities to oversee the planning, regulation and auditing of basic sanitation services in metropolitan regions. On March 6, 2013, the court ruled that this decision would come into effect after a 24-month period with respect to the State of Rio de Janeiro. The São Paulo metropolitan region accounted for 73.2% of our gross operating revenue in 2013 (excluding revenues relating to the construction of concession infrastructure). We cannot predict how the shared management of these operations will be carried out in the São Paulo metropolitan region and other metropolitan regions we operate in or what effect it may have on our business, financial condition or results of operation. See “Item 3.D. Risk Factors—Risks Relating to Our Business—Current regulatory uncertainty, especially with regard to implementation and interpretation of the Brazilian Basic Sanitation Law, may have an adverse effect on our business.”



On June 18, 2009, Municipal Law No. 14,934/2009 was enacted and this law revoked Law No. 13,670/2003, which had originally created the discussion on whether the State or the Municipality was the one with the power to grant and monitor formal concessions for water and sewage services in the city of São Paulo. On June 23, 2010, we entered into a formal agreement with both the State and the city of São Paulo to regulate the provision of water and sewage services in the city of São Paulo for a 30 year period, which may be extended for an additional 30 year period. See “Item 3.D. Risk Factors—Risks Relating to Our Business—The terms of our agreement to provide water and sewage services in the City of São Paulo could have a material adverse effect on us.”

### ***Public Consortia and Cooperation Agreement Law for Joint Management***

On April 6, 2005, the federal government enacted Federal Law No. 11,107, or the Federal Public Consortia and Cooperation Agreement Law, which regulates Article 241 of the Brazilian Constitution. This statute provides general principles to be observed when a public consortia enters 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. 6,017/2007 details the conditions of establishment of joint management and the execution of the program agreement regulating the Public Consortia and Cooperation Agreement Law. This federal legislation introduces significant changes in the relationship among municipalities, states and companies providing public sanitation services, prohibiting the latter from exercising activities of planning, oversight and regulation, including tariff regulation, of the services and creating the program agreement for contracting entities whose share control is held by one of the Brazilian political divisions and subdivisions upon waiver of the public bidding process and compliance with concession legislation, as applicable.

On January 13, 2006, the Governor of the State of São Paulo enacted State Decree No. 50,470, amended by State Decrees No. 52,020, dated July 30, 2007, and No. 53,192, dated July 1, 2008, which provide for the rendering of water and sewage services in the State of São Paulo. According to these decrees, we may enter into agreements with municipalities in connection with the provision of water and sewage services by means of the so called “program agreement without a public bidding process.” In addition, these decrees establish that we will continue to render services in the areas covered by the concession granted by the State.

Based on these statutes, in January 2007 we executed our first program agreement with the municipality of Lins, located in the State of São Paulo. Subsequently, we formalized agreements with other municipalities in the State of São Paulo. These other municipalities transferred the oversight and regulation of our services to the State of São Paulo through a cooperation agreement.

On June 8, 2006, the State of São Paulo enacted Decree No. 50,868 creating the Commission for the Regulation of Sanitation Service of the State of São Paulo (*Comissão de Regulação do Serviço de Saneamento do Estado de São Paulo – CORSANPA*) to regulate sanitation services. The Commission for the Regulation of Sanitation Service of the State of São Paulo is directly subordinated to the State Secretariat for Sanitation and Water Resources. On August 5, 2009, the State of São Paulo enacted Decree No. 54,644, which revoked Decree No. 50,868 and regulated the composition, organization and operation of the State Sanitation Council (*Conselho Estadual de Saneamento – CONESAN*) created by Supplementary Law No. 7,750/92.

The main duty of the Commission for the Regulation of Sanitation Service of the State of São Paulo was conducting studies for the creation of a regulatory agency for the basic sanitation industry and the presentation of legal and regulatory measures. The completion of such duties resulted in the publication of supplementary Law No. 1,025 of

December 7, 2007, which created ARSESP and partially revoked Supplementary Law No. 7,750/92. Furthermore, Supplementary Law No. 1,025/2007 maintained the State Sanitation Council, as an advisory council to define and implement the state basic sanitation policy, and the State Sanitation Fund (*Fundo Estadual de Saneamento – FESAN*). The State Sanitation Fund is connected to the State Secretariat for Sanitation and Water Resources, and collects and manages resources that support State approved programs, as well as the development of technology, management and human resources and a sanitation information system, in addition to other support programs.

ARSESP regulates the basic sanitation services that belong to the State, relating to the federal and municipal jurisdictions and prerogatives, and is responsible for:

- the compliance with and enforcement of state and federal basic sanitation legislation;
- the publication of the organizational platform for the services, indicating the types of services provided by the State, as well as the equipment and facilities that compose the system;
- the acceptance, where applicable, of the legal attributions of the jurisdictional authority;
- the establishment, in accordance with the tariff guidelines defined by Decree No. 41,446/96, of tariffs and other methods that provide compensation for our services, adjustment and review of such tariffs and methods to ensure the financial economic balance of services and low cost tariffs through mechanisms that increase service efficiency and lead to the distribution of productivity gains to society; and
- the approval, oversight and regulation (including tariff issues) of the sewage treatment and wholesale water supply agreements entered into between the state supplier and other suppliers, pursuant to Article 12 of the Basic Sanitation Law.

With respect to municipal basic sanitation, ARSESP oversees and regulates services (including tariff issues) that have been delegated by municipalities to the State as a result of cooperation agreements that authorize program agreements between the municipalities and us for as long as it is convenient to the municipality's public interest.

For its services, ARSESP charges 0.50% of the annual total invoice from gross operating revenue (excluding revenues relating to the construction of concession infrastructure) of the municipality. This fee is collected from municipalities that have a signed program agreement with us and the municipalities located in the metropolitan regions.

In connection with the scope of our services, Supplementary Law No. 1,025/2007 expanded 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 our own or third party use.

