ECHELON CORP
Form 10-Q
November 10, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark one)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2008

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to __________

000-29748

(Commission file number)

ECHELON CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**77-0203595**
(State or other jurisdiction of	**(IRS Employer**
incorporation or organization)	**Identification Number)**

550 Meridian Avenue

San Jose, CA 95126

(Address of principal executive office and zip code)

(408) 938-5200

(Registrant s telephone number, including area code)

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 filing requirements for the past 90 days.

Yes x No ¨

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

Large accelerated filer ¨	Accelerated filer x	Non-accelerated filer ¨ (do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No x

As of October 31, 2008, 40,442,279 shares of the registrant s common stock were outstanding.

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ECHELON CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2008

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FORWARD-LOOKING INFORMATION

This report contains forward-looking statements within the meaning of the U.S. federal securities laws that involve risks and uncertainties. Certain statements contained in this report are not purely historical including, without limitation, statements regarding our expectations, beliefs, intentions, anticipations, commitments or strategies regarding the future that are forward-looking. These statements include those discussed in Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations, including Critical Accounting Estimates, Results of Operations, Off-Balance-Sheet Arrangements and Other Critical Contractual Obligations, Liquidity and Capital Resources, and Recently Issued Accounting Standards, and elsewhere in this report.

In this report, the words may, could, would, might, will, should, plan, forecast, anticipate, believe, expect, intend, estimate, predict, potential, continue, future, moving toward or the negative of these terms or other similar expressions also identify forward-looking statements. Our actual results could differ materially from those forward-looking statements contained in this report as a result of a number of risk factors including, but not limited to, those set forth in the section entitled Factors That May Affect Future Results of Operations and elsewhere in this report. You should carefully consider these risks, in addition to the other information in this report and in our other filings with the SEC. All forward-looking statements and reasons why results may differ included in this report are made as of the date of this report, and we assume no obligation to update any such forward-looking statement or reason why such results might differ.

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PART I. FINANCIAL INFORMATION

ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

ECHELON CORPORATION

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

(Unaudited)

	September 30, 2008	December 31, 2007
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 80,030	$ 76,062
Short-term investments	14,845	31,128
Accounts receivable, net [(1)]	16,568	33,469
Inventories	16,956	14,012
Deferred cost of goods sold	7,123	6,656
Other current assets	5,544	2,092
Total current assets	141,066	163,419
Property and equipment, net (note 3)	40,945	30,776
Goodwill	8,448	8,548
Other long-term assets	2,001	1,964
TOTAL ASSETS	$ 192,460	$ 204,707
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 7,929	$ 12,945
Accrued liabilities	5,830	4,551
Current portion lease financing obligations (note 7)	1,407	2,900
Deferred revenues	14,415	16,312
Total current liabilities	29,581	36,708
LONG-TERM LIABILITIES:		
Lease financing obligations, net of current portion (note 7)	25,720	13,151
Other long-term liabilities	1,660	1,637
Total long-term liabilities	27,380	14,788
STOCKHOLDERS EQUITY:		
Common stock	436	432
Additional paid-in capital	309,916	298,556
Treasury stock	(28,130)	(19,259)
Accumulated other comprehensive income	1,094	1,718
Accumulated deficit	(147,817)	(128,236)

Total stockholders equity		135,499		153,211
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	$	192,460	$	204,707

(1) Includes related party amounts of $3,663 as of September 30, 2008 and $3,000 as of December 31, 2007. See Note 12 for additional information on related party transactions.

See accompanying notes to condensed consolidated financial statements.

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ECHELON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
REVENUES:				
Product	$ 28,875	$ 23,733	$ 95,008	$ 89,247
Service	625	980	2,244	1,431
Total revenues [2]	29,500	24,713	97,252	90,678
COST OF REVENUES:				
Cost of product [1]	15,715	14,004	56,998	57,969
Cost of service [1]	592	722	1,980	1,710
Total cost of revenues	16,307	14,726	58,978	59,679
GROSS PROFIT	13,193	9,987	38,274	30,999
OPERATING EXPENSES:				
Product development [1]	9,713	7,820	28,151	23,716
Sales and marketing [1]	5,653	4,884	17,820	15,279
General and administrative [1]	3,761	3,976	12,997	11,707
Total operating expenses	19,127	16,680	58,968	50,702
LOSS FROM OPERATIONS	(5,934)	(6,693)	(20,694)	(19,703)
INTEREST AND OTHER INCOME, NET	1,141	1,381	2,319	4,366
INTEREST EXPENSE ON LEASE FINANCING OBLIGATIONS	(435)	(297)	(974)	(924)
LOSS BEFORE PROVISION FOR INCOME TAXES	(5,228)	(5,609)	(19,349)	(16,261)
INCOME TAX EXPENSE	136	108	230	323
NET LOSS	$ (5,364)	$ (5,717)	$ (19,579)	$ (16,584)
NET LOSS PER SHARE:				
Basic	$ (0.13)	$ (0.14)	$ (0.48)	$ (0.42)
Diluted	$ (0.13)	$ (0.14)	$ (0.48)	$ (0.42)
SHARES USED IN COMPUTING NET LOSS PER SHARE:				
Basic	40,554	40,121	40,704	39,622
Diluted	40,554	40,121	40,704	39,622

(1) Amounts include stock-based compensation costs as follows:

Cost of product	$ 450	$ 217	$ 1,203	$ 526
Cost of service	56	18	150	45
Product development	1,754	655	4,455	1,647
Sales and marketing	750	383	2,193	1,020
General and administrative	617	489	2,735	1,450
Total	$ 3,627	$ 1,762	$ 10,736	$ 4,688

(2) Includes related party amounts of $5,469 and $3,036 for the three months ended September 30, 2008 and 2007, respectively, and $8,384 and $8,023 for the nine months ended September 30, 2008 and 2007, respectively. See Note 12 for additional information on related party transactions.

See accompanying notes to condensed consolidated financial statements.

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ECHELON CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	$ (19,579)	$ (16,584)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	5,834	5,427
Loss on disposal of fixed assets	9	4
Increase in (reduction of) allowance for doubtful accounts	(16)	47
Reduction of accrued investment income	645	403
Stock-based compensation	10,736	4,688
Change in operating assets and liabilities:		
Accounts receivable	16,931	282
Inventories	(2,923)	446
Deferred cost of goods sold	(467)	12,854
Other current assets	(3,472)	(608)
Accounts payable	(5,019)	1,953
Accrued liabilities	1,232	2,883
Deferred revenues	(1,852)	(10,510)
Deferred rent	(22)	(52)
Net cash provided by operating activities	2,037	1,233
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of available-for-sale short-term investments	(45,411)	(65,545)
Proceeds from maturities and sales of available-for-sale short-term investments	61,030	104,139
Change in other long-term assets	(40)	44
Capital expenditures	(3,474)	(5,752)
Net cash provided by investing activities	12,105	32,886
CASH FLOWS FROM FINANCING ACTIVITIES:		
Principal payments of lease financing obligations	(1,451)	(1,902)
Proceeds from exercise of stock options	2,047	10,094
Repurchase of common stock from employees for payment of taxes on vesting of performance shares and upon exercise of stock options	(1,358)	(4,029)
Repurchase of common stock under stock repurchase program	(8,871)	
Net cash provided by (used in) financing activities	(9,633)	4,163
EFFECT OF EXCHANGE RATE CHANGES ON CASH AND CASH EQUIVALENTS	(541)	328
NET INCREASE IN CASH AND CASH EQUIVALENTS	3,968	38,610
CASH AND CASH EQUIVALENTS:		
Beginning of period	76,062	37,412

End of period	$ 80,030	$ 76,022
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Cash paid for income taxes	$ 482	$ 352
Cash paid for interest on lease financing obligations	$ 1,025	$ 914
Noncash investing and financing information Increase in property and equipment and related lease financing obligation due to lease extension (see Note 3)	$ 12,526	$

See accompanying notes to condensed consolidated financial statements.

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ECHELON CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Summary of Significant Accounting Policies

Basis of Presentation

The condensed consolidated financial statements include the accounts of Echelon Corporation (the Company), a Delaware corporation, and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

While the financial information furnished is unaudited, the condensed consolidated financial statements included in this report reflect all adjustments (consisting only of normal recurring adjustments) which the Company considers necessary for the fair presentation of the results of operations for the interim periods covered and of the financial condition of the Company at the date of the interim balance sheet. The results for interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated financial statements should be read in conjunction with the Company s consolidated financial statements for the year ended December 31, 2007 included in its Annual Report on Form 10-K/A.

Revenue Recognition

The Company s revenues are derived from the sale and license of its products and to a lesser extent, from fees associated with training, technical support, and custom software design services offered to its customers. Product revenues consist of revenues from hardware sales and software licensing arrangements. Service revenues consist of product technical support (including software post-contract support services), training, and custom software development services.

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, collectability is probable, and there are no post-delivery obligations. For hardware sales, including sales to third party manufacturers, these criteria are generally met at the time of shipment. For sales made to the Company s distributor partners, these criteria are generally met at the time the distributor sells the products through to its end-use customer. For software licenses, these criteria are generally met upon shipment to the final end-user. Service revenue is recognized as the training services are performed, or ratably over the term of the support period.

In accordance with AICPA Statement of Position 97-2 (SOP 97-2), *Software Revenue Recognition*, as amended, revenue earned on software arrangements involving multiple elements is allocated to each element based upon the relative fair values of the elements. The Company uses the residual method to recognize revenue when a license agreement includes one or more elements to be delivered at a future date. In these instances, the amount of revenue deferred at the time of sale is based on vendor specific objective evidence (VSOE) of the fair value for each undelivered element. If VSOE of fair value does not exist for each undelivered element, all revenue attributable to the multi-element arrangement is deferred until sufficient VSOE of fair value exists for each undelivered element or all elements have been delivered.

The Company currently sells a limited number of its LonWorks® Infrastructure products that are considered multiple element arrangements under SOP 97-2. Revenue for the software license element is recognized at the time of delivery of the applicable product to the end-user. The only undelivered element at the time of sale consists of post-contract customer support (PCS). The VSOE for this PCS is based on prices paid by the Company s customers for stand-alone purchases of PCS. Revenue for the PCS element is deferred and recognized ratably over the PCS service period. The costs of providing these PCS services are expensed when incurred.

In most instances involving large-scale deployments, the Company s Networked Energy Services (NES) System products are sold as part of multiple element arrangements, which may include electricity meters and data concentrators (collectively, the Hardware); NES System software, for which a royalty is charged on a per-meter basis; PCS for the NES System software; and extended warranties for the Hardware. These arrangements may require the Company to deliver Hardware over an extended period of time. In accordance with SOP 97-2, when the multiple element arrangement includes NES System software, the Company defers the recognition of all revenue until all software required under the arrangement has been delivered to the customer. Once the software has been delivered, the Company recognizes revenues for the Hardware and NES System software royalties upon customer acceptance of the Hardware based on a constant ratio of meters to data concentrators, which is determined on a contract-by-contract basis. To the extent actual deliveries of either meters or data concentrators is disproportionate to the expected overall ratio for any given arrangement, revenue for the excess meters or data concentrators is

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deferred until such time as additional deliveries of meters or data concentrators has occurred. The Company has established VSOE for the PCS on the NES System software, as well as for extended warranties on its NES Hardware products, based on stated renewal rates. These revenues are recognized ratably over the associated service period, which generally commences upon the later of the delivery of all software, or the customer s acceptance of any given Hardware shipment.

In arrangements which include significant customization or modification of software, the Company recognizes revenue using the percentage-of-completion method, as described in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, if the Company believes it is able to make reasonably dependable estimates of the extent of progress toward completion. The Company measures progress toward completion using an input method based on the ratio of costs incurred, principally labor, to date to total estimated costs of the project. These estimates are assessed continually during the term of the contract, and revisions are reflected when the changed conditions become known. Revenues from these types of arrangements are included in service revenues in the condensed consolidated statement of operations.

The Company accounts for the rights of return, price protection, rebates, and other sales incentives offered to its distributors in accordance with Statement of Financial Accounting Standards (SFAS) No. 48, *Revenue Recognition When Right of Return Exists,* and EITF Issue No. 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products).*

Deferred Revenue and Deferred Cost of Goods Sold

Deferred revenue and deferred cost of goods sold result from transactions where the Company has shipped product or performed services for which all revenue recognition criteria have not yet been met. Deferred cost of goods sold related to deferred product revenues includes direct product costs and applied overhead. Deferred cost of goods sold related to deferred service revenues includes direct labor costs and applied overhead. Once all revenue recognition criteria have been met, the deferred revenues and associated cost of goods sold are recognized.

Recently Issued Accounting Standards

With the exception of the items discussed below, there have been no recent accounting pronouncements or changes in accounting pronouncements during the three and nine months ended September 30, 2008, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K/A for the year ended December 31, 2007, that are of significance, or potential significance, to the Company.

In October 2008, the FASB issued FSP SFAS No. 157-3 (FSP 157-3), *Determining the Fair Value of a Financial Asset When The Market for That Asset Is Not Active,* to clarify the application of the provisions of SFAS No. 157, *Fair Value Measurement*, in an inactive market. FSP 157-3 is effective immediately and applies to the Company s September 30, 2008 financial statements. The application of the provisions of FSP 157-3 did not have a material impact on the Company s financial position, cash flows or results of operations.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161 (SFAS 161), *Disclosures about Derivative Instruments and Hedging Activities*. SFAS 161 requires companies with derivative instruments to disclose information that should enable financial statement users to understand how and why a company uses derivative instruments, how derivative instruments and related hedged items are accounted for under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and how derivative instruments and related hedged items affect a company s financial position, financial performance, and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The Company believes that the adoption of SFAS 161 will not have a material impact on its consolidated financial statements as it does not currently engage in the use of derivative instruments or hedging activities.