In addition, the 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;
- create subsidiaries, which may become majority or minority shareholders in other companies; and
- 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.

### ***Public Private Partnerships***

The Public-Private Partnership (PPP) is a form of agreement with the public administration used for the concession of services to private enterprises, as well as for construction works coupled with the provision of services. PPPs are regulated by the State of São Paulo through Law No. 11,688, which was enacted on May 19, 2004. PPPs may be used

for: (i) implantation, expansion, improvement, reform, maintenance or management of public infrastructure; (ii) provision of public services; and (iii) exploitation of public assets and non material rights belonging to the State.

Payment is conditioned upon performance. The payment may be collected through: (i) tariffs paid by users; (ii) use of resources from the budget; (iii) assignment of credits belonging to the State; (iv) transfer of rights related to the commercial exploitation of public assets; (v) transfer of real property and other property of assets; (vi) public debts securities; and (vii) other revenues.

In our case, payment is conditional upon performance and is collected through the use of resources from the budget.

### ***Public Bidding Procedures***

Pursuant to the Federal Public Bidding Law, the public bid process commences with publication by the granting authority in a federal, state or municipal official newspaper, as the case may be, and another leading Brazilian newspaper. The publication announces that the granting authority 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: (i) the purpose, duration and goals of the bid; (ii) the participation of bidders, either individually or forming a consortium; (iii) a description of the qualifications required for adequate performance of the services covered by the bid; (iv) the deadlines for the submission of the bids; (v) the criteria used for the selection of the winning bidder; and (vi) a list of the documents required to establish the bidder's technical, financial and legal capabilities.

The invitation to bid is binding on the granting authority. Bidders may submit their proposals either individually or in consortia, as provided for in the invitation to bid. After receiving proposals, the granting authority will evaluate each proposal according to the following criteria, which must have been set forth in the invitation to bid:

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

The provisions of State Law No. 6,544 of November 2, 1989, as amended, or 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 our business operations or in connection with our capital expenditure program, in each case subject to certain exceptions.

### ***Water Usage***

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

- rational utilization of water resources, ensuring that their primary use is to supply water to the population;
- 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 hydrological 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 against pollution and excessive exploitation; and
- prevention of soil erosion in urban and rural areas, with a view to protecting against physical pollution and silting of water resources.

Among other instruments established by this Policy, the competent public authority grants for the right to use water for the implementation of any enterprise that demands the use of surface or underground water resources (for the collection or release of effluents), as well as for the execution of services that alter the regime or quality of such water resources. In the case of rivers under the federal government's domain (rivers crossing more than one state), ANA 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, DAEE is the public authority responsible for granting such authorizations.

In conducting our principal activities, we have grants for the rights to use water, and there is a corporate program in place to obtain and maintain the rights to use water for the remaining activities. As of the date of this annual report, we do not own all the required grants for the right to use water in connection with our operations. However, all of our water-usage activities have filed requests for grants for the right to use water with the competent authority; many of these requests have been granted and others are under analysis by DAEE and ANA.

State Law No. 12,183, which was enacted on December 29, 2005, established the basis for charging for the use of the water resources under the domain of the State of São Paulo. To apply such charging, the law provides for, among other provisions, the participation of the Water Basins Committees, the formulation of criteria by such Committees, the creation of basin agencies and the organization of a registered list of water resource users. The basin committee's proposals regarding the criteria to calculate the amounts to be charged at each basin must be approved by the State Water Resource Council, and formalized by a decree issued by the State Governor.

According to existing law, the hydrographic basins committees are authorized to charge users, such as us, for the abstraction of water from, or dumping of sewage into, water bodies.

Charging for the use of water is under gradual implementation by the State of São Paulo, where the largest individual contributors are located, and it is a management tool of the Policy on Water Resources to promote the rational use of water and finance programs and actions established by the basin plans. In 2013, we paid about R\$27.0 million for the use of water resources.

Charging for the use of water from rivers of federal domain began in 2003 in the Paraíba do Sul basin, and charging for the use of water from rivers of state domain began in 2007 in the Paraíba do Sul, Piracicaba, Capivari and Jundiá basins. Subsequently, charges were implemented for the use of water from the Sorocaba, Middle Tietê and Santos Region basins. In 2013, charges were implemented for the use of water from the Baixo Tietê basin and, in April 2014, for the use of water from the Alto Tietê Basin. It is probable that the same will occur in 2014 in the following basins: Tietê/Batalha, Tietê/Jacaré, Baixo Pardo e Grande, Litoral Norte, Mogi-Guacu, Pardo, Pontal do Paranapanema, Sapucaí Mirim/Grande, Serra da Mantiqueira, Ribeira do Iguape/Litoral Sul and Turvo/Grande. In 2015, charges for the use of water are expected to be implemented for the basins of Alto Paranapanema, Aguapeí/Peixe, Médio Paranapanema and São José dos Dourados.

### ***Water Quality***

Administrative Rule No. 2,914/2011, issued by the Ministry of Health of the federal government, provides the standards for potable water for human consumption in Brazil. This rule is similar to the U.S. Safe Drinking Water Act and the regulations enacted by the U.S. Environmental Protection Agency, which establishes rules for sampling and limits related to substances that are potentially hazardous to human 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. 5,440/2005 provides that the quality of water must be disclosed to consumers. We have been complying with this regulation by publishing the required information in monthly bills and annual reports delivered to all consumers that we serve.

### ***Environmental Regulation***

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

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. The National Environmental Council (*Conselho Nacional de Meio Ambiental*), or the CONAMA, is the federal agency responsible for the regulation of potentially polluting activities. In the State of São Paulo, the Companhia Ambiental do Estado de São Paulo, or CETESB, is the governmental entity responsible for the control, supervision, monitoring and licensing of polluting activities, pursuant to State Law No. 997 of 1976 and State Law No. 13,542 of 2009.



The control and environmental planning instruments are defined by several legal instruments, such as State Law No. 997/1976, which regulates environmental pollution control; CONAMA Resolution No. 05/1988, which requires licensing of sanitation projects that cause significant alterations to the environment; CONAMA Resolution No. 237/1997, which regulates (i) environmental licenses, (ii) federal, state and local jurisdiction over environmental issues, (iii) the list of activities subject to licensing, and (iv) environmental impact studies and reports; State Decree No. 47,400/2002 and related articles from State Law No. 9,509/1997 regarding environmental licensing; State Decree No. 8,468/76, CONAMA Resolution No. 357/2005, and CONAMA Resolution No. 397/08, which establish standards of quality for receiving bodies of water; Decreto Estadual 8,468/76 and CONAMA Resolution No. 430/11 which establish the standards for discharge of effluents; and *Portaria Departamento de Águas e Energia Elétrica 717/96*, which regulates the concession of grants for the right to use water and rights to interfere in water resources.

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, including the following licenses:

- preliminary 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 compliance with approved plans, programs and projects, including environmental control measures and other necessary technical requirements; and
- operation license – authorizing the operation of a unit or activity, subject to compliance with the technical requirements contained in the installation license.

We have been implementing a program (*Programa Corporativo de Manutenção e Obtenção do Licenciamento Ambiental*) since 2010, in order to comply with environmental regulation by 2016. As of the date of this annual report, we were not in possession of all licenses required in connection with our operations.

#### *Sewage Requirements*

State law sets forth regulations regarding pollution control and environmental preservation in the State of São Paulo. According to this law, in areas in which there is a public sewage system, all effluents of a “polluting source” must be discharged to such system, as is the case for industrial enterprises. It is the responsibility of the polluting source to connect itself to the public sewage system. All effluents to be discharged are required to meet the standards and conditions established by the applicable environmental law, which allows such effluents to be treated by our treatment facilities and discharged in an environmentally safe manner. Effluents that do not comply with such criteria 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. Effluents from our treatment facilities must comply with effluent limitation guidelines and meet the water quality standards of the receiving water bodies established by federal and state legislation. See “—Sewage Operations—Sewage System”.

The CETESB is authorized under State law to monitor discharges of effluents into the water bodies, among other things. The CETESB also issues the environmental licenses to the polluting sources, including sewage treatment stations. For more information, see “Item 4.B. Business Overview—Environmental Matters.”

State and federal water resource legislation establishes the charging of fees for the discharge of treated effluents into water bodies. This charge is already in force for some water basins, and it is in different implementation stages for the remaining basins. See “—Government Regulation—Water Usage.”

### ***Governmental Restrictions on Incurrence of Debt***

On June 30, 1998, the CMN issued Resolution No. 2,515/98 amending certain conditions that must be observed with respect to 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 borrower, 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 CMN resolution further provides that the requirements described above do not apply to financing transactions involving multilateral or official organizations such as the International Bank for Reconstruction and Development, or IBRD, the IADB or the JICA. 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 borrower. 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 foreign currency denominated transactions are also subject to the approval of the National Secretariat of Treasury (*Secretaria do Tesouro Nacional*) and the Central Bank. After reviewing the financial terms and conditions of the transaction, the National Secretariat of Treasury and the Central Bank 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.

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

The CMN Resolution No. 2,827 dated as of March 30, 2001, as amended, limits 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.

### ***Scope of Business***

State Law No. 12,292, dated as of March 2, 2006, and amended State Law No. 119, dated as of June 29, 1973, which created our Company, authorizes us to provide water and sewage services outside São Paulo (in other states of Brazil and other countries). This law also authorizes us to own interests in other public or private public companies and Brazilian or international consortia. In addition, this law permits us to incorporate subsidiaries and enter into a

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partnership with or acquire interests in a private company with a corporate purpose related to the sanitation business.

**C. Organizational structure**

Not applicable.

## **D. Property, Plant, Equipment and Intangible Assets**

Our principal property, plant and equipment comprise administrative facilities which are stated at historical costs less depreciation. The reservoirs, water treatment facilities, water distribution networks consisting of water pipes, water transmission lines, water connections and water meters, sewage treatment facilities, and sewage collection networks consisting of sewer lines and sewage connections are recorded as intangible assets (concession assets). As of December 31, 2013, we operated through 69,619 kilometers of water pipes and water transmission lines and 47,103 kilometers of sewer lines. As of that same date, we operated 232 water treatment facilities and 509 sewage treatment facilities (including nine ocean outfalls), 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 IBRD that was guaranteed by the federal government. As of December 31, 2013, we held assets in the amount of R\$249.0 million pledged as collateral to 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. The debt owed to the PAES Program was entirely paid in 120 months, and the last installment was paid on June 28, 2013.

As of December 31, 2013, the total net book value of our property, plant and equipment and intangible assets (including concession assets) was R\$24,045.7 million.

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 elsewhere in this annual report. The financial statements included elsewhere in this annual report have been prepared in accordance with IFRS as issued by the IASB. 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."

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.

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

#### **Overview**

As of December 31, 2013, we operated water and sewage systems in the State of São Paulo, including in the city of São Paulo, Brazil's largest city, and in 362 municipalities in the State of São Paulo, which represented 56% of all municipalities in the State. We also provided water services on a wholesale basis to six municipalities located in the São Paulo metropolitan region in which we did not operate water distribution systems.

The São Paulo metropolitan region, which includes the city of São Paulo, is our most important service region. With a total population of approximately 21 million, the São Paulo metropolitan region accounted for 73.2%, 74.2% and 74.0% of our gross operating revenue in 2013, 2012 and 2011 (excluding revenues relating to the construction of concession infrastructure), respectively. As of December 31, 2013, 56.9% of the concession intangible assets reflected on our balance sheet were 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 operating revenue, we have concentrated 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, control costs and improve productivity, general economic conditions in Brazil and abroad and, in some periods, meteorological conditions.