2. Cash Equivalents and Investments

The Company measures at fair value its cash equivalents and available-for-sale investments in accordance with SFAS 157. SFAS 157 specifies a valuation hierarchy based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company s own assumptions. These two types of inputs have created the following fair value hierarchy:

Level 1 Quoted prices for identical instruments in active markets;

Level 2 Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets; and

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Level 3 Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

This hierarchy requires the Company to minimize the use of unobservable inputs and to use observable market data, if available, when estimating fair value. Other than cash and money market funds, the Company s only financial assets or liabilities required to be measured at fair value on a recurring basis at September 30, 2008, are fixed income available-for-sale securities. The fair value of cash equivalents and short-term investments was determined using the following inputs at September 30, 2008 (in thousands):

		Fair Value Measurements at Reporting Date Using		
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market funds	$ 35,480	$ 35,480	$	$
Fixed income available-for-sale securities	54,808		54,808	
Total	$ 90,288	$ 35,480	$ 54,808	$

Fixed income available-for-sale securities are included in cash and cash equivalents and short-term investments in the Company s condensed consolidated balance sheet. Of the $54.8 million of fixed income available-for-sale securities, approximately $40.0 million are classified as cash equivalents, while the remaining $14.8 million are classified as short-term investments. Cash equivalents consist of either investments with remaining maturities of three months or less at the date of purchase, or money market funds for which the carrying amount is a reasonable estimate of fair value.

As of September 30, 2008, the Company s available-for-sale securities had contractual maturities from three to twenty-four months and an average remaining term to maturity of four months. As of September 30, 2008, the amortized cost basis, aggregate fair value, and gross unrealized holding losses by major security type were as follows (in thousands):

	Amortized Cost	Aggregate Fair Value	Unrealized Holding Gains	Unrealized Holding Losses
U.S. corporate securities:				
Commercial paper	$ 4,981	$ 4,981	$	$
Corporate notes and bonds	4,342	4,354	21	9
	9,323	9,335	21	9
Foreign corporate notes and bonds	518	518		
U.S. government and agency securities	4,978	4,992	14	
Total investments in debt securities	$ 14,819	$ 14,845	$ 35	$ 9

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3. Property and Equipment

A summary of property and equipment, net as of September 30, 2008 and December 31, 2007 is as follows (in thousands):

	September 30, 2008	December 31, 2007
Buildings and improvements	$ 37,356	$ 40,850
Computer and other equipment	22,126	19,403
Software	4,600	4,511
Furniture and fixtures	2,778	2,666
Leasehold improvements	3,878	3,809
	70,738	71,239
Less: Accumulated depreciation and amortization	(29,793)	(40,463)
Property and equipment, net	$ 40,945	$ 30,776

Property and equipment are stated at cost. Prior to June 2008, the cost of buildings and improvements for our leased San Jose, California headquarters facilities, for which we are the deemed owner for accounting purposes only, had included both the costs paid for directly by the Company and the costs paid for by the builder (lessor) from the period commencing with the start of construction through the lease commencement date for each building. These building assets are reflected as Buildings and Improvements in the schedule above. Building improvements paid for by the Company subsequent to the lease commencement date of each building are reflected as Leasehold Improvements in the schedule above.

Effective June 2008, the building leases were amended, resulting in an extension of the lease term for both buildings through March 2020. As a result of the lease extensions, the lease financing obligations for each building were increased based on the present value of the revised lease payments on the date of the extension, with a corresponding increase to the net carrying amount of the cost of the building assets (see further information below).

Depreciation is provided using the straight-line method as follows:

Building assets and leasehold improvements are depreciated over the shorter of the remaining lease term or estimated useful lives (see further information below);

Computer equipment and related software, other equipment, and furniture and fixtures are depreciated over their estimated useful lives of two to five years; and

Certain telecommunications equipment is depreciated over its estimated useful life of 10 years.

Accounting for buildings and improvements

In December 1999, the Company entered into a lease agreement with a real estate developer for its existing corporate headquarters in San Jose, California. In October 2000, the Company entered into a second lease agreement with the same real estate developer for an additional building at its headquarters site. These leases were scheduled to expire in 2011 and 2013, respectively.

Effective June 2008, the building leases were amended resulting in an extension of the lease term for both buildings through March 2020. The extended leases require minimum lease payments through March 2020 totaling approximately $48.9 million. Both leases permit the Company to exercise an option to extend the respective lease for two sequential five-year terms. In addition, the amended leases eliminated the Company s requirement to provide the landlord with security deposits totaling $6.2 million, which the Company had previously satisfied by causing to have issued standby letters of credit (LOCs). As of June 30, 2008, the previously issued LOCs had been returned to the bank that issued them and were cancelled.

The Company has historically accounted for the two buildings at its San Jose, California headquarters site under EITF Issue No. 97-10 (EITF 97-10), *The Effect of Lessee Involvement in Asset Construction*, and SFAS No. 98 (SFAS 98), *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases an amendment of FASB Statements No. 13, 66, and 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11*. EITF 97-10 applies to entities involved with the construction of an asset that will be leased when the construction project is completed. During construction, the Company paid for certain tenant improvements, including structural elements of the buildings, and, in accordance with EITF 97-10, is therefore the deemed owner for accounting purposes of the two buildings at its San Jose, California headquarters site. Accordingly, the Company recorded assets for the total costs of the buildings and improvements, including the costs paid by the lessor (the legal owner of the buildings), with corresponding liabilities for the costs paid by the lessor. Upon completion of construction of each building, the Company did not meet the sale-leaseback criteria in SFAS 98 for de-recognition of the building assets and liabilities. Therefore the leases are accounted for as financing obligations.

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For the December 1999 and October 2000 lease agreements, the Company initially recorded lease financing obligations of $12.0 million and $15.2 million, respectively, which corresponded to the building asset costs paid for by the lessor. As a result of the lease extension in June 2008, the Company increased the carrying amount of its lease financing obligations by approximately $12.5 million to approximately $27.6 million (an amount equal to the present value of the revised lease payments at the date of the lease extension), with a corresponding increase to the net carrying amount of the building assets. In addition, all of accumulated depreciation on the building assets at the date of the lease extensions (approximately $16.0 million) was eliminated with a corresponding decrease to the gross carrying amount of the building assets. As a result of the extension in lease terms, the Company also extended the estimated useful lives of the building assets and the leasehold improvements to equal the amended lease term.

For the three and nine months ended September 30, 2008, the Company recorded depreciation expense associated with the building assets of $504,000 and $1.8 million, respectively. For the three and nine months ended September 30, 2007, the Company recorded depreciation expense associated with the building assets of $681,000 and $2.0 million, respectively. As of September 30, 2008 and December 31, 2007, the net book value of the building assets was $23.2 million and $12.5 million, respectively.

Under the lease agreements, a portion of the total lease payments is accounted for as an operating lease of land and recorded as expense on a straight-line basis over the term of the lease. The remaining portions of the monthly lease payments are considered to be payments of principal and interest on the lease financing obligations. For the three and nine months ended September 30, 2008, land lease expense was $185,000 and $419,000, respectively, principal reductions on the lease financing obligations were $333,000 and $1.5 million, respectively, and interest expense was $435,000 and $974,000, respectively. For the three and nine months ended September 30, 2007, land lease expense was $113,000 and $338,000, respectively, principal reductions on the lease financing obligations were $650,000 and $1.9 million, respectively, and interest expense was $297,000 and $924,000, respectively.

4. Earnings Per Share

The following is a reconciliation of the numerators and denominators of the basic and diluted net loss per share computations for the three months and nine months ended September 30, 2008 and September 30, 2007 (in thousands, except per share amounts):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net loss (Numerator):				
Net loss, basic & diluted	$ (5,364)	$ (5,717)	$ (19,579)	$ (16,584)
Shares (Denominator):				
Weighted average common shares outstanding	40,554	40,121	40,704	39,622
Shares used in basic computation	40,554	40,121	40,704	39,622
Common shares issuable upon exercise of stock options (treasury stock method)				
Shares used in diluted computation	40,554	40,121	40,704	39,622
Net loss per share:				
Basic	$ (0.13)	$ (0.14)	$ (0.48)	$ (0.42)
Diluted	$ (0.13)	$ (0.14)	$ (0.48)	$ (0.42)

For the three and nine months ended September 30, 2008 and 2007, the diluted net loss per share calculation is equivalent to the basic net loss per share calculation as there were no potentially dilutive stock options due to the Company s net loss position. The number of stock options, stock appreciation rights, and restricted stock units excluded from this calculation for the three and nine months ended September 30, 2008 and 2007 was 8,260,816 and 8,040,768, respectively.

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5. Stockholders Equity and Employee Stock Option Plans

Common Stock

In April 2008, the Company s board of directors approved a stock repurchase program, which authorizes the Company to repurchase up to 3.0 million shares of the Company s common stock. During the three months ended September 30, 2008, the Company repurchased 533,250 shares at a cost of $6.2 million. During the nine months ended September 30, 2008, the Company repurchased 750,000 shares at a cost of $8.9 million. As of September 30, 2008, 2,250,000 shares were available for repurchase. The stock repurchase program will expire in April 2011.

Comprehensive Loss

Comprehensive loss for the Company consists of net loss plus the effect of unrealized holding gains or losses on investments classified as available-for-sale and foreign currency translation adjustments. Comprehensive loss for the three and nine months ended September 30, 2008 and 2007 is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net loss	$ (5,364)	$ (5,717)	$ (19,579)	$ (16,584)
Other comprehensive income/(loss), net of tax:				
Foreign currency translation adjustment	(1,111)	406	(605)	530
Unrealized holding gain (loss) on available-for-sale securities	92	41	(18)	38
Comprehensive loss	$ (6,383)	$ (5,270)	$ (20,202)	$ (16,016)

Stock Award Activity

The total intrinsic value of options exercised during the three and nine months ended September 30, 2008 was approximately $457,000 and $1.6 million, respectively. The intrinsic value is calculated as the difference between the market value on the date of exercise and the exercise price of the awards.

The total fair value of performance shares vested and released during the three and nine months ended September 30, 2008 was approximately $1.8 million and $3.4 million, respectively. The fair value is calculated by multiplying the fair market value of the Company s stock on the vesting date by the number of shares vested.

Equity Compensation Expense for Share Awards with Financial- Based Performance Vesting Requirements

As of September 30, 2008, there were 188,614 nonvested share awards (with a grant date fair value of $2.0 million) that were subject to certain financial-based performance requirements that must be achieved before vesting can occur. Cumulative compensation expense of $569,000 through September 30, 2008 associated with 121,181 of these performance shares (with a grant date fair value of approximately $1.1 million) has been recognized assuming that those financial performance requirements will be achieved. If such requirements are not met, no compensation cost is recognized and any recognized compensation cost will be reversed. No compensation expense has been recognized associated with the remaining 67,433 share awards (with a grant date fair value of $898,000) as management does not currently expect the financial performance requirements for these awards will be met.

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6. Significant Customers

The Company markets its products and services throughout the world to original equipment manufacturers (OEMs) and systems integrators in the building, industrial, transportation, utility/home, and other automation markets. During the three and nine months ended September 30, 2008 and 2007, the Company had six customers that accounted for a majority of its revenues: EBV Electronik GmbH (EBV), the Company s primary distributor of its LonWorks® Infrastructure products in Europe, Enel S.p.A. (Enel), an Italian utility company (including Enel s third party meter manufacturers), Duke Energy Corporation (Duke), a US utility company that purchases NES products directly from the Company, and Telvent Energia y Medioambiente SA (Telvent), Limited Liability Company Engineering Center ENERGOAUDITCONTROL (EAC), and ES Elektrosandberg AB (ES), European based value added resellers of the Company s NES products. For the three and nine months ended September 30, 2008 and 2007, the percentage of the Company s revenues attributable to sales made to these customers was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
ES	3.6%	14.0%	18.3%	12.2%
EBV	18.5%	17.6%	16.9%	14.7%
Telvent	1.0%	19.1%	10.9%	33.6%
Enel	18.2%	12.3%	8.2%	8.8%
EAC	7.2%	%	7.7%	%
Duke	10.2%	%	5.6%	%
Total	58.7%	63.0%	67.6%	69.3%

Of the percentage of sales made to EBV, approximately 0.4% for both the three and nine months ended September 30, 2008, related to sales of components we sold to EBV, which EBV in turn sold to one of Enel s third party meter manufacturers. Elsewhere in this document, those sales are reported as Enel Project revenues. The Company s contract with EBV, which has been in effect since 1997 and has been renewed annually thereafter, expires in December 2008. Please refer to Note 12, Related Parties, for additional information regarding the Company s agreements with Enel.

7. Commitments and Contingencies

Lease Commitments

As discussed in Note 3, the December 1999 and October 2000 leases of our corporate headquarters facilities, as amended in June 2008, are accounted for under EITF 97-10 and SFAS 98.

In addition, the Company leases facilities under operating leases for its sales, marketing, and product development personnel located elsewhere within the United States and in ten foreign countries throughout Europe and Asia including a land lease for accounting purposes associated with the Company s corporate headquarters facilities in San Jose, California. These operating leases expire on various dates through 2020, and in some instances are cancelable with advance notice. Lastly, the Company also leases certain equipment and, for some of its sales personnel, automobiles. These operating leases are generally less than five years in duration.

Royalties

The Company has certain royalty commitments associated with the shipment and licensing of certain of its products. Royalty expense is generally based on a U.S. dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense, which is recorded as a component of cost of product revenues in our condensed statements of income, was approximately $127,000 during the three months ended September 30, 2008, and $133,000 for the same period in 2007. Royalty expense was approximately $400,000 for the nine months ended September 30, 2008, and $432,000 for the same period in 2007.

The Company will continue to be obligated for royalty payments in the future associated with the shipment and licensing of certain of its products. The Company is currently unable to estimate the maximum amount of these future royalties. However, such amounts will continue to be dependent on the number of units shipped or the amount of revenue generated from these products.

Warranties

The Company typically sells its products with a limited warranty against defects in manufacture or performance. When evaluating the reserve for warranty costs, management takes into consideration the term of the warranty coverage, the quantity of product in the field that is currently under warranty, historical return rates, and historical costs of repair. In addition, certain other applicable factors, such as technical complexity, may also be taken into consideration when historical information is not yet available for recently introduced products. Estimated reserves for warranty costs are generally provided for when the associated revenue is recognized. In addition, additional warranty reserves may be established when the Company becomes aware of a specific warranty related problem, such as a product recall. Such additional warranty reserves are based on the Company s current estimate of the total out-of-pocket costs expected to be incurred to resolve the problem, including, but not limited to, costs to replace or repair the defective items and shipping costs. The reserve for warranty costs was $603,000 as of September 30, 2008 and $301,000 as of December 31, 2007.

Guarantees

In the normal course of business, the Company provides indemnifications of varying scope to its customers against claims of intellectual property infringement made by third parties arising from the use of its products. Historically, costs related to these indemnification provisions have not been significant. However, the Company is unable to estimate the maximum potential impact of these indemnification provisions on its future results of operations.

As permitted under Delaware law, the Company has entered into agreements whereby it indemnifies its officers and directors for certain events or occurrences while the officer or director is, or was serving, at the Company s request in such capacity. The indemnification period covers all pertinent events and occurrences during the officer s or director s lifetime. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited. However, the Company has directors and officers insurance coverage that would enable it to recover a portion of any future amounts paid. The Company believes the estimated fair value of these indemnification agreements in excess of the applicable insurance coverage is minimal.

Taxes

The Company conducts operations in many tax jurisdictions throughout the world. In many of these jurisdictions, non-income based taxes such as property taxes, sales and use taxes, and value-added taxes are assessed on the Company s operations in that particular location. While the Company strives to ensure compliance with these various non-income based tax filing requirements, there have been instances where potential non-compliance exposures have been identified. In accordance with accounting principles generally accepted in the United States of America, the Company makes a provision for these exposures when it is both probable that a liability has been incurred and the amount of the exposure can be reasonably estimated. To date, such provisions have been immaterial, and the Company believes that, as of September 30, 2008, it has adequately provided for such contingencies. However, it is possible that the Company s results of operations, cash flows, and financial position could be harmed if one or more non-compliance tax exposures are asserted by any of the jurisdictions where the Company conducts its operations.

Legal Actions

From time to time, in the ordinary course of business, the Company is subject to legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, and other matters. In accordance with generally accepted accounting principles, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While the Company believes it has adequately provided for such contingencies as of September 30, 2008, the amounts of which were immaterial, it is possible that the Company s results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

8. Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market and include material, labor and manufacturing overhead. When required, provisions are made to reduce excess and obsolete inventories to their estimated net realizable value. Inventories consist of the following (in thousands):

	September 30, 2008	December 31, 2007
Purchased materials	$ 7,262	$ 4,379
Work-in-process	39	360
Finished goods	9,655	9,273
	$ 16,956	$ 14,012

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9. Accrued Liabilities

Accrued liabilities consist of the following (in thousands):

	September 30, 2008	December 31, 2007
Accrued payroll and related costs	$ 2,906	$ 3,006
Accrued taxes		37
Customer deposits	1,759	932
Accrued warranty	603	301
Other accrued liabilities	562	275
	$ 5,830	$ 4,551

10. Segment Disclosure

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing business performance. The Company s chief operating decision-making group is the Executive Staff, which is comprised of the Chief Executive Officer and his direct reports. SFAS 131 also requires disclosures about products and services, geographic areas, and major customers.

The Company operates in one principal industry segment, its reportable segment: the design, manufacture and sale of products for the controls network industry, and markets its products primarily to the building automation, industrial automation, transportation, and utility/home automation markets. The Company s products provide the infrastructure and support required to implement and deploy open, interoperable, control network solutions. For the electric utility industry, the Company has developed an advanced metering infrastructure system called the Networked Energy Services (NES) system. The NES system provides a two-way information and control path between the utility and its customer, which enables utilities to reduce operating costs; improve customer service; offer multiple tariff plans, including time-of-use metering and prepay metering; promote energy efficiency; better utilize distribution assets; improve grid quality and reliability; control loads and reduce peak demand; and respond more rapidly to changing customer and regulatory requirements. All of the Company s products either incorporate or operate with the Neuron® Chip and/or the LonWorks protocol. The Company also provides a range of services to its customers that consist of technical support, training courses covering its LonWorks network technology and products, and custom software development. In total, the Company offers a wide ranging set of products and services that together constitute the LonWorks system. Any given customer purchases a small subset of such products and services that are appropriate for that customer s application.

The Company operates in three main geographic areas: the Americas; Europe, Middle East and Africa (EMEA); and Asia Pacific/ Japan (APJ). Each geographic area provides products and services to the Company s customers located in the respective region. The Company s long-lived assets include property and equipment, goodwill, loans to certain key employees, purchased technology, and deposits on its leased facilities. Long-lived assets are attributed to geographic areas based on the country where the assets are located. As of September 30, 2008 and December 31, 2007, long-lived assets of approximately $47.8 million and $37.7 million, respectively, were domiciled in the United States. Long-lived assets for all other locations are not material to the consolidated financial statements.

The Company has three primary product lines: NES, LonWorks Infrastructure, and products and services sold to Enel. Summary revenue information by product line for the three and nine months ended September 30, 2008 and 2007 is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
NES	$ 9,370	$ 8,624	$ 46,510	$ 42,896
LonWorks Infrastructure	14,660	13,054	42,358	39,759
Enel	5,470	3,035	8,384	8,023

Total	$ 29,500	$ 24,713	$ 97,252	$ 90,678

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In North America, the Company sells its products primarily through a direct sales organization and select third-party electronics representatives. Outside North America, the Company sells its products through direct sales organizations in EMEA and APJ, value-added resellers, and local distributors. Revenues are attributed to geographic areas based on the country where the customer is domiciled. Summary revenue information by geography for the three and nine months ended September 30, 2008 and 2007 is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Americas	$ 8,606	$ 4,544	$ 20,879	$ 13,795
EMEA	17,565	15,347	68,165	62,447
APJ	3,329	4,822	8,208	14,436
Total	$ 29,500	$ 24,713	$ 97,252	$ 90,678

For information regarding the Company s major customers, please refer to Note 6, Significant Customers.

11. Income Taxes

The provision for income taxes for the three months ended September 30, 2008 and 2007 was $136,000 and $108,000, respectively. The provision for income taxes for the nine months ended September 30, 2008 and 2007 was $230,000 and $323,000, respectively. The difference between the statutory rate and the Company s effective tax rate is primarily due to the impact of foreign taxes, changes in the valuation allowance on deferred tax assets, and changes in the accruals related to unrecognized tax benefits recorded in accordance with FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109*.

The Company adopted FIN 48 on January 1, 2007. This interpretation prescribes a recognition threshold and measurement attributes for the financial statement recognition and measurement of a tax position taken or expected to be taken on a tax return. FIN 48 also provides guidance on de-recognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, and disclosure and transition.

As of September 30, 2008 and December 31, 2007, the Company had gross unrecognized tax benefits of approximately $6.2 million and $5.8 million, respectively, of which $902,000 and $921,000, respectively, if recognized, would impact the effective tax rate on income from continuing operations. The $344,000 increase in unrecognized tax benefits during the nine months ended September 30, 2008, is primarily comprised of a $107,000 increase due to the impact of foreign exchange rates on the December 31, 2007 balances and a $327,000 increase due to tax positions expected to be taken in the current year; partially offset by a $90,000 decrease due to the expiration of the statute of limitations in certain foreign jurisdictions.

The Company s practice is to recognize interest and/or penalties related to unrecognized tax benefits in income tax expense. As of September 30, 2008 and December 31, 2007, the Company had $280,000 and $327,000, respectively, accrued for interest and penalties. The $47,000 reduction in accrued interest and penalties during the nine months ended September 30, 2008 was primarily attributable to a $49,000 reduction due to the expiration of the statute of limitations in certain foreign jurisdictions and a $33,000 decrease due to the impact of foreign exchange rates on December 31, 2007 balances; partially offset by a $35,000 increase for interest and penalties accrued during the period. The Company estimates that the total interest and penalties related to unrecognized tax benefits will decrease by approximately $36,000 over the next twelve months.

12. Related Parties

The law firm of Wilson Sonsini Goodrich & Rosati, P.C. acted as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C.

In August 2009, our Board of Directors approved an arrangement whereby Echelon will reimburse our Chairman and Chief Executive Officer, M. Kenneth Oshman, for 50% of the costs incurred by Mr. Oshman for his private plane or charter aircraft travel on Company business. Such costs include flight charges (subject to any discounted rate that may apply), fuel, fuel surcharges, landing fees, crew costs and related expenses.

Mr. Oshman from time to time uses his private plane or charter aircraft for Company business for himself and any employees that accompany him.

In June 2000, the Company entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of our common stock. Under the terms of the stock purchase agreement, Enel has the right to nominate a member of the Company s board of directors. A representative of Enel is not presently serving on the Company s board.

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At the same time as the Company entered into the stock purchase agreement with Enel, it also entered into a Research and Development and Technological Cooperation Agreement with an affiliate of Enel (the R&D Agreement). Under the terms of the R&D Agreement, the Company cooperated with Enel to integrate LonWorks technology into Enel s remote metering management project in Italy, the Contatore Elettronico. The Company completed the sale of its components and products for the deployment phase of the Contatore Elettronico project during 2005. During 2006, the Company supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, the Company entered into a new development and supply agreement and a software enhancement agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers may purchase additional electronic components and finished goods from Echelon. Under the software enhancement agreement, the Company provides software enhancements to Enel for use in its Contatore Elettronico system. The development and supply agreement expires in December 2011, and the software enhancement agreement expires in December 2009, although delivery of products and services can extend beyond those dates and the agreements may be extended under certain circumstances.

For the three months ended September 30, 2008 and 2007, the Company recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $5.5 million and $3.0 million, respectively. For the nine months ended September 30, 2008 and 2007, the Company recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $8.4 million and $8.0 million, respectively. As of September 30, 2008, and December 31, 2007, $3.7 million and $3.0 million, respectively, of the Company s total accounts receivable balance related to amounts owed by Enel and its designated manufacturers.

13. Subsequent Event

On October 27, 2008, the Company announced to its employees its intent to offer employees a voluntary employee stock option exchange program (the Exchange Program), whereby eligible employees will have an opportunity to exchange some or all of their outstanding stock options or stock appreciation rights (the Surrendered Awards) for a predetermined number of new stock appreciation rights (the Replacement Awards). Non-employee members of the Company s Board of Directors will not be eligible to participate in the Exchange Program.

The Company has not yet finalized the terms of the Exchange Program, although it is expected that: 1) the grant date for the Replacement Awards will be the last day of the Exchange Program; 2) depending on the exercise price of the Surrendered Awards, employees may receive fewer Replacement Awards; 3) the term of the Replacement Awards may be different from the term of the Surrendered Awards; and 4) the vesting for the Replacement Awards will restart on the grant date. The Company currently anticipates that the Exchange Program will be concluded during the quarter ending December 31, 2008.

Under SFAS No. 123R, *Share Based Payment*, to the extent that the fair value of the Replacement Awards exceeds the fair value of the Surrendered Awards at the date of completion of the Exchange Program, the incremental fair value would be recognized as additional expense over the vesting term of the Replacement Awards. The Company would also continue to amortize previously unrecognized expense related to the fair value of the Surrendered Awards at their original date of grant.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this Quarterly Report. The following discussion contains predictions, estimates, and other forward-looking statements that involve a number of risks and uncertainties about our business. These statements may be identified by the use of words such as we believe, expect, anticipate, intend, plan, goal, continues, may, and similar expressions. In addition, forward-looking statements include statements that refer to projections of our future financial performance, our anticipated growth and trends in our businesses, and other characterizations of future events or circumstances. Such statements are based on our current expectations and could be affected by the uncertainties and risk factors described throughout this filing and particularly in the Factors That May Affect Future Results Of Operations section. Our actual results may differ materially.

Overview

Echelon Corporation was incorporated in California in February 1988 and reincorporated in Delaware in January 1989. We are based in San Jose, California, and maintain offices in ten foreign countries throughout Europe and Asia. We develop, market, and sell system and network infrastructure products that enable everyday devices such as air conditioners, appliances, electricity meters, light switches, thermostats, and valves to be made smart and inter-connected. Working together, products and systems equipped with our technology can monitor and save energy, lower costs, improve productivity and enhance service, quality, safety and convenience. We offer these hardware and software products and related services to OEMs and systems integrators in the building, industrial, transportation, utility/home, and other automation markets.

We have been investing in products for use by electricity utilities for use in management of electricity distribution. We began to receive modest amounts of revenue resulting from these investments in 2004, which grew to approximately $883,000 in 2005, decreased slightly to $791,000 in 2006, grew substantially to $70.6 million in 2007, and totaled $46.5 million for the first nine months of 2008. We refer to this revenue as networked energy services, or NES, revenue. We sell certain of our products to Enel and certain suppliers of Enel for use in Enel s Contatore Elettronico electricity meter management project in Italy. We refer to Echelon s revenue derived from sales to Enel and Enel s designated manufacturers as Enel Project revenue. We refer to all other revenue as LonWorks Infrastructure, or LWI, revenue. We also provide a variety of technical training courses related to our products and the underlying technology. Some of our customers also rely on us to provide customer support on a per-incident or term contract basis.

We have a history of losses and, although we achieved profitability in past fiscal periods, we incurred a loss for the years ended December 31, 2007, 2006, and 2005. We also expect to incur an operating loss in 2008.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. Note 1 Significant Accounting Policies of Notes to Consolidated Financial Statements in our Annual Report on Form 10-K/A for the year ended December 31, 2007, which we filed with the Securities and Exchange Commission in May 2008, describes the significant accounting policies and methods used in the preparation of our consolidated financial statements. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to our stock-based compensation, allowance for doubtful accounts, inventories, and commitments and contingencies. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies and estimates relate to those policies that are most important to the presentation of our consolidated financial statements and require the most difficult, subjective and complex judgments.

Revenue Recognition. Our revenues are derived from the sale and license of our products and to a lesser extent, from fees associated with training, technical support, and custom software design services offered to our customers. Product revenues consist of revenues from hardware sales and software licensing arrangements. Service revenues consist of product technical support (including software post-contract support services), training, and custom software development services.

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, collectibility is probable, and there are no post-delivery obligations. For hardware sales, including sales to third party manufacturers, these criteria are generally met at the time of shipment. For sales made to our distributor partners, these criteria are generally met at the time the distributor sells the products through to its end-use customer. For software licenses, these criteria are generally met upon shipment to the final end-user.