Our results of operations for the 2013, 2012 and 2011 fiscal years were affected by a provision for severance payments in the amount of R\$21.3 million for employees who resigned in 2013, R\$49.9 million in 2012 and R\$47.0 million in 2011.

### *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 enactment of the Basic Sanitation Law in 2007, as a general rule, regulatory agencies are 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 enacted by the federal government from time to time; and
- when necessary, the readjustment to maintain the original balance between each party's obligation and economic gain (*equilíbrio econômico financeiro*) under the agreement.

Readjustment of our tariffs continues to be set annually and depend on the parameters established by the Basic Sanitation Law and ARSESP. The guidelines also establish procedural steps and the terms for annual adjustments. The annual adjustments must be announced 30 days prior to the effective date of the new tariffs. See "4.B. Business Overview – Tariffs."

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

	<b>Year ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
Increase in average tariff <sup>(1)</sup>	5.8410%	5.2%	6.8%
Inflation – IPC – FIPE	3.88%	5.1%	5.8%
Inflation – IPCA	5.91%	5.8%	6.5%
Inflation – IGP M	5.51%	7.8%	5.1%

(1) See "Item 4.B. Business Overview—Tariffs" for addition information on tariff increases.

Sources: Central Bank, *Fundação Getulio Vargas*, or FGV, 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 the economic activity and the inflation rate. For example, the general performance of the Brazilian economy may affect our cost of capital and inflation may affect our costs and margins. The Brazilian economic environment has been characterized by significant variations in economic growth rates. However, as our product is viewed as essential, our sales revenue has demonstrated high stability over the past three years.

*General Economic Conditions*

In 2011, Brazilian GDP increased 2.7% in comparison with 2010. At that same year, Brazil had US\$352 billion in currency reserves and its trade surplus was US\$29.8 billion. The average unemployment rate in Brazil's principal metropolitan regions was 6% in 2011.



In 2012, Brazilian GDP increased 0.9% in comparison with 2011. At that same year, Brazil had US\$378 billion in currency reserves and its trade surplus was US\$19.4 billion. The average unemployment rate in Brazil's principal metropolitan regions was 5.5% in 2012, the lowest it has been since March 2002.

In 2013, Brazilian GDP increased 2.3% in comparison with 2012. Also in 2013, Brazil had US\$375 billion in currency reserves and its trade surplus was US\$2.6 billion, the worst in 13 years, and its trade balance fell 86% in comparison with 2012. The average unemployment rate in Brazil's principal metropolitan regions was 5.4%, the lowest rate in history according to the Brazilian Institute of Geography and Statistics (*Instituto Brasileiro de Geografia e Estatística*), or IBGE.

### *Interest Rates*

In 2011, until the month of August, the Central Bank continued increasing the SELIC rate, reaching 12.50% in July. In the month of August, the Central Bank started decreasing the SELIC, closing 2011 at 11.00%. This downward trend was maintained in 2012, with the SELIC rate closing the year of 2012 at 7.25%. In 2013, the SELIC rate was kept at 7.25% until April, after which the Central Bank started to gradually raise it. The SELIC rate at December 31, 2013 was 9.9%.

With respect to our foreign currency-denominated debt, in 2013 we experienced stability in the cost of debt linked to floating interest rates as compared to 2012, but with an upward trend beginning in the second half of 2013. With regards to our fixed-rate foreign currency denominated capital market debt, the reduction in secondary market earnings in 2012 continued during the first half of 2013. By the beginning of the third quarter, this yield rose, returning to 2010-2011 levels similar to those existing at the time of our 2010 Eurobond issuance.

We have not utilized any derivative financial instruments or any hedging instruments to mitigate interest rate fluctuations. However, we prioritize long term debt in foreign currency alongside multilateral organizations and official foreign government agencies and take advantage of market opportunities to preform "liability management" to reduce cost and anticipate refinancing situations.

### *Inflation*

Inflation affects our financial performance by increasing our costs of services rendered and operating expenses. Part of our *real* denominated debt is directly indexed to take into account the effects of inflation. Additionally, we are exposed to the mismatch between the inflation adjustment indices of our loans and financing and those of our receivables. Water supply and sewage service tariffs do not necessarily follow the increases in inflation adjustment and interest rates affecting our debt. We cannot assure you that our tariffs will be increased, in future periods, to offset, in full or in part, the effects of inflation.

Inflation adjustments derive from collections from or payment to third parties, as contractually required by law or court decision, and are recognized on an accrual basis. Inflation adjustments included in these agreements and decisions are not considered embedded derivatives, since they are deemed as inflation adjustments for us. See Notes 3.20, 4.3.1 and 26 of the Financial Statements for the impacts of inflation adjustments on our financial performance and debt.

### *Currency Exchange Rates*

We had total foreign currency denominated indebtedness of R\$3,698.6 million as of December 31, 2013, of which R\$216.0 million relates to our current portion of our long-term foreign currency denominated obligations. 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 is 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. In 2011, the 12.6% depreciation of the *real* against the U.S. dollar and the 18.6% depreciation of the *real* against the yen, respectively, led to a foreign exchange loss of R\$382.3 million. In 2012, the 8.94% depreciation of the *real* against the U.S. dollar offset by the 2.4% appreciation of the *real* against the yen, respectively, led to a foreign exchange loss of R\$50.5 million. In 2013, the 14.64% depreciation of the *real* against the U.S. dollar offset by the 5.91% appreciation of the *real* against the yen, respectively, led to a foreign exchange loss of R\$267.8 million. However, since most of our debt denominated in foreign currencies is long-term debt with a long amortization schedule, a devaluation of the *real* would principally impact cash flows regarding the current portion of our long-term debt.