In most instances involving large-scale deployments, our Networked Energy Services (NES) System products are sold as part of multiple element arrangements as that term is defined under AICPA Statement of Position 97-2 (SOP 97-2), *Software Revenue Recognition*, as amended. These arrangements may include electricity meters and data concentrators (collectively, the Hardware); NES System software, for which a royalty is charged on a per-meter basis; post-contract customer support (PCS) for the NES System software; and extended warranties for the Hardware. These arrangements may require us to deliver Hardware over an extended period of time. In accordance with SOP 97-2, when the multiple element arrangement includes NES System software, we defer the recognition of all revenue until all software required under the arrangement has been delivered to the customer. Once the software has been delivered, we recognize revenues for the Hardware and NES System software royalties upon customer acceptance of the Hardware based on a constant ratio of meters to data concentrators, which is determined on a contract-by-contract basis. To the extent actual deliveries of either meters or data concentrators is disproportionate to the expected overall ratio for any given arrangement, revenue for the excess meters or data concentrators is deferred until such time as additional deliveries of meters or data concentrators has occurred. We have established vendor specific objective evidence for the PCS on the NES System software, as well as for extended warranties on our NES Hardware products, based on stated renewal rates. These revenues are recognized ratably over the associated service period, which generally commences upon the latter of the delivery of all software, or the customer s acceptance of any given Hardware shipment.

We account for the rights of return, price protection, rebates, and other sales incentives offered to distributors of our products in accordance with Statement of Financial Accounting Standards (SFAS) No. 48, *Revenue Recognition When Right of Return Exists,* and EITF Issue No. 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products).*

Stock-Based Compensation. Effective January 1, 2006, we adopted the provisions of and account for stock-based compensation in accordance with SFAS 123R. We elected the modified-prospective method, under which prior periods are not revised for comparative purposes. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the estimated fair value of the award and is recognized as expense ratably over the requisite service period, which is the vesting period.

We currently use the Black-Scholes-Merton (BSM) option-pricing model to estimate the fair value of stock options. The estimation of fair value of share-based payment awards on the date of grant using the BSM option-pricing model is affected by the fair market value of our stock on the date of grant, as well as a number of highly complex and subjective variables. These variables include the expected term of the option, the expected volatility of our stock price over the expected term of the option, risk-free interest rates, and expected dividends.

The expected term of the option is based on historical experience and on the terms and conditions of the stock awards granted to employees. The expected volatility is based on the implied volatility of market traded options on our common stock, adjusted for other relevant factors including historical volatility of our common stock over the most recent period commensurate with the estimated expected term of the options granted to employees. We base the risk-free interest rate that we use in the BSM option-pricing model on U.S. Treasury issues in effect at the time of option grant that have remaining terms similar to the expected term of the option. We have never paid cash dividends on our common stock, and do not anticipate paying cash dividends in the foreseeable future. Therefore, we use an expected dividend yield of zero in the BSM option-pricing model.

SFAS 123R also requires us to record compensation expense for stock-based compensation net of estimated forfeitures, and to revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. All share-based payment awards are amortized using the multiple option method over their requisite service period, which is generally the vesting period.

Certain of the stock-based compensation awards we issue vest upon the achievement of specific financial-based performance requirements. SFAS 123R requires us to estimate whether or not it is probable that these financial-based performance requirements will be met, and, in some cases, when they will be met. These estimates of future financial performance are based on the best information available at the time of grant, and each quarterly period thereafter until the awards are either earned or forfeited. Any changes we make to our estimates of future financial performance could have a material impact on the amount and timing of compensation expense associated with these awards.

There are significant differences among valuation models, and there is a possibility that we will adopt different valuation models in the future. This may result in a lack of consistency in future periods and may materially affect the estimated fair value of stock-based payments. It may also result in a lack of comparability with other companies that use different models, methods, and assumptions. The BSM option-pricing model was developed for use in estimating the fair value of traded options that have no vesting or hedging restrictions and that are fully transferable, characteristics that are not present in our option grants.

If factors change and we employ different assumptions for estimating stock-based compensation expense in future periods, or if we decide to use a different option-pricing model, stock-based compensation expense in those future periods may differ significantly from what we have recorded in the current period and could materially affect our operating results.

Allowance for Doubtful Accounts. We typically sell our products and services to customers with net 30-day payment terms. In certain instances, payment terms may extend to as much as approximately net 90 days. For a customer whose credit worthiness does not meet our minimum criteria, we may require partial or full payment prior to shipment. Alternatively, customers may be required to provide us with an irrevocable letter of credit prior to shipment.

We evaluate the collectibility of our accounts receivable based on a combination of factors. In circumstances where we are aware of a specific customer s inability to meet its financial obligations to us, we record a specific allowance against amounts due to reduce the net recognized receivable to the amount we reasonably believe will be collected. These determinations are made based on several sources of information, including, but not limited to, a specific customer s payment history, recent discussions we have had with the customer, updated financial information for the customer, and publicly available news related to that customer. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are past due, the current business environment, the credit worthiness of our overall customer base, changes in our customers payment patterns, and our historical experience. If the financial condition of our customers were to deteriorate, or if general economic conditions worsened, additional allowances may be required in the future, which could materially impact our results of operations and financial condition. Our allowance for doubtful accounts was $313,000 as of September 30, 2008, and $330,000 as of December 31, 2007.

Inventory Valuation. At each balance sheet date, we evaluate our ending inventories for excess quantities and obsolescence. In general, the evaluation for excess quantities includes analyses of historical sales levels by product and projections of future demand. Inventories on hand in excess of one year s forecasted demand are generally deemed to be excess.

In performing the excess inventory analysis, management considers factors that are unique to each of our NES and LWI product lines. For our NES products, the analysis requires us to consider that NES customers procure specific meter types that meet their requirements. In other words, any given customer will buy a meter that is custom to their specifications. Accordingly, management must make significant judgments not only as to which customers will buy how many meters (and associated data concentrators), but also which meter type(s) each customer will buy. In making these judgments, management uses the best sales forecast information available at the time. However, because future sales volumes for any given customer opportunity have the potential to be significant, actual results could be materially different from original estimates. This could increase our exposure to excess inventory for which we would need to record a reserve, thereby resulting in a potentially material negative impact to our operating results.

For our LWI products, our customers generally buy from a portfolio of off-the-shelf or standard products. In addition, whereas for our NES customers our revenues are attributable to a relatively few customers buying substantial quantities of any given product, our LWI revenues are composed of a larger volume of smaller dollar transactions. Accordingly, while any single LWI customer s demand for a given product may fluctuate from quarter to quarter, the fact that there are so many LWI customers buying a standard product tends to average out increases or decreases in any individual customer s demand. This has historically resulted in a relatively stable future demand forecast for our LWI products, which management evaluates in determining its requirement for an excess inventory reserve.

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In addition to providing a reserve for excess inventories, we also do not value inventories that we consider obsolete. We consider a product to be obsolete when one of several factors exists. These factors include, but are not limited to, our decision to discontinue selling an existing product, the product has been re-designed and we are unable to rework our existing inventory to update it to the new version, or our competitors introduce new products that make our products obsolete.

We adjust remaining inventory balances to approximate the lower of our cost or market value. If future demand or market conditions are less favorable than our projections, additional inventory write-downs may be required and would be reflected in cost of sales in the period the revision is made.

Warranty Reserves. We evaluate our reserve for warranty costs based on a combination of factors. In circumstances where we are aware of a specific warranty related problem, for example a product recall, we reserve an estimate of the total out-of-pocket costs we expect to incur to resolve the problem, including, but not limited to, costs to replace or repair the defective items and shipping costs. When evaluating the need for any additional reserve for warranty costs, management takes into consideration the term of the warranty coverage, the quantity of product in the field that is currently under warranty, historical warranty-related return rates, historical costs of repair, and knowledge of new products introduced. If any of these factors were to change materially in the future, we may be required to increase our warranty reserve, which could have a material negative impact on our results of operations and our financial condition. Our reserve for warranty costs was $603,000 as of September 30, 2008, and $301,000 as of December 31, 2007.

RESULTS OF OPERATIONS

The following table reflects the percentage of total revenues represented by each item in our Condensed Consolidated Statements of Operations for the three and nine months ended September 30, 2008 and September 30, 2007:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Revenues:				
Product	97.9%	96.0%	97.7%	98.4%
Service	2.1	4.0	2.3	1.6
Total revenues	100.0	100.0	100.0	100.0
Cost of revenues:				
Cost of product	53.3	56.7	58.6	63.9
Cost of service	2.0	2.9	2.0	1.9
Total cost of revenues	55.3	59.6	60.6	65.8
Gross profit	44.7	40.4	39.4	34.2
Operating expenses:				
Product development	32.9	31.6	29.0	26.2
Sales and marketing	19.2	19.8	18.3	16.8
General and administrative	12.7	16.1	13.4	12.9
Total operating expenses	64.8	67.5	60.7	55.9
Loss from operations	(20.1)	(27.1)	(21.3)	(21.7)
Interest and other income, net	3.9	5.6	2.4	4.8
Interest expense on lease financing obligations	(1.5)	(1.2)	(1.0)	(1.0)
Loss before provision for income taxes	(17.7)	(22.7)	(19.9)	(17.9)
Income tax expense	0.5	0.4	0.2	0.4

Net loss	(18.2%)	(23.1%)	(20.1%)	(18.3%)

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Revenues

Total Revenues

(Dollars in thousands)	Three Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
Total revenues	$ 29,500	$ 24,713	$ 4,787	19.4%

(Dollars in thousands)	Nine Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
Total revenues	$ 97,252	$ 90,678	$ 6,574	7.2%

The $4.8 million increase in total revenues for the three months ended September 30, 2008 as compared to the same period in 2007 was primarily the result of a $2.4 million increase in Enel Project revenues, a $1.6 million increase in LWI revenues, and a $746,000 increase in NES revenues. The $6.6 million increase in total revenues for the nine months ended September 30, 2008 as compared to the same period in 2007 was primarily the result of a $3.6 million increase in NES revenues, a $2.6 million increase in LWI revenues, and a $361,000 increase in Enel Project revenues.

NES revenues

(Dollars in thousands)	Three Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
NES revenues	$ 9,370	$ 8,624	$ 746	8.7%

(Dollars in thousands)	Nine Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
NES revenues	$ 46,510	$ 42,896	$ 3,614	8.4%

NES revenues generated during the three and nine month periods ended September 30, 2008 and 2007 were primarily related to large scale deployments of our NES system products.

Of the $42.9 million of NES revenue reported for the nine months ended September 30, 2007, approximately $14.4 million related to shipments of hardware products that were accepted by our customers and, in some cases paid for, in 2006. However, we could not record this revenue in 2006 since we had not yet met all of the required criteria for revenue recognition. As of September 30, 2008, approximately $8.1 million of NES revenue was deferred. This revenue will be recognized in future periods once all of the required criteria for revenue recognition have been met.

We expect that, during 2008, shipments of our NES products will remain relatively consistent with 2007 levels. Our ability to recognize revenue on these shipments depends on several factors, including, but not limited to, delivery to the customer of all of the software called for in any given agreement, the impact on delivery dates of any modifications to existing shipment schedules included in the contracts that have been awarded to us thus far, and certain contractual provisions, such as customer acceptance. In addition, the complex revenue recognition rules relating to products such as our NES system will likely require us to defer some or all of the revenue associated with NES product shipments until certain conditions are met in a future period. For example, once all other revenue recognition criteria have been met, we recognize revenues for the meters (and related NES System software royalties) and data concentrators based on a constant ratio of meters to data concentrators, which is determined on a contract-by-contract basis. To the extent actual deliveries of either meters or data concentrators is disproportionate to the expected overall ratio for any given arrangement, revenue for the excess meters or data concentrators is deferred until such time as additional deliveries of meters or data concentrators has occurred. In some instances, the reasons for these deferrals may not be fully under our control, which could result in the actual timing of revenue being significantly different than we currently anticipate.

We also expect that some foreign utilities will require us to price our NES system in the respective utility s local currency, which will expose us to foreign currency risk. For the nine months ended September 30, 2008, the portion of our NES revenues conducted in currencies other than the U.S. dollar, principally the European Euro and the Australian dollar, was about $194,000, or 0.4%. For the nine months ended September 30, 2007, the portion of our NES revenues conducted in currencies other than the U.S. dollar, principally the Australian dollar, was about $298,000, or 0.7%. In most cases, in the event of a significant contract award, we intend to hedge this foreign currency risk so long as we can secure forward currency contracts that are reasonably priced and that are consistent with the scheduled deliveries for that project. In addition, we will face foreign currency exposures from the time we submit our foreign currency denominated bid until the award of a contract by the utility (the bid to award term). This bid to award term can often exceed several months. If a utility awards us a contract that gives the utility the right to exercise options for additional supply in the future, we would also be exposed to foreign currency risk until such time as these options, if any, were exercised. We may decide that it is too expensive to hedge the foreign currency risks during the bid to award term or for any unexercised options. Any resulting adverse foreign currency fluctuations could significantly harm our revenues, results of operations, and financial condition.

LonWorks Infrastructure revenues

(Dollars in thousands)	Three Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
LonWorks Infrastructure revenues	$ 14,660	$ 13,054	$ 1,606	12.3%

(Dollars in thousands)	Nine Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
LonWorks Infrastructure revenues	$ 42,358	$ 39,759	$ 2,599	6.5%

Our LWI revenues are primarily comprised of sales of our hardware and software products, and to a lesser extent, revenues we generate from our customer support and training offerings. Both the $1.6 million increase in LWI revenue for the three months ended September 30, 2008 as compared to the same period in 2007, and the $2.6 million increase for the nine months ended September 30, 2008 as compared to the same period in 2007, was primarily due to increases in LWI revenues in the EMEA and Americas regions, slightly offset by a reduction in sales in the APJ region. Within the LWI family of products, the quarterly and nine month increases were primarily attributable to increases in our power line transceiver and i.Lon products, partially offset by a reduction in sales of our development tool and network services products.

Although worldwide economic conditions have deteriorated significantly in recent months, we currently believe our LWI revenues will grow modestly in 2008 as compared to the $52.8 million we reported in 2007. However, within any given region, revenue growth may fluctuate up or down. In addition, the expected improvement in 2008 LWI revenues will also be subject to further fluctuations in the exchange rates between the United States dollar and the foreign currencies in which we sell our LWI products and services. In general, if the dollar were to weaken against these currencies, our revenues from those foreign currency sales, when translated into United States dollars, would increase. Conversely, if the dollar were to strengthen against these currencies, our revenues from those foreign currency sales, when translated into United States dollars, would decrease. The extent of this exchange rate fluctuation increase or decrease will depend on the amount of sales conducted in these currencies and the magnitude of the exchange rate fluctuation from year to year. The portion of our LWI revenues conducted in currencies other than the U.S. dollar, principally the Japanese Yen, was about 5.2% for the nine months ended September 30, 2008 and 6.9% for the same period in 2007. We do not currently expect that, during the remainder of 2008, the amount of our LWI revenues conducted in these foreign currencies will fluctuate significantly from prior year levels. Given the historical and expected future level of sales made in foreign currencies, we do not currently plan to hedge against these currency rate fluctuations. However, if the portion of our revenues conducted in foreign currencies were to grow significantly, we would re-evaluate these exposures and, if necessary, enter into hedging arrangements to help minimize these risks.

Enel Project revenues

(Dollars in thousands)	Three Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
Enel Project revenues	$ 5,470	$ 3,036	$ 2,434	80.2%

(Dollars in thousands)	Nine Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
Enel Project revenues	$ 8,384	$ 8,023	$ 361	4.5%

In October 2006, we entered into two new agreements with Enel, a development and supply agreement and a software enhancement agreement. Under the development and supply agreement, Enel is purchasing additional metering kit and data concentrator products from us. Under the software enhancement agreement, we are providing software enhancements to Enel for use in its Contatore Elettronico system. The $5.5 million and $3.0 million of Enel project revenue recognized during the three months ended September 30, 2008 and 2007, respectively, and the

$8.4 million and $8.0 million of Enel project revenues recognized during the nine months ended September 30, 2008 and 2007, respectively, related primarily to shipments under the new development and supply agreement, and to a lesser extent, from revenues attributable to the software enhancement agreement. The development and supply agreement expires in December 2011, and the software enhancement agreement expires in December 2009, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances.

We sell our products to Enel and its designated manufacturers in U.S. dollars. Therefore, the associated revenues are not subject to foreign currency risks.

We currently expect that our full year 2008 Enel Project revenues will decrease from the $14.2 million reported in 2007, due primarily to a reduction in the number of metering kits we expect to ship to Enel and its designated meter manufacturers during 2008.

EBV revenues

	Three Months Ended September 30,		2008 over 2007 $	2008 over 2007 %
(Dollars in thousands)	**2008**	**2007**	**Change**	**Change**
EBV revenues	$ 5,343	$ 4,340	$ 1,003	23.1%

	Nine Months Ended September 30,		2008 over 2007 $	2008 over 2007 %
(Dollars in thousands)	**2008**	**2007**	**Change**	**Change**
EBV revenues	$ 15,967	$ 13,348	$ 2,619	19.6%

Sales to EBV, our largest distributor and the sole independent distributor of our products in Europe, accounted for 18.1% of our total revenues for the three months ended September 30, 2008 and 17.6% of our total revenues for the comparable period in 2007; and 16.4% of our total revenues for the nine months ended September 30, 2008 and 14.7% for the comparable period in 2007. The primary factor contributing to the $1.0 million increase between the two quarters and the $2.6 million increase between the two nine month periods was an increase in sales of our control and connectivity transceiver products.

We currently sell our products to EBV in U.S. dollars. Therefore, the associated revenues are not subject to foreign currency exchange rate risks. However, EBV has the right, on notice to our company, to require that we sell our products to them in Euros.

Our contract with EBV, which has been in effect since 1997 and to date has been renewed annually thereafter, expires in December 2008. If our agreement with EBV is not renewed, or is renewed on terms that are less favorable to us, our revenues could decrease and our results of operations and financial condition could be harmed.

Product revenues

	Three Months Ended September 30,		2008 over 2007 $	2008 over 2007 %
(Dollars in thousands)	**2008**	**2007**	**Change**	**Change**
Product revenues	$ 28,875	$ 23,733	$ 5,142	21.7%

	Nine Months Ended September 30,		2008 over 2007 $	2008 over 2007 %
(Dollars in thousands)	**2008**	**2007**	**Change**	**Change**
Product revenues	$ 95,008	$ 89,247	$ 5,761	6.5%

The $5.1 million increase in product revenues for the three months ended September 30, 2008 as compared to the same period in 2007 was primarily the result of a $2.9 million increase in Enel project product revenues, a $1.7 million increase in LWI product revenues, and a $477,000 increase in NES product revenues. The $5.8 million increase in product revenues for the nine months ended September 30, 2008 as compared to the same period in 2007 was primarily the result of a $2.7 million increase in NES product revenues, a $2.7 million increase in LWI product revenues, and a $303,000 increase in Enel project product revenues.

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Service revenues

(Dollars in thousands)	Three Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
Service revenues	$ 625	$ 980	$ (355)	(36.2%)

(Dollars in thousands)	Nine Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
Service revenues	$ 2,244	$ 1,431	$ 813	56.8%

The $355,000 decrease in service revenues during the three months ended September 30, 2008 as compared to the same period in 2007 was primarily due to a $495,000 decrease in custom software development revenues generated from the Enel project and a $130,000 decrease in LWI customer support and training revenues, partially offset by a $270,000 increase in NES support revenues. The $813,000 increase in service revenues during the nine months ended September 30, 2008 as compared to the same period in 2007 was primarily due to an $898,000 increase in NES support revenues and a $58,000 increase in custom software development revenues generated from the Enel project, partially offset by a $143,000 decrease in LWI customer support and training revenues.

Gross Profit and Gross Margin

(Dollars in thousands)	Three Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
Gross Profit	$ 13,193	$ 9,987	$ 3,206	32.1%
Gross Margin	44.7%	40.4%		4.3

(Dollars in thousands)	Nine Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
Gross Profit	$ 38,274	$ 30,999	$ 7,275	23.5%
Gross Margin	39.4%	34.2%		5.2

Gross profit is equal to revenues less cost of goods sold. Cost of goods sold for product revenues includes direct costs associated with the purchase of components, subassemblies, and finished goods, as well as indirect costs such as allocated labor and overhead; costs associated with the packaging, preparation, and shipment of products; and charges related to warranty and excess and obsolete inventory reserves. Cost of goods sold for service revenues consists of employee-related costs such as salaries and fringe benefits as well as other direct and indirect costs incurred in providing training, customer support, and custom software development services. Gross margin is equal to gross profit divided by revenues.

The 4.3 and 5.2 percentage point increases in gross margin during the three and nine months ended September 30, 2008, as compared to the same periods in 2007, were due to several factors. Favorably impacting gross margins during 2008 was the impact of improved gross margins in our NES product line. During the first nine months of 2007, our NES revenues were primarily generated from sales of earlier versions of our NES products. These older versions were generally more expensive to manufacture. In late 2007, we began shipping more recent, cost reduced versions of our NES products that, when sold at approximately the same price as the earlier versions, yield higher gross margins. As our 2008 NES revenues were generated primarily from sales of these newer, cost reduced NES products, the gross margin attributable to our NES revenues improved.

Also contributing to the fluctuation in gross margins for the periods presented was the impact of fluctuating total revenue levels. As discussed above, a portion of our cost of goods sold relates to indirect costs. Some of these costs do not increase or decrease in conjunction with revenue levels, but rather remain relatively constant from quarter to quarter. As a result, when revenues increase, as they did in the three and nine months ended September 30, 2008 as compared to the same periods in 2007, gross margins are favorably impacted.

Our gross margin for the three and nine months ended September 30, 2008 was negatively impacted by excess and obsolete inventory reserves we recorded during the quarter ended September 30, 2008. These additional reserves were primarily attributable to excess raw material inventory we purchased from our former contract electronic manufacturer (CEM), WKK (see further discussion below). As mentioned in our discussion of Critical Accounting Estimates above, reserves for excess and obsolete inventory are highly subjective and complex, and are based on management s best estimate of future demand at each reporting date. To the extent actual demand differs from these estimates, additional reserves could be required in the future, which could have a material negative effect on our results of operations. For example, we have not provided an excess and obsolete inventory reserve against approximately $600,000 worth of raw material inventory used to manufacture a particular version of one of our older generation NES meters because we currently expect we will receive orders to ship those meters. If those orders do not materialize, we would be required to provide additional excess and obsolete inventory reserves against the unused portion of the $600,000 of raw material inventory.

Lastly, during the quarter ended June 30, 2008, our inventory levels increased substantially as a result of our transition between CEMs. Much of this inventory remained on our balance sheet as of September 30, 2008. As a result, the amount of indirect overhead spending that was capitalized in inventory as of September 30, 2008 was higher than what was capitalized as of September 30, 2007. This had the effect of improving gross margin as those costs would otherwise have been expensed during the respective periods. We expect our inventory levels to decrease modestly during the remainder of 2008, which will result in the reduction of capitalized overhead in inventory. When this occurs, it will cause gross margin rates to decrease.

We expect that, for the full year ending December 31, 2008, our gross margins will improve modestly from the 36.5% recorded in 2007. As previously discussed, during the first nine months of 2008, our gross margins have been favorably affected by increased sales of the more recent, cost reduced versions of our NES products and higher than normal capitalized indirect overhead balances. However, there are several other factors that have had, and we expect could continue to have, a negative impact on gross margins. Among those other factors are the transition we undertook earlier this year to move our product manufacturing from WKK Technology to alternative CEMs in Asia. As noted above, this effort has required us to purchase inventory from WKK that WKK procured in anticipation of our production requirements, and resell that inventory to the new CEMs as they require it. This process has resulted in historically high inventory levels, and has also increased our exposure to excess and obsolete inventories, for which we have provided additional reserves during the third quarter of 2008. To the extent we identify additional excess and obsolete inventories in the future, we will be required to provide a reserve against them, which will reduce our gross margins. In addition, the impact of foreign exchange rate fluctuations may also continue to affect our gross margins in the future. We currently outsource the manufacturing of most of our products requiring assembly to CEMs located in China. To the extent the dollar were to weaken against the Chinese currency, or other currencies used by our CEMs, our costs for the products they manufacture could rise, which would negatively affect our gross margins. Lastly, many of our products, particularly our NES products, contain significant amounts of certain commodities, such as copper and cobalt. Recently, prices for these commodities have been very volatile, which in turn has in some cases increased the prices we pay for the products in which they are incorporated.

Operating Expenses

Product Development

(Dollars in thousands)	Three Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
Product Development	$ 9,713	$ 7,820	$ 1,893	24.2%

(Dollars in thousands)	Nine Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
Product Development	$ 28,151	$ 23,716	$ 4,435	18.7%

Product development expenses consist primarily of payroll and related expenses for development personnel, fees paid to third party consultants, facility costs, equipment and supplies, depreciation and amortization, and other costs associated with the development of new technologies and products.

The $1.9 million and $4.4 million increases in product development expenses for the three and nine month periods ended September 30, 2008 as compared to the same periods in 2007 were primarily due to increases of $1.1 million and $2.7 million, respectively, in non-cash equity compensation expenses for our product development personnel. Also contributing to the increase between the two quarterly periods were additional cash based compensation expenses resulting from an increase in our development personnel headcount. Contributing additionally to the increase between the two nine month periods were additional cash based compensation expenses, partially offset by reductions in fees paid to third party service providers, and equipment and supplies used in the development process.

We expect that, for full year 2008, product development expenses will increase over 2007 levels. This increase will primarily be the result of increased development efforts related to our NES system products as well as increased equity and other compensation related expenses.

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Sales and Marketing

(Dollars in thousands)	Three Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
Sales and Marketing	$ 5,653	$ 4,884	$ 769	15.7%

(Dollars in thousands)	Nine Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
Sales and Marketing	$ 17,820	$ 15,279	$ 2,541	16.6%

Sales and marketing expenses consist primarily of payroll and related expenses for sales and marketing personnel, including commissions to sales personnel, travel and entertainment, facilities costs, advertising and product promotion, and other costs associated with our sales and support offices.

The $769,000 increase in sales and marketing expenses for the three months ended September 30, 2008 as compared to the same period in 2007 was primarily due to an $820,000 increase in compensation and related expenses (including a $358,000 increase in non-cash equity compensation expense). The $2.5 million increase in sales and marketing expenses for the nine months ended September 30, 2008 as compared to the same period in 2007 was primarily due to a $2.1 million increase in compensation and related expenses (including a $1.1 million increase in non-cash equity compensation expense), and to a lesser extent, increases in facilities costs and fees paid to third party service providers.

Also contributing to the increases between the three and nine month periods was the impact of foreign currency exchange rate fluctuations between the U.S. dollar and the local currencies in several of the foreign countries in which we operate, including the Euro, the British Pound Sterling, and the Japanese Yen. Approximately $110,000 of the $769,000 increase between the two quarterly periods, and $528,000 of the $2.5 million increase between the two nine month periods, was the result of these foreign currency exchange rate fluctuations.

We expect that, during 2008, our sales and marketing expenses will increase over 2007 levels due in part to increased commissions paid to our sales personnel as well as higher equity compensation expenses. In addition, if the United States dollar were to weaken against the foreign currencies where we operate, our sales and marketing expenses could increase further. Conversely, if the dollar were to strengthen against these currencies, it would have a favorable impact on our sales and marketing expenses.

General and Administrative

(Dollars in thousands)	Three Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
General and Administrative	$ 3,761	$ 3,976	$ (215)	(5.4%)

(Dollars in thousands)	Nine Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
General and Administrative	$ 12,997	$ 11,707	$ 1,290	11.0%

General and administrative expenses consist primarily of payroll and related expenses for executive, finance, and administrative personnel, professional fees for legal and accounting services rendered to the company, facility costs, insurance, and other general corporate expenses.

The $215,000 decrease in general and administrative expenses during the three months ended September 30, 2008 as compared to the same period in 2007 was primarily attributable to a $217,000 decrease in facility costs resulting from the June 2008 lease extension for our headquarters facility in San Jose, California and a $126,000 reduction in fees paid for third party service providers, including accounting and legal fees. Partially offsetting these decreases was a $122,000 increase in travel and entertainment expenses. The $1.3 million increase in general and administrative expenses during the nine months ended September 30, 2008 was primarily attributable to a $1.3 million increase in non-cash equity compensation expenses.

We believe that, for full year 2008, general and administrative costs will increase above 2007 levels due primarily to increased equity compensation expenses.

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Interest and Other Income, Net

(Dollars in thousands)	Three Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
Interest and Other Income, Net	$ 1,141	$ 1,381	$ (240)	(17.4%)

(Dollars in thousands)	Nine Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
Interest and Other Income, Net	$ 2,319	$ 4,366	$ (2,047)	(46.9%)

Interest and other income, net primarily reflects interest income earned by our company on cash and short-term investment balances. In addition, foreign exchange translation gains and losses related to short-term intercompany balances are also reflected in this amount.