We manage our indebtedness portfolio closely to decrease the cost of servicing our indebtedness as a whole and our exposure to exchange rate fluctuations. We do not speculate in foreign currencies, and we do not have any exposure to derivatives tied to foreign currencies.

The following table shows the fluctuation of the *real* against the U.S. dollar, the period end exchange rates and the average exchange rates as of or for the periods indicated:

	<b>Year ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
Depreciation (appreciation) of the <i>real</i> versus U.S. dollar....	14.6%	8.9%	12.6%
Period end exchange rate – US\$1.00	R\$2.3426	R\$2.0435	R\$1.8758
Average exchange rate – US\$1.00 <sup>(1)</sup>	R\$2.1605	R\$1.9550	R\$1.6746

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(1) Represents the average for period indicated.

Source: Central Bank.

The following table shows the fluctuation of the *real* against the yen, the period end exchange rates and the average exchange rates as of or for the periods indicated:

	<b>Year ended December 31,</b>		
	<b>2013</b>	<b>2012</b>	<b>2011</b>
Depreciation (appreciation) of the <i>real</i> versus yen....	(5.9)%	(2.4)%	18.6%
Period end exchange rate – ¥1.00	R\$0.0223	R\$0.0237	R\$0.0243
Average exchange rate – ¥1.00 <sup>(1)</sup>	R\$0.0221	R\$0.0245	R\$0.0211

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(1) Represents the average for period indicated.

Source: Central Bank.

From time to time, we may enter into forward exchange transactions to mitigate foreign currency exposure. In addition, we have monitored, overseen and controlled our foreign currency denominated indebtedness, taking advantage of market opportunities to improve the profile of our indebtedness and reduce our costs. During the years ended December 31, 2013, 2012 and 2011 we had no forward exchange transactions.

#### ***Effects of Extreme Weather Events – Drought***

We operate in a region of Brazil that has been prone to droughts, although historically droughts have not impacted all of our water supply systems equally. Brazil experienced a prolonged and severe drought during 2000 and 2001. As a result, from mid June to mid September of 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, which reduced our total water production by approximately 8%. In March 2004 when our reservoirs were at extremely low levels, we implemented a water usage reduction bonus program. After returning to normal rainfall levels, which occurred between 2004 and early 2005, the condition of our reservoirs improved. In 2007 and 2008, rainfall exceeded the levels of previous years, increasing the volume of water held in our reservoirs and thereby providing a cushion to meet demand.

Part of the Brazil's Southeastern region, in particular the southern region of Minas Gerais State and the Piracicaba river basin, from which we extract the water used in the Cantareira System, and the northern area of the São Paulo metropolitan region have been experiencing below average rainfall since 2012, which worsened at the end of 2013 and beginning of 2014. With rainfall significantly below average, there has been a reduction in the level of water stored during the rainy season, from October to March, in the reservoirs of the Cantareira System, which is the largest system of the São Paulo metropolitan region. In order to minimize the effects of this drought, in February 2014, we approved a program that incentivizes water consumption reduction, based on a bonus system, pursuant to which customers who achieve their consumption reduction goal (20% water consumption reduction) will be entitled to a 30% discount on their service bill. Initially, this incentive program was scheduled to last seven months from February 1, 2014 or until the water level in the reservoirs is normalized. However, in April 2014 the incentive program was extended for the entire São Paulo metropolitan region until the end of 2014 or until the water level in the reservoirs is normalized. For more information on droughts, see "Item 3.D Risk Factors—Risks Relating to Our Business—Droughts, the water consumption reduction program or other measures may result in a significant decrease in the volume of water billed and the revenues from services we provide, which may have a material adverse effect on our company."

As of December 31, 2013, the reservoirs in the São Paulo metropolitan region, where our largest market is located, had a utilization rate of 41%, compared to a 50.6% utilization rate as of December 31, 2012.

### **Critical Accounting Estimates and Judgments**

We make estimates and judgments concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results. The estimates and judgments that have a significant risk of causing material adjustment to the carrying amount of our assets and liabilities within the next financial year are mentioned below.

#### ***Allowance for Doubtful Accounts***

We record an allowance for doubtful accounts in an amount that our management considers sufficient to cover probable losses, based on an analysis of customer accounts receivable, in accordance with the accounting policy stated in Note 3.4 to our financial statements as of December 31, 2013 and 2012 and for the years ended December 31, 2013, 2012 and 2011. Provisions for the allowance for doubtful accounts are included in selling expenses, net of recoveries. The net charge to this allowance was R\$103.9 million, R\$192.3 million and R\$120.3 million in 2013, 2012 and 2011, respectively.

The methodology for determining the allowance for doubtful accounts 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 used are reasonable, actual results could differ from those estimates.

#### ***Valuation of Long Lived Assets***

As of December 31, 2013, we had property, plant and equipment and intangible assets of R\$199.5 million and R\$23,846.2 million, respectively.

Property, plant and equipment, intangibles and other noncurrent assets with definite useful lives, are reviewed annually for impairments or whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The Company does not have assets with indefinite useful lives and concluded that there are no indications of impairment losses.

We recognize intangible assets arising from concession contracts under IFRIC 12. We estimate the fair value of construction and other work on the infrastructure to recognize the cost of the intangible asset, which is recognized when the infrastructure is built and provided that it will generate future economic benefits. The great majority of the Company's contracts for service concession arrangements entered with each grantor is under service concession agreements in which the Company has the right to receive, at the end of the contract, a payment equivalent to the unamortized asset balance of the concession intangible asset, which in this case, is amortized over the useful life of the underlying physical assets; thus at the end of the contract, the remaining value of the intangible would be equal to the residual value of the related physical asset.

The fair value of construction and other work on the infrastructure is recognized as revenue, at its fair value, when the infrastructure is built, provided that this work is expected to generate future economic benefits. The accounting policy for the recognition of construction revenue is described in Note 3.3 “Operating Revenue.”