The $240,000 and $2.0 million decreases in interest and other income, net during the three and nine month periods ended September 30, 2008 as compared to the same periods in 2007 was primarily attributable to a $1.1 million and $2.7 million, respectively, decrease in interest income. The reduction in interest income is primarily the result of a reduction in our average invested cash balance between the periods coupled with reductions in the weighted average yield on our investment portfolio.

Partially offsetting the reductions in interest income for both the three and nine month periods ended September 30, 2008 as compared to the same periods in 2007 were increases in foreign currency translation gains of $814,000 and $583,000, respectively. In accordance with SFAS No. 52, *Foreign Currency Translation*, we account for foreign currency translation gains and losses associated with our short-term intercompany balances by reflecting these amounts as either other income or loss in our consolidated statements of operations. During periods when the U.S. dollar weakens in value against these foreign currencies, the associated translation losses negatively impact other income. Conversely, when the U.S. dollar strengthens, as it did during the third quarter of 2008, the resulting translation gains favorably impact other income.

We expect that, for full year 2008, interest and other income, net will decrease significantly from the $5.7 million reported for 2007. This expected decrease is primarily attributable to our current belief that the average yield on our investment portfolio will decline significantly as a result of the continued reductions in short-term interest rates. In addition, future fluctuations in the exchange rates between the United States dollar and the currencies in which we maintain our short-term intercompany balances (principally the European Euro and the British Pound Sterling) will also affect our interest and other income, net.

Interest Expense on Lease Financing Obligations

(Dollars in thousands)	Three Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
Interest Expense on Lease Financing Obligations	$ 435	$ 297	$ 138	46.5%

(Dollars in thousands)	Nine Months Ended September 30, 2008	2007	2008 over 2007 $ Change	2008 over 2007 % Change
Interest Expense on Lease Financing Obligations	$ 974	$ 924	$ 50	(5.4%)

In December 1999 and October 2000, we entered into two separate lease agreements with a local real estate developer for the two buildings we currently occupy at our San Jose headquarters site. The terms of these leases were extended in June 2008. As discussed in Note 3 of Notes to Condensed Consolidated Financial Statements in Item 1 of this Report, we have accounted for these leases in accordance with EITF 97-10 and SFAS 98. The application of this accounting literature causes Echelon to be considered the deemed owner of the two buildings for accounting purposes only.

Accordingly, we initially recorded assets and corresponding financing liabilities for an amount equal to these lessor paid construction costs. As a result of the lease extension in June 2008, we adjusted the lease financing liabilities to equal the present value of the new lease payments we are obligated to make, with a corresponding increase to the net book value of the building assets. The monthly rent payments we make to our lessor under our lease agreements are recorded in our financial statements as land lease expense and principal and interest on the lease financing obligations. Interest expense on lease financing obligations reflects the portion of our monthly lease payments that is allocated to interest expense.

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We expect that, during 2008, interest expense on lease financing obligations will increase from the amounts reported for 2007. As with any amortizing fixed rate loan, payments made earlier in the term of the loan are comprised primarily of interest expense with little being allocated to principal repayment. Payments made later in the term of the loan, however, have an increasing proportion of principal repayment, with less being attributable to interest expense. As a result of the June 2008 lease extension, we will now be making payments against a new lease financing obligation balance. Accordingly, a higher percentage of the post-lease extension payments we make in 2008 will be allocated to interest expense and less will be allocated to principal repayment.

Provision for Income Taxes

	Three Months Ended September 30,		2008 over 2007 $	2008 over 2007 %
(Dollars in thousands)	2008	2007	Change	Change
Provision for Income Taxes	$ 136	$ 108	$ 28	25.9%

	Nine Months Ended September 30,		2008 over 2007 $	2008 over 2007 %
(Dollars in thousands)	2008	2007	Change	Change
Provision for Income Taxes	$ 230	$ 323	$ (93)	(28.8%)

The provision for income taxes for the three months ended September 30, 2008 and 2007 was $136,000 and $108,000, respectively. The provision for income taxes for the nine month periods ended September 30, 2008 and 2007 was $230,000 and $323,000, respectively. The difference between the statutory rate and our effective tax rate is primarily due to the impact of foreign taxes, changes in the valuation allowance on deferred tax assets, and changes in the accruals related to unrecognized tax benefits recorded in accordance with FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109*.

Although we expect to generate a loss before provision for income taxes in 2008, we will be required to book income tax expense to cover, at a minimum, the foreign taxes owed on income generated by our profitable foreign subsidiaries and various state minimum taxes. We currently expect our 2008 provision for income taxes will be modestly higher than the amounts provided for in 2007.

OFF-BALANCE-SHEET ARRANGEMENTS AND OTHER CONTRACTUAL OBLIGATIONS

Off-Balance-Sheet Arrangements. We have not entered into any transactions with unconsolidated entities whereby we have financial guarantees, subordinated retained interests, derivative instruments, or other contingent arrangements that expose Echelon to material continuing risks, contingent liabilities, or any other obligation under a variable interest in an unconsolidated entity that provides financing, liquidity, market risk, or credit risk support to us.

Lease Commitments. We lease our present corporate headquarters facility in San Jose, California, under two non-cancelable leases, each of which expires in March 2020. Upon expiration, both lease agreements provide for extensions of up to ten years. The leases of our corporate headquarters facilities are accounted for under EITF 97-10 and SFAS 98 (see Note 3 of Notes to Condensed Consolidated Financial Statements).

In addition, we lease facilities under operating leases for our sales, marketing, distribution, and product development personnel located elsewhere within the United States and in ten foreign countries throughout Europe and Asia including a land lease for accounting purposes associated with our corporate headquarters facilities in San Jose, California (see Note as referenced above). With the exception of the land lease associated with our corporate headquarters facilities, which has a term commensurate with the building leases, these operating leases expire on various dates through 2020, and in some instances are cancelable with advance notice. Lastly, we also lease certain equipment and, for some of our sales personnel, automobiles. These operating leases are generally less than five years in duration.

Purchase Commitments. We utilize several contract manufacturers who manufacture and test our products requiring assembly. These contract manufacturers acquire components and build product based on demand information supplied by us in the form of purchase orders and demand forecasts. These purchase orders and demand forecasts generally cover periods that range from one to six months, and in some cases, up to one year. We also obtain individual components for our products from a wide variety of individual suppliers. We generally acquire these components through the issuance of purchase orders, and in some cases through demand forecasts, both of which cover periods ranging from one to nine months.

We also utilize purchase orders when procuring capital equipment, supplies, and services necessary for our day-to-day operations. These purchase orders generally cover periods ranging up to twelve months, but in some instances cover a longer duration.

Indemnifications. In the normal course of business, we provide indemnifications of varying scope to customers against claims of intellectual property infringement made by third parties arising from the use of our products. Historically, costs related to these indemnification provisions have not been significant. However, we are unable to estimate the maximum potential impact of these indemnification provisions on our future results of operations.

As permitted under Delaware law, we have agreements whereby we indemnify our officers and directors for certain events or occurrences while the officer or director is, or was serving, at our request in such capacity. The indemnification period covers all pertinent events and occurrences during the officer s or director s lifetime. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have director and officer insurance coverage that could enable us to recover a portion of any future amounts paid. We believe the estimated fair value of these indemnification agreements in excess of the applicable insurance coverage is minimal.

Royalties. We have certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense is generally based on a U.S. dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense, which is recorded under our cost of products revenue on our consolidated statements of operations, was approximately $127,000 during the three months ended September 30, 2008, and $133,000 for the same period in 2007, and $400,000 for the nine months ended September 30, 2008, and $432,000 for the same period in 2007.

We will continue to be obligated for royalty payments in the future associated with the shipment and licensing of certain of our products. While we are currently unable to estimate the maximum amount of these future royalties, such amounts will continue to be dependent on the number of units shipped or the amount of revenue generated from these products.

Taxes. We conduct our operations in many tax jurisdictions throughout the world. In many of these jurisdictions, non-income based taxes such as property taxes, sales and use taxes, and value-added taxes are assessed on Echelon s operations in that particular location. While we strive to ensure compliance with these various non-income based tax filing requirements, there have been instances where potential non-compliance exposures have been identified. In accordance with generally accepted accounting principles, we make a provision for these exposures when it is both probable that a liability has been incurred and the amount of the exposure can be reasonably estimated. To date, such provisions have been immaterial, and we believe that, as of September 30, 2008, we have adequately provided for such contingencies. However, it is possible that our results of operations, cash flows, and financial position could be harmed if one or more non-compliance tax exposures are asserted by any of the jurisdictions where we conduct our operations.

Legal Actions. From time to time, in the ordinary course of business, we are subject to legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, and other matters. In accordance with generally accepted accounting principles, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While we believe we have adequately provided for such contingencies as of September 30, 2008, it is possible that our results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

Liquidity and Capital Resources

Since our inception, we have financed our operations and met our capital expenditure requirements primarily from the sale of preferred stock and common stock, although during the years 2002 through 2004, we were also able to finance our operations through operating cash flow. From inception through September 30, 2008, we raised $291.4 million from the sale of preferred stock and common stock, including the exercise of stock options and warrants from our employees and directors.

In March and August 2004, March 2006, and February 2007, our board of directors approved a stock repurchase program, which authorized us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. Since inception, we have repurchased a total of 2,204,184 shares under the program at a cost of $16.1 million. The stock repurchase program expired in March 2008.

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In April 2008, our board of directors approved a new stock repurchase program, which authorizes us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. Since inception, we have repurchased a total of 750,000 shares under the program at a cost of $8.9 million. As of September 30, 2008, 2,250,000 shares were available for repurchase. The new stock repurchase program will expire in April 2011.

The following table presents selected financial information as of September 30, 2008, and for each of the last three fiscal years (dollars in thousands):

	September 30, 2008	December 31, 2007	2006	2005
Cash, cash equivalents, and short-term investments	$ 94,875	$ 107,190	$ 124,157	$ 154,480
Trade accounts receivable, net	16,568	33,469	13,918	11,006
Working capital	111,485	126,711	129,521	154,869
Stockholders equity	135,499	153,211	153,663	178,551

As of September 30, 2008, we had $94.9 million in cash, cash equivalents, and short-term investments, a decrease of $12.3 million as compared to December 31, 2007. Historically, our primary source of cash, other than stock sales, has been receipts from revenue, and to a lesser extent, proceeds from the exercise of stock options and warrants by our employees and directors. Our primary uses of cash have been cost of product revenue, payroll (salaries, commissions, bonuses, and benefits), general operating expenses (costs associated with our offices such as rent, utilities, and maintenance; fees paid to third party service providers such as consultants, accountants, and attorneys; travel and entertainment; equipment and supplies; advertising; and other miscellaneous expenses), acquisitions, capital expenditures, and purchases under our stock repurchase programs.

Cash flows from operating activities. Cash flows from operating activities have historically been driven by net income (loss) levels, adjustments for non-cash charges such as stock-based compensation, depreciation, amortization, and in-process research and development charges, as well as fluctuations in operating asset and liability balances. Net cash provided by operating activities was $2.0 million for the nine months ended September 30, 2008, an increase of approximately $804,000 from the same period in 2007. During the nine months ended September 30, 2008, net cash provided by operating activities was primarily the result of stock-based compensation expenses of $10.7 million, depreciation and amortization expense of $5.8 million, changes in our operating assets and liabilities of $4.4 million, and a reduction in our accrued investment income of $645,000; partially offset by our net loss of $19.6 million. During the nine months ended September 30, 2007, net cash provided by operating activities was primarily a result of our net loss of $16.6 million, offset by changes in our operating assets and liabilities of $7.2 million, stock-based compensation expenses of $4.7 million, depreciation and amortization expense of $5.4 million, a reduction of accrued investment income of $403,000, and an increase in our allowance for doubtful accounts of $47,000.

Cash flows from investing activities. Cash flows from investing activities have historically been driven by transactions involving our short-term investment portfolio, capital expenditures, changes in our long-term assets, and acquisitions. Net cash provided by investing activities was $12.1 million for the nine months ended September 30, 2008, a $20.8 million decrease from the same period in 2007. During the nine months ended September 30, 2008, net cash provided by investing activities was primarily the result of proceeds from maturities and sales of available-for-sale short-term investments of $61.0 million, partially offset by purchases of available-for-sale short-term investments of $45.4 million and capital expenditures of $3.5 million. During the nine months ended September 30, 2007, net cash provided by investing activities was primarily the result of proceeds from maturities and sales of available-for-sale short-term investments of $104.1 million, and changes in our other long-term assets of $44,000; partially offset by purchases of available-for-sale short-term investments of $65.5 million, and capital expenditures of $5.8 million.

Cash flows from financing activities. Cash flows from financing activities has historically been driven by the proceeds from issuance of common and preferred stock offset by transactions under our stock repurchase programs and principal payments on our lease financing obligations. Net cash used in financing activities was $9.6 million for the nine months ended September 30, 2008, a $13.8 million increase over the same period in 2007. During the nine months ended September 30, 2008, net cash used in financing activities was primarily the result of $8.9 million worth of open-market repurchases of our common stock under our stock repurchase program, $1.5 million in principal payments on our building lease financing obligations, and $1.4 million worth of shares repurchased from employees for payment of employee taxes on vesting of share awards and upon exercise of stock options; partially offset by proceeds of $2.0 million from the exercise of stock options by our employees. During the nine months ended September 30, 2007, net cash provided by financing activities was attributable to proceeds of $10.1 million from issuance of common stock as a result of options exercised by our employees; partially offset by $4.0 million of repurchases of common stock from our employees for payment of income and other payroll taxes they owed upon the vesting of share awards and upon the exercise of stock options and principal payments on lease financing obligations of $1.9 million.

We use well-regarded investment management firms to manage our invested cash. Our portfolio of investments managed by these investment managers is primarily composed of highly rated United States corporate obligations, United States government securities, money market funds, and to a lesser extent, foreign corporate obligations. All investments are made according to guidelines and within compliance of policies approved by the Audit Committee of our board of directors.

We expect that cash requirements for our payroll and other operating costs will continue at or slightly above existing levels. We also expect that we will continue to acquire capital assets such as computer systems and related software, office and manufacturing equipment, furniture and fixtures, and leasehold improvements, as the need for these items arises. Furthermore, our cash reserves may be used to strategically acquire other companies, products, or technologies that are complementary to our business.