Intangible assets related to concession agreements and program contracts, when there is no right to receive the residual value of the assets at the end of the contract, are amortized on a straight-line basis over the period of the contract or the useful life of the underlying asset, whichever is shorter.

Investments made and not recovered through rendering of services, within the terms of our agreement, must be indemnified by the concession grantor; (1) with cash or cash equivalents or also, in general, (2) with a contract extension. These investments are amortized over the useful life of the asset.

Law 11445/07 prescribes that, whenever possible, basic sanitation public utilities shall have their economic and financial sustainability ensured through the consideration received from service collection, preferably as tariffs and other public charges, which may be established for each service or both. Therefore, investments made and not recovered through these services, within the original term of the contract, are recorded as intangible assets and amortized over the useful life of the asset, taking into consideration a solid track record of concession renewal and, therefore, the continuity of services.

The recognition of fair value for the intangible assets arising on concession contracts is subject to assumptions and estimates, and the use of different assumptions could affect the balances recorded. The amortization of intangible assets and estimated useful lives of the underlying assets also requires significant assumptions and estimates, which different assumptions and estimates, and changes in future circumstances, could affect amortization of intangible assets and remaining useful lives of the underlying assets and can have a significant impact on the results of operations.

### ***Provision***

As of December 31, 2013, we were party to judicial and administrative proceedings, relating to civil, environmental and tax matters, amounting to R\$1,180.4 million (deducting the amount of R\$309.5 million related to escrow deposits) with respect to which we considered the risk of loss as probable. As of that date, proceedings with respect to which we considered the risk of loss as possible amounted to R\$3,244.5 million, and those with respect to which we considered the risk of loss as remote amounted to R\$34,179.7 million.

We are a party to a number of legal proceedings involving significant monetary claims. These legal proceedings include, among other types, disputes with customers and suppliers and tax, labor, civil, environmental and other proceedings. For a more detailed discussion of these legal proceedings, see Note 18 to our financial statements as of December 31, 2013 and 2012 and for the years ended December 31, 2013, 2012 and 2011. 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. Therefore, 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 provisions for risks, actual losses realized in future periods could differ significantly from our estimates and could exceed the amounts which we have provisioned.

### ***Pension Benefits***

The present value of the pension obligations depends on a number of factors that are determined on an actuarial basis using a number of assumptions. The assumptions used in determining the net cost (income) for pensions include a discount rate and a mortality table. Any changes in these assumptions will impact the carrying amount of pension obligations.

We determine the appropriate discount rates at the end of each year, which is the interest rate that should be used to determine the present value of estimated future cash outflows expected to be required to settle the pension obligations. The discount rate was increased from 4.0% in 2012 to 6.46% in 2013 under Plan G0 and from 4.1% in 2012 to 6.36% in 2013 under Plan G1 in order to follow the decrease in the rates applicable to the Brazilian Government NTN – B, long term notes, which term is similar to the duration of the pension benefits, as described in Notes 3.19 (a) and 19 (b) to our financial statements as of December 31, 2013 and 2012 and for the years ended December 31, 2013, 2012 and 2011.

Other key assumptions for pension obligations are based in part on current market conditions. Additional information on the pension plans under Plan G0 and G1 is disclosed in Note 19.

### ***Deferred income tax and social contribution***

The Company recognizes and settles taxes on income based on the results of operations verified according to the Brazilian Corporate Law, taking into consideration the provisions of the tax laws. Pursuant to IAS 12, the Company recognizes deferred tax assets and liabilities based on the differences between the accounting balances and the tax bases of assets and liabilities.

The Company regularly reviews the recoverability of deferred tax assets and recognizes a provision for impairment if it is probable that these assets will not be realized, based on historic taxable income, the projection of future taxable income and the estimated period to reverse temporary differences. These calculations require the use of estimates and assumptions. The use of different estimates and assumptions could result in provision for impairment of all or a significant amount of deferred tax assets.

As of December 31, 2013 and 2012, we have recognized R\$114.0 million and R\$145.3 million, respectively, as deferred income tax assets, net of the deferred tax liabilities, as disclosed in Note 17 to our financial statements as of December 31, 2013 and 2012 and for the years ended December 31, 2013, 2012 and 2011.

### **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 State owned companies which merged to form our Company. These amounts must be reimbursed to us by the State, as primary obligor.

In November 2008, we entered into the third amendment to the agreement with the State relating to payments of pension benefits made by us on its behalf. The State acknowledged that it owed us an outstanding balance of R\$915.3 million as of September 30, 2008, relating to payments of pension benefits made by us on its behalf. We provisionally accepted, but it is not recognized in our books, the reservoirs in the Alto Tietê System as partial payment in the amount of R\$696.3 million, subject to the transfer of the property rights of these reservoirs to us. Since November 2008, the State has been paying the remaining balance in the amount of R\$219.0 million in 114 successive monthly installments. See Note 9 to our financial statements as of December 31, 2013 and 2012 and for the years ended December 31, 2013, 2012 and 2011 and “Item 7. Major Shareholders and Related Party Transactions.”



As of December 31, 2013 and 2012, the amounts not recorded related to pension benefits paid on behalf of the State by the Company, totaled R\$1,412.5 million and R\$1,351.2 million respectively, including the amount of R\$696.3 million related to the transfer of the reservoirs in the Alto Tietê system. As a result, the Company also recognized the obligation related to pension benefits, maintained with the beneficiaries and pensioners of Plan G0. As of December 31, 2013 and 2012, the pension benefit obligations of Plan G0 totaled R\$1,780.3 million and R\$1,987.7 million, respectively. For detailed information on the pension benefit obligations refer to Note 19 of our Financial Statements.

### ***Accounts Receivable from the State for Water and Sewage Services Rendered***

Certain of these accounts receivable have been overdue for a long period. We have entered into agreements with the State with respect to these accounts receivable. For further information on these agreements, see Note 9 to our financial statements as of December 31, 2013 and 2012 and for the years ended December 31, 2013, 2012 and 2011 and “Item 7. Major Shareholders and Related Party Transactions.”