Our existing cash, cash equivalents, and investment balances will likely decline during 2008 as a result of our anticipated operating losses. In addition, the continued weakening of current economic conditions, or changes in our planned cash outlay, could negatively affect our existing cash, cash equivalents, and investment balances. Based on our current business plan and revenue prospects, we believe that our existing cash and short-term investment balances will be sufficient to meet our projected working capital and other cash requirements for at least the next twelve months. Cash from operations could be affected by various risks and uncertainties, including, but not limited to, the risks detailed later in this discussion in the section titled *Factors That May Affect Future Results of Operations.* In the unlikely event that we would require additional financing within this period, such financing may not be available to us in the amounts or at the times that we require, or on acceptable terms. If we fail to obtain additional financing, when and if necessary, our business would be harmed.

Related Party Transactions

During the three and nine months ended September 30, 2008, and the years ended December 31, 2007, 2006, and 2005, the law firm of Wilson Sonsini Goodrich & Rosati, P.C. acted as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C.

In August 2009, our Board of Directors approved an arrangement whereby Echelon will reimburse our Chairman and Chief Executive Officer, M. Kenneth Oshman, for 50% of the costs incurred by Mr. Oshman for his private plane or charter aircraft travel on Company business. Such costs include flight charges (subject to any discounted rate that may apply), fuel, fuel surcharges, landing fees, crew costs and related expenses. Mr. Oshman from time to time uses his private plane or charter aircraft for Company business for himself and any employees that accompany him.

In June 2000, we entered into a stock purchase agreement with Enel pursuant to which Enel purchased 3.0 million newly issued shares of our common stock for $130.7 million (see Note 12 to our accompanying condensed consolidated financial statements for additional information on our transactions with Enel). The closing of this stock purchase occurred on September 11, 2000. At the closing, Enel had agreed that it would not, except under limited circumstances, sell or otherwise transfer any of those shares for a specified time period. That time period expired September 11, 2003. To our knowledge, Enel has not disposed of any of its 3.0 million shares.

Under the terms of the stock purchase agreement, Enel has the right to nominate a member of our board of directors. As of October 31, 2008, a representative of Enel is not presently serving on our board.

At the time we entered into the stock purchase agreement with Enel, we also entered into a research and development agreement with an affiliate of Enel (the R&D Agreement). Under the terms of the R&D Agreement, we cooperated with Enel to integrate our LonWorks technology into Enel s remote metering management project in Italy, the Contatore Elettronico. We completed the sale of our components and products for the deployment phase of the Contatore Elettronico project during 2005. During 2006, we supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, we entered into a new development and supply agreement and a software enhancement agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers purchase additional electronic components and finished

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goods from us. Under the software enhancement agreement, we provide software enhancements to Enel for use in its Contatore Elettronico system. The development and supply agreement expires in December 2011, and the software enhancement agreement expires in December 2009, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances.

For the three months ended September 30, 2008 and 2007, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $5.5 million and $3.0 million, respectively. For the nine months ended September 30, 2008 and 2007, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $8.4 million and $8.0 million, respectively. As of September 30, 2008, and December 31, 2007, $3.7 million and $3.0 million, respectively, of our total accounts receivable balance related to amounts owed by Enel and its designated manufacturers.

RECENTLY ISSUED ACCOUNTING STANDARDS

With the exception of the items discussed below, there have been no recent accounting pronouncements or changes in accounting pronouncements during the nine months ended September 30, 2008, as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K/A for the year ended December 31, 2007, that are of significance, or potential significance, to Echelon.

In October 2008, the FASB issued FSP SFAS No. 157-3 (FSP 157-3), *Determining the Fair Value of a Financial Asset When The Market for That Asset Is Not Active,* to clarify the application of the provisions of SFAS No. 157, *Fair Value Measurements*, in an inactive market. FSP 157-3 is effective immediately and applies to our September 30, 2008 financial statements. The application of the provisions of FSP 157-3 did not have a material impact on our financial position, cash flows or results of operations.

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161 (SFAS 161), *Disclosures about Derivative Instruments and Hedging Activities*. SFAS 161 requires companies with derivative instruments to disclose information that should enable financial statement users to understand how and why a company uses derivative instruments, how derivative instruments and related hedged items are accounted for under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and how derivative instruments and related hedged items affect a company s financial position, financial performance, and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. We believe that the adoption of SFAS 161 will not have a material impact on our consolidated financial statements as we do not currently engage in the use of derivative instruments or hedging activities.

FACTORS THAT MAY AFFECT FUTURE RESULTS OF OPERATIONS

Interested persons should carefully consider the risks described below in evaluating our company. Additional risks and uncertainties not presently known to us, or that we currently consider immaterial, may also impair our business operations. If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. In that case, the trading price of our common stock would likely decline.

Our NES revenues may not be predictable.

We and our partners sell our NES system to utilities. For several reasons, sales cycles with utility companies are generally extended and unpredictable. Utilities generally have complex budgeting, purchasing, and regulatory processes that govern their capital spending. In addition, in many instances, a utility may require one or more field trials of an automated meter infrastructure (AMI) system (such as one based on our NES system) before moving to a volume deployment. There is also generally an extended development and integration effort required in order to incorporate a new technology into a utility s existing infrastructure. A number of other factors may also need to be addressed before the utility decides to engage in a full-scale deployment of our NES system, including:

- regulatory factors that may affect the requirements of the AMI system or the timing of its deployment;
- the time it takes for utilities to evaluate multiple competing bids, negotiate terms, and award contracts for large scale metering system deployments;
- the deployment schedule for projects undertaken by our utility or systems integrator customers; and

delays in installing, operating, and evaluating the results of an AMI field trial that is based on our NES system.

In addition, shipment of NES products to a particular jurisdiction or customer is generally dependent on either obtaining regulatory approval for the NES meter or other products from a third party for the relevant jurisdiction, or satisfying the customer s internal testing requirements, or both. This approval process is often referred to as homologation or type testing. Further, shipment of NES products into some jurisdictions requires our contract manufacturers to pass certain tests and meet various standards related to the production of our NES meters. Failure to receive any such approval on a timely basis or at all, or failure to maintain any such approval, would have a material adverse impact on our ability to ship our NES system products, and would therefore have an adverse affect on our results of operations and our financial condition.

Once a utility decides to move forward with a large-scale deployment of an AMI project that is based on our NES system, the timing of and our ability to recognize revenue on our NES system product shipments will depend on several factors. These factors, some of which may not be under our control, include shipment schedules that may be delayed or subject to modification, other contractual provisions, such as customer acceptance of all or any part of the AMI system, and our ability to manufacture and deliver quality products according to expected schedules. In addition, the complex revenue recognition rules relating to products such as our NES system may also require us to defer some or all of the revenue associated with NES product shipments until certain conditions, such as the acceptance of software deliverables, are met in a future period. As a consequence, our ability to predict the amount of NES revenues that we may expect to recognize in any given fiscal quarter is likely to be limited. As NES revenues account for an increasing percentage of our overall revenues, we and our investors may have increasing difficulty in projecting our financial results.

Sales of our NES system may fail to meet our financial targets.

We have invested and intend to continue to invest significant resources in the development and sales of our NES system. Our long-term financial goals include expectations for a reasonable return on these investments. However, to date the revenues generated from sales of our NES system products have not yielded gross margins in line with our long term goals for this product line, while our NES related operating expenses have increased significantly.

In order to achieve our financial targets, we must meet the following objectives:

Increase market acceptance of our NES system products in order to increase revenues;

Increase gross margin from our NES revenues by continuing to reduce the cost of manufacturing our NES system products, while at the same time managing manufacturing cost pressures associated with commodity prices and foreign exchange fluctuations;

Manage the manufacturing transition to reduced-cost NES products; and

Manage our operating expenses to a reasonable percentage of revenues.

We cannot assure you that we will meet any or all of these objectives to the extent necessary to achieve our financial goals.

Unfavorable economic conditions may adversely affect our operating results.

A deterioration in global economic and market conditions may lead to slowdowns in expenditures for networking technology products, resulting in reduced product demand, increased price competition, and higher excess inventory levels. Recently, economic conditions in many parts of the world where we operate have been challenged by slowing growth and a contraction in the credit markets, which could have an impact on our business. For example, the inability to obtain credit could cause a utility to postpone its decision to move forward with a large scale deployment of our NES system. If the global economic climate does not improve, our business and operating results may be harmed.

We depend on a limited number of key suppliers.

Our future success will depend significantly on our ability to timely manufacture our products cost-effectively, in sufficient volumes, and in accordance with quality standards. For most of our products requiring assembly, we rely on a limited number of contract electronic manufacturers (CEMs), principally Jabil, Flextronics, and TYCO. These CEMs procure material and assemble, test, and inspect the final products to our specifications. This strategy involves certain risks, including reduced control over quality, costs, delivery schedules, availability of materials, components, finished products, and manufacturing yields. In addition, CEMs can experience turnover and instability, exposing us to additional risks as well as missed commitments to our customers.

We also maintain manufacturing agreements with a limited number of semiconductor manufacturers for the production of key products, including those used in our NES system. The Neuron Chip, which is an important component that we and our customers use in control network devices, is currently manufactured and distributed by two providers, Toshiba and Cypress Semiconductor. Another semiconductor supplier, STMicroelectronics, manufactures our power line smart transceiver products, for which we have no alternative source. In addition, we currently purchase several key products and components from sole or limited source suppliers with which we do not maintain signed agreements that would obligate them to supply to us on negotiated terms.

We may elect to change any of these key suppliers. For example, we have ended our relationship with a former CEM partner, WKK Technology (WKK). As part of this transition, we have moved the production of products WKK built for us to alternative CEMs. We have also been required to purchase certain raw material and in-process inventory from WKK that WKK procured in anticipation of our production requirements. In addition, we currently have capital equipment located at WKK that must be relocated to the new CEMs in order to continue manufacturing our products there. In addition, if any of our key suppliers were to stop manufacturing our products or supplying us with our key components, it could be expensive and time consuming to find a replacement. Also, as our NES business grows, we will be required to expand our business with our key suppliers or find additional sources of supply, as we have recently done with Flextronics and Jabil. There is no guarantee that we would be able to find acceptable alternative or additional sources. Additional risks that we face if we must transition between CEMs include:

- moving raw material, in-process inventory, and capital equipment between locations, some of which may be in different parts of the world;
- reestablishing acceptable manufacturing processes with a new work force; and
- exposure to excess or obsolete inventory held by contract manufacturers for use in our products.

The failure of any key manufacturer to produce a sufficient number of products on time, at agreed quality levels, and fully compliant with our product, assembly and test specifications could adversely affect our revenues and gross profit, and could result in claims against us by our customers, which could harm our results of operations and financial position.

Our products use components or materials that may be subject to price fluctuations, shortages, or interruptions of supply.

We may be vulnerable to price increases for products, components, or materials, such as copper and cobalt. In addition, in the past we have occasionally experienced shortages or interruptions in supply for certain of these items, including products or components that have been or will be discontinued, which caused us to delay shipments beyond targeted or announced dates. To help address these issues, we may decide to purchase quantities of these items that are in excess of our estimated requirements. As a result, we could be forced to increase our excess and obsolete inventory reserves to provide for these excess quantities, which could harm our operating results.

If we experience any shortage of products or components of acceptable quality, or any interruption in the supply of these products or components, or if we are not able to procure them from alternate sources at acceptable prices and within a reasonable period of time, our revenues, gross profits or both could decrease. In addition, under the terms of some of our contracts with our customers, we may also be subject to penalties if we fail to deliver our products on time.

If we are not able to develop or enhance our products in a timely manner, our revenues will suffer.

Due to the nature of development efforts in general, we often experience delays in the introduction of new or improved products beyond our original projected shipping date for such products. Historically, when these delays have occurred, we experienced an increase in our development costs and a delay in our ability to generate revenues from these new products. We believe that similar new product introduction delays in the future, particularly with respect to the NES system, could also increase our costs and delay our revenues.

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We may incur penalties and/or be liable for damages with respect to sales of our NES system products.

In the event of late deliveries, late or improper installations or operations, failure to meet product specifications or other product failures, failure to achieve performance specifications, indemnities or other compliance issues, the agreements governing the sales of the NES system may expose us to penalties, damages and other liabilities. Even in the absence of such contractual provisions, we may agree to assume certain liabilities for the benefit of our customers. Any such liabilities would have an adverse effect on our financial condition and operating results.

The markets for our products are highly competitive.

Competition in our markets is intense and involves rapidly changing technologies, evolving industry standards, frequent new product introductions, rapid changes in customer or regulatory requirements, and localized market requirements. In each of our markets, we compete with a wide array of manufacturers, vendors, strategic alliances, systems developers and other businesses.

The principal competitive factors that affect the markets for our products include the following:

- our ability to anticipate changes in customer or regulatory requirements and to develop or improve our products to meet these requirements in a timely manner;
- the price and features of our products such as adaptability, scalability, functionality, ease of use, and the ability to integrate with other products;
- our product reputation, quality, performance, and conformance with established industry standards;
- our ability to meet a customer s required delivery schedules;
- our customer service and support;
- warranties, indemnities, and other contractual terms; and
- customer relationships and market awareness.

Competitors for our NES system products include the Bayard Capital group of companies, ESCO, Elster, Enel, General Electric, Iskraemeco, Itron/Actaris, Kamstrup, Sensus, and Siemens, which directly or through IT integrators such as IBM or telecommunications companies such as Telenor, offer metering systems that compete with our NES system offering.

For our LWI products, our competitors include some of the largest companies in the electronics industry, operating either alone or together with trade associations and partners. Key company competitors include companies such as Siemens in the building industry; Allen-Bradley (a subsidiary of Rockwell Automation), Groupe Schneider and Siemens in the industrial automation industry; Siemens in the transportation industry; and Zensys in the home control market. Key industry standard and trade group competitors include BACnet, DALI, and Konnex in the buildings industry; DeviceNet, HART, and Profibus in the industrial control market; DLMS in the utility industry; Echonet, Zigbee and the Z-Wave alliance in the home control market; and the Train Control Network (TCN) in the rail transportation market. Each of these standards and/or alliances is backed by one or more competitors. For example, the Zigbee alliance includes over 150 member companies with promoter members such as Eaton, Freescale, Motorola, Texas Instruments, STMicroelectronics, Ember, Siemens, Honeywell, Mitsubishi Electric, Samsung, Schneider Electric, Tendril, Huawei Technologies, and Philips.