### ***Use of Certain Assets***

*Empresa Metropolitana de Águas e Energia S.A. – EMAE* plans to receive credit and to obtain financial compensation for the use of water from the Guarapiranga and Billings reservoirs, which we use in our operations, as well as reimbursement of damages related to non-payment in due course.

We understand that no amounts are due for the use of these reservoirs given the grants already made. Should these reservoirs not be available for our use, there could be a need to collect water in more distant locations and a risk of not being able to properly render services in the region and an increase in water supply cost.

Several lawsuits were filed by EMAE, among them a lawsuit to enforce an arbitration clause related to the Guarapiranga reservoir, a proceeding which has already begun and another lawsuit, pleading for financial compensation due to our water abstraction from the Billings reservoir for public supply. These two lawsuits allege that this conduct has caused permanent and increasing loss in the capacity of the Henry Borden hydroelectric power plant to generate electricity as well as financial losses.

We understand that the expectation for all cases is of possible losses, and for the time being, it is not feasible to estimate the amounts involved, since they were not determined.

On April 10, 2014, we issued an Announcement to the Market to communicate that we are negotiating with EMAE regarding a potential future agreement. However, no adjustment has been confirmed, and no agreement has been executed by either party as of yet.

### **Results of Operations**

The following table sets forth, for the periods indicated, certain items in our statement of operations, each expressed as a percentage of net operating revenues:

	<b>Year ended December 31,</b>					
	<b>2013</b>	<b>2012</b>		<b>2011</b>		
	<i>(in millions of reais, except percentages)</i>					
Net operating revenues	11,315.6	100.0%	10,737.6	100.0%	9,927.4	100.0%
Cost of sales and services	(6,816.3)	(60.2)%	(6,449.9)	(60.1)%	(6,018.7)	(60.6)%

Gross profit	4,499.3	39.8%	4,287.7	39.9%	3,908.7	39.4%
Selling expenses	(637.1)	(5.6)%	(697.3)	(6.5)%	(619.3)	(6.2)%
Administrative expenses	(729.1)	(6.4)%	(717.4)	(6.7)%	(683,6)	(6.9)%
Other operating income (expenses), net	5.7	(0.1)%	(29.7)	(0.3)%	(93.8)	(0.9)%
Operating profit	3,138.8	27.7%	2,843.3	26.5%	2,512.0	25.3%
Financial income (expenses), net.	(483.2)	(4.3)%	(295.7)	(2.8)%	(633.0)	(6.4)%
Profit before income tax and social contribution	2,655.6	23.5%	2,547.6	23.7%	1,879.0	18.9%
Income tax and social contribution	(732.0)	(6.5)%	(635.7)	(5.9)%	(498.1)	(5.0)%
Net income for the year	1,923.6	17.0%	1,911.9	17.8%	1,380.9	13.9%

***Year Ended December 31, 2013 Compared to Year Ended December 31, 2012***

We restated our financial statements as of and for the years ended December 31, 2012 and 2011 as a result of the adoption, as of January 1, 2013, of two new standards issued by the IASB: IAS 19 (Employee Benefits – as revised in 2011) and IFRS 11 (Joint Arrangements). These new standards were applied retrospectively to 2012 and 2011 pursuant to IAS 8 (Accounting Policies, Changes in Accounting Estimates and Errors) for comparison purposes. The adoption of these new standards impacted several line items of our financial statements. One of these impacts relates to the method of accounting for the results of joint-ventures, which are now recognized using the equity method of accounting instead of the proportional consolidation method we used prior to the adoption of the IFRS 11. See note 4.1 to our financial statements for a description of these standards and their impact on our financial statements.

***Net operating revenues***

Net operating revenues increased by R\$578.0 million, or 5.4%, to R\$11,315.6 million in 2013 from R\$10,737.6 million in 2012.

Net operating revenues relating to water services increased by R\$323.7 million, or 7.1%, to R\$4,906.0 million in 2013 from R\$4,582.3 million in 2012. This increase was principally due to:

- an average 2.6% increase in the volume of water invoiced in 2013; and
- the effect of the 5.15% tariff increase in September 2012, 2.35% tariff adjustment in April 2013 and 3.1% tariff adjustment in December 2013.

Net operating revenues relating to sewage services increased by R\$274.0 million, or 7.4%, to R\$3,964.9 million in 2013 from R\$3,690.9 million in 2012. This increase was principally due to:

- an average 2.9% increase in the volume of sewage services invoiced in 2013; and
- the effect of the 5.15% tariff increase in September 2012, 2.35% tariff adjustment in April 2013 and 3.1% tariff adjustment in December 2013.

Gross revenue from construction decreased by R\$19.7 million, or 0.8%, to R\$2,444.8 million in 2013 from R\$2,464.5 million in 2012. See Note 3.3(b) to our financial statements as of December 31, 2013 and 2012 and for the years ended December 31, 2013, 2012 and 2011 for a description of the accounting policies applicable to our construction services business.

***Cost of Sales and Services***

The cost of sales and services increased by R\$366.4 million, or 5.7%, to R\$6,816.3 million in 2013 from R\$6,449.9 million in 2012. As a percentage of net operating revenues, cost of sales and services increased to 60.2% in 2013 from 60.1% in 2012.

The increase in costs of sales and services was principally due to the following factors:

- an increase of R\$147.3 million or 11.7%, in salaries and related charges due to the following factors: (i) an increase of 6.17% in salaries since May 2012 and 8.0% since May 2013 associated to the implementation of the Company's new job and salary plan, which had an impact of approximately R\$109.3 million; and (ii) the increase in the provision for pension plan expenses, amounting to R\$22.1 million, due to changes in actuarial assumptions;

- an increase of R\$95.2 million in depreciation and amortization, due to the increase in operating intangible assets in 2013, arising mainly from input of the works in operation;
- an increase of R\$63.2 million or 35.6% in expenses related to water-treatment materials, mainly due to increased consumption and the substitution of water-treatment products in order to meet increased demand while maintaining the same efficiency levels in water treatment;
- an increase of R\$62.0 million in costs of outsourced services, mainly due to: (i) preventive and corrective sewage system maintenance in the amount of R\$17.7 million; (ii) environmental compensation with the beach recovery service in the amount of R\$9.4 million; (iii) expenses related to consulting, advisory, and specialized services, which amounted to R\$9.3 million; (iv) preventive and corrective maintenance in the water sewage operating systems in the amount of R\$9.2 million; and (v) services provided for conservation of property and operating facilities in the amount of R\$5.9 million, due to increase in areas being monitored; and
- an increase of R\$21.2 million payable incurred on expropriations, mainly to honor the commitments assumed with the municipality of Paraguaçu Paulista.

These increases were partially offset by a decrease of R\$36.5 million, in the cost of electricity, mainly due to the decrease in the Tariff for the Use of Distribution System (TUSD), as a consequence of Provisional Presidential Decree 579/12 and Law 12,783/13.

### ***Gross Profit***

As a result of the factors discussed above, gross profit for the year ended December 31, 2013 increased by R\$211.6 million, or 4.9%, from R\$4,287.7 million in 2012 to R\$4,499.3 in 2013. As a percentage of net operating revenues, gross profit decreased to 39.8% in 2013 from 39.9% in 2012.

### ***Selling Expenses***

Selling expenses decreased by R\$60.2 million, or 8.6%, to R\$637.1 million in 2013 from R\$697.3 million in 2012. As a percentage of net operating revenues, selling expenses decreased to 5.6% in 2013 from 6.49% in 2012.

The decrease in selling expenses was principally due to the account receivables allowance for losses, due to the higher recovery of amounts in 2013, under installment agreements.

This decrease was partially offset by an increase of R\$18.7 million in salaries and related charges, due to the 6.17% in salaries since May 2012 and 8.0% since May 2013 associated to the implementation of the Company's new job and salary plan, which had an impact of approximately R\$12.5 million.

### ***Administrative Expenses***

Administrative expenses increased by R\$11.7 million, or 1.6%, to R\$729.1 in 2013 from R\$717.4 million in 2012. As a percentage of net operating revenues, administrative expenses decreased to 6.4% in 2013 from 6.7% in 2012.

The increase in administrative expenses was principally due to the following factors:

- an increase of R\$34.6 million in amortization costs of software in 2013;

- an increase of R\$22.2 million in salaries and related charges due to the following factors: (i) an increase of 6.17% in salaries since May 2012 and 8.0% since May 2013 associated with the implementation of the Company's new job and salary plan, which had an impact of approximately R\$7.8 million; and (ii) the increase in the provision for pension plan expenses, amounting to R\$13.5 million, due to changes in actuarial assumptions;

- an increase in tax expenses of R\$7.3 million, or 12.0% due to: (i) regulatory tax to ARSESP in the amount of R\$4.3 million; and (ii) R\$1.0 million in income tax on remittances abroad as a result of the local currency depreciation in 2013.

The increase was partially offset by the following:

- a decrease of R\$28.9 million, or 19.9% mainly on services provided by third parties relating to advertising campaigns, in the amount of R\$29.4 million;
- a decrease of R\$25.3 million in general expenses, mainly due to the expenses on judicial proceedings in the amount of R\$14.2 million.

#### ***Other Operating Income (Expenses), Net***

Other operating income (expenses), net, decreased by R\$35.4 million, or 119.2%, to R\$5.7 million income in 2013 from R\$29.7 million expense in 2012. Other operating expenses showed a decrease of R\$37.5, or 40.9%, mainly due to the provision for losses for the indemnification of assets related to the concession for the municipality of Diadema, in the amount of R\$60.3 million in 2012. The decrease was partially offset by the asset write-offs related to asset obsolescence, in the amount of R\$17.8 million in 2013.

#### ***Financial income (expenses), net***

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

Financial income (expenses), net increased by R\$187.5 million, or 63.4%, to a R\$483.2 million expense in 2013 from a R\$295.7 million expense in 2012. As a percentage of net operating revenues, financial income (expenses), net increased to 4.3% in 2013 from 2.80% in 2012.

The increase in financial income (expenses), net was principally due to:

- an increase in foreign exchange losses related to loans and financing of R\$217.3 million as a result of the 14.6% depreciation of the real against the U.S. dollar in 2013, compared to a depreciation of 8.9% of the real against the U.S. dollar in 2012;
- an increase of R\$38.1 million in expenses with inflation adjustment on loans and internal financings, mainly relating to the seventeenth and eighteenth debentures issued in February and December 2013, respectively.

The increase in financial income (expenses), net was partially offset by:

- an increase of R\$34.3 million in finance income, mainly due to the investment of interest earned on installment payment plans, and to the interest on the seventeenth and eighteenth debentures issued; and
- a decrease of R\$10.0 million interest expenses on local loans and financing, mainly due to the repayment of the debt to Banco do Brasil in 2013, in the of R\$380.7 million, associated to the change in debt (issue of

the seventeenth debenture in February 2013 and anticipation of the amortization of the 11th debenture balance).

***Profit before income tax and social contribution***

As a result of the factors discussed above, profit before income tax and social contribution increased by 4.2%, to R\$2,655.6 million in 2013 from R\$2,547.6 million in 2012. As a percentage of net operating revenues, our profit before income tax and social contribution decreased to 23.5% in 2013 from 23.7% in 2012.



*Income Tax and Social Contribution*

Income tax and social contribution increased by R\$96.3 million, or 15.1%, to R\$732.0 million in 2013 from R\$635.7 million in 2012.