Many of our competitors, alone or together with their trade associations and partners, have significantly greater financial, technical, marketing, service and other resources, significantly greater name recognition, and broader product offerings. In addition, the utility metering market is experiencing a trend towards consolidation. As a result, these competitors may be able to devote greater resources to the development, marketing, and sale of their products, and may be able to respond more quickly to changes in customer requirements or product technology. If we are unable to compete effectively in any of the markets we serve, our revenues, results of operations, and financial position would be harmed.

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Liabilities resulting from defects in or misuse of our products, whether or not covered by insurance, may delay our revenues and increase our liabilities and expenses.

Our products may contain undetected errors or failures when first introduced, as new versions are released, or as a result of the manufacturing or shipping process. In addition, our customers or their installation partners may improperly install or implement our products, which could delay completion of a deployment or hinder our ability to win a subsequent award. Furthermore, because of the low cost and interoperable nature of our products, LONWORKS technology could be used in a manner for which it was not intended.

If errors or failures are found in our products, we may not be able to successfully correct them in a timely manner, or at all. Such errors or failures could delay our product shipments and divert our engineering resources while we attempt to correct them. In addition, we could decide to extend the warranty period, or incur other costs outside of our normal warranty coverage, to help address any known errors or failures in our products and mitigate the impact on our customers. This could delay our revenues and increase our expenses.

To address these issues, the agreements we maintain with our customers may contain provisions intended to limit our exposure to potential errors and omissions claims as well as any liabilities arising from them. In certain very limited instances, these agreements require that we be named as an additional insured on our customers insurance policies. However, our customer contracts and additional insured coverage may not effectively protect us against the liabilities and expenses associated with errors or failures attributable to our products.

Defects in our products may also cause us to be liable for losses in the event of property damage, harm or death to persons, claims against our directors or officers, and the like. Such liabilities could harm our reputation, expose our company to liability, and adversely affect our operating results and financial position.

To help reduce our exposure to these types of liabilities, we currently maintain property, general commercial liability, errors and omissions, directors and officers, and other lines of insurance. However, it is possible that such insurance may not be available in the future or, if available, may be insufficient in amount to cover any particular claim, or we might not carry insurance that covers a specific claim. In addition, we believe that the premiums for the types of insurance we carry will continue to fluctuate from period to period. Significant cost increases could also result in increased premiums or reduced coverage limits. Consequently, if we elect to reduce our coverage, or if we do not carry insurance for a particular type of claim, we will face increased exposure to these types of claims.

If we do not maintain adequate distribution channels, our revenues will be harmed.

We market our NES system products directly, as well as through selected VARs and integration partners. We believe that a significant portion of our NES system sales will be made through our VARs and integration partners, rather than directly by our company. To date, our VARs and integration partners have greater experience in overseeing projects for utilities. As a result, if our relationships with our VARs and integration partners are not successful, or if we are not able to create similar distribution channels for our NES system products with other companies in various geographic areas, revenues from sales of our NES system products may not meet our financial targets, which will harm our operating results and financial condition.

Currently, significant portions of our LWI revenues are derived from sales to distributors, including EBV, the primary independent distributor of our products to OEMs in Europe. Historically, sales to EBV, as well as sales to our other distributor partners, have accounted for a substantial portion of our total LWI revenues. Agreements with our distributor partners are generally renewed on an annual basis. If any of these agreements are not renewed, we would be required to locate another distributor or add our own distribution capability to meet the needs of our end-use customers. Any replacement distribution channel could prove less effective than our current arrangements. In addition, if any of our distributor partners fail to dedicate sufficient resources to market and sell our products, our revenues would suffer. Furthermore, if they significantly reduce their inventory levels for our products, service levels to our end-use customers could decrease.

We face financial and operational risks associated with international operations.

We have operations located in ten countries around the world. Revenues from international sales, which include both export sales and sales by international subsidiaries, accounted for about 70.8% of our total net revenues for the quarter ended September 30, 2008, and 81.6% of our total net revenues for the same period in 2007, and 78.5% of our total net revenues for the nine months ended September 30, 2008, and 84.8% for the same period in 2007. We expect that international sales will continue to constitute a significant portion of our total net revenues.

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Changes in the value of currencies in which we conduct our business relative to the U.S. dollar have caused and could continue to cause fluctuations in our reported financial results. The three primary areas where we are exposed to foreign currency fluctuations are revenues, cost of goods sold, and operating expenses.

In general, we sell our products to foreign customers primarily in U.S. dollars. As such, fluctuations in exchange rates could have an impact on revenues. As the value of the dollar rises, our products will become more expensive to our foreign customers, which could result in their decision to postpone or cancel a planned purchase.

With respect to the relatively minimal amount of our revenues generated in foreign currencies, our historical foreign currency exposure has been related primarily to the Japanese Yen and has not been material to our consolidated results of operations. However, in the future, we expect that some foreign utilities may require us to price our NES system in the utility s local currency, which will increase our exposure to foreign currency risk. In addition, we have agreed with EBV, our European distributor, that upon notice from EBV, we will sell our products to EBV in European Euros rather than U.S. dollars. If EBV were to exercise this right, our revenue exposure to foreign currency fluctuations would increase.

For our cost of goods sold, our products are generally assembled by CEMs in China. Although our transactions with these vendors have historically been denominated in U.S. dollars, in the future they may require us to pay in their local currency, or demand a U.S. dollar price adjustment or other payment to address a change in exchange rates, which would increase our cost to procure our products. This is particularly a risk in China, where any future revaluations of the Chinese currency against the U.S. dollar could result in significant cost increases. In addition, any future increase in labor costs in the markets where our products are manufactured could also result in higher costs to procure our products.

We use the local currency to pay for our operating expenses in the various countries where we have operations. If the value of the U.S. dollar declines as compared to the local currency where the expenses are incurred, our expenses, when translated back into U.S. dollars, will increase.

To date, we have not hedged any of our foreign currency exposures and currently do not maintain any hedges to mitigate our foreign currency risks. Consequently, any resulting adverse foreign currency fluctuations could significantly harm our revenues, cost of goods sold, or operating expenses.

Additional risks inherent in our international business activities include the following:

- timing of and costs associated with localizing products for foreign countries and lack of acceptance of non-local products in foreign countries;
- inherent challenges in managing international operations;
- the burdens of complying with a wide variety of foreign laws and unexpected changes in regulatory requirements, tariffs, and other trade barriers;
- economic and political conditions in the countries where we do business;
- differing vacation and holiday patterns in other countries, particularly in Europe;
- labor actions generally affecting individual countries, regions, or any of our customers, which could result in reduced demand for, or could delay delivery or acceptance of, our products;
- international terrorism and anti-American sentiment; and

- potentially adverse tax consequences, including restrictions on repatriation of earnings.

Any of these factors could have a material adverse effect on our revenues, results of operations, and our financial condition.

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Our executive officers and technical personnel are critical to our business.

Our company s success depends substantially on the performance of our executive officers and key employees. Due to the specialized technical nature of our business, we are particularly dependent on our Chief Executive Officer and our technical personnel. In May 2008, our President and Chief Operating Officer, Beatrice Yormark, passed away unexpectedly. Her duties have been assumed by our Chief Executive Officer. Our future success will depend on our ability to attract, integrate, motivate and retain qualified technical, sales, operations, and managerial personnel, as well as our ability to successfully implement a plan for management succession.

Competition for qualified personnel in our business areas is intense, and we may not be able to continue to attract and retain qualified executive officers and key personnel. Our product development and marketing functions are largely based in Silicon Valley, which is a highly competitive marketplace. It may be particularly difficult to recruit, relocate and retain qualified personnel in this geographic area. Moreover, the cost of living, including the cost of housing, in Silicon Valley is known to be high. Because we are legally prohibited from making loans to executive officers, we will not be able to assist potential key personnel as they acquire housing or incur other costs that might be associated with joining our company. In addition, if we lose the services of any of our key personnel and are not able to find suitable replacements in a timely manner, our business could be disrupted, other key personnel may decide to leave, and we may incur increased operating expenses in finding and compensating their replacements.

The sales cycle for our LWI products is lengthy and unpredictable.

The sales cycle between initial LWI customer contact and execution of a contract or license agreement with a customer or purchase of our products, can vary widely. Initially, we must educate our customers about the potential applications of and cost savings associated with our products. If we are successful in this effort, OEMs typically conduct extensive and lengthy product evaluations before making a decision to design our products into their offerings. Once the OEM decides to incorporate our products, volume purchases of our products are generally delayed until the OEM s product development, system integration, and product introduction periods have been completed. In addition, changes in our customer s budgets, or the priority they assign to control network development, could also affect the sales cycle.

We generally have little or no control over these factors, any of which could prevent or substantially delay our ability to complete a transaction and could adversely affect the timing of our revenues and results of operations.

If we sell our NES system products directly to a utility, we will face additional risks.

If we sell our NES system products to a utility directly, we may be required to assume responsibility for installing the NES system in the utility s territory, integrating the NES system into the utility s operating and billing system, overseeing management of the combined system, and undertaking other activities. To date, we do not have any significant experience with providing these types of services. As a result, if we sold directly to a utility, it may be necessary for us to contract with third parties to satisfy these obligations. We cannot assure you that we would find appropriate third parties to provide these services on reasonable terms, or at all. Assuming responsibility for these or other services would add to the costs and risks associated with NES system installations, and could also negatively affect the timing of our revenues and cash flows related to these transactions.

Fluctuations in our operating results may cause our stock price to decline.

Our quarterly and annual results have varied significantly from period to period, and we have sometimes failed to meet securities analysts expectations. Moreover, we have a history of losses and cannot assure you that we will achieve sustained profitability in the future. Our future operating results will depend on many factors, many of which are outside of our control, including the following:

- the mix of products and services that we sell may change to a less profitable mix;
- shipment, payment schedules, and product acceptance may be delayed;
- the complex revenue recognition rules relating to products such as our NES system could require us to defer some or all of the revenue associated with NES product shipments until certain conditions, such as delivery and acceptance criteria for our software

and/or hardware products, are met in a future period;

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- our contract electronic manufacturers may not be able to provide quality products on a timely basis, especially during periods where capacity in the CEM market is limited;

- our products may not be manufactured in accordance with specifications or our established quality standards, or may not perform as designed;

- our products may not be accepted by utilities, OEMs, systems integrators, service providers and end-users at the levels we project;

- downturns in any customer s or potential customer s business, or declines in general economic conditions, could cause significant reductions in capital spending, thereby reducing the levels of orders from our customers;

- recording of expense relating to equity compensation as required under SFAS No. 123R will decrease our earnings;

- we may incur costs associated with any future business acquisitions; and

- results of impairment tests for goodwill and other intangible assets in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, and SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, with respect to goodwill and other identified intangible assets that we acquired in the past or that we may acquire in the future may negatively affect our earnings and financial condition.

Any of the above factors could, individually or in the aggregate, have a material adverse effect on our results of operations and our financial condition, which could cause our stock price to decline.

We may be unable to promote and expand acceptance of our open, interoperable control systems over competing protocols, standards, or technologies.

LONWORKS technology is open, meaning that many of our technology patents are broadly licensed without royalties or license fees. As a result, our customers are able to develop hardware and software solutions that compete with some of our products. Because some of our customers are OEMs that develop and market their own control systems, these customers in particular could develop competing products based on our open technology. For instance, we have published all of the network management commands required to develop software that competes with our LNS software.

In addition, many of our competitors are dedicated to promoting closed or proprietary systems, technologies, software and network protocols or product standards that differ from or are incompatible with ours. We also face strong competition from large trade associations that promote alternative technologies and standards for particular vertical applications or for use in specific countries. These include BACnet, DALI, and KNX in the buildings market; DeviceNet, HART, and ProfiBus in the industrial controls market; TCN in the rail transportation market; DLMS in the metering market; and Echonet, Zigbee, and Z-Wave in the home control market.

Our technologies, protocols, or standards may not be successful or we may not be able to compete with new or enhanced products or standards introduced by our competitors, which would have a material adverse affect on our revenues, results of operations, and financial condition.

Our business may suffer if it is alleged or found that our products infringe the intellectual property rights of others.

We may be contractually obligated to indemnify our customers or other third parties that use our products in the event our products are alleged to infringe a third party s intellectual property rights. From time to time, we may also receive notice that a third party believes that our products may be infringing patents or other intellectual property rights of that third party. Responding to those claims, regardless of their merit, can be time consuming, result in costly litigation, divert management s attention and resources, and cause us to incur significant expenses.

As the result of such a claim, we may elect or be required to redesign our products, some of our product offerings could be delayed, or we could be required to cease distributing some of our products. In the alternative, we could seek a license to the third party s intellectual property. Even if our products do not infringe, we may elect to take a license or settle to avoid incurring litigation costs. However, it is possible that we would not be able to obtain such a license or settle on reasonable terms, or at all.

Lastly, our customers may not purchase our products if they are concerned our products may infringe third party intellectual property rights. This could reduce the market opportunity for the sale of our products and services.

Any of the foregoing risks could have a material adverse affect on our revenues, results of operations, and financial condition.

We have limited ability to protect our intellectual property rights.

Our success depends significantly upon our intellectual property rights. We rely on a combination of patent, copyright, trademark and trade secret laws, non-disclosure agreements and other contractual provisions to establish, maintain and protect these intellectual property rights, all of which afford only limited protection. If any of our patents fail to protect our technology, or if we do not obtain patents in certain countries, our competitors may find it easier to offer equivalent or superior technology.

We have also registered or applied for registration for certain trademarks, and will continue to evaluate the registration of additional trademarks as appropriate. If we fail to properly register or maintain our trademarks or to otherwise take all necessary steps to protect our trademarks, the value associated with the trademarks may diminish. In addition, if we fail to protect our trade secrets or other intellectual property rights, we may not be able to compete as effectively in our markets.

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or services or use information that we regard as proprietary, or it may not be economically feasible to enforce them. Any of our patents, trademarks, copyrights or intellectual property rights could be challenged, invalidated or circumvented. In addition, we cannot assure you that we have taken or will take all necessary steps to protect our intellectual property rights. Third parties may also independently develop similar technology without breach of our trade secrets or other proprietary rights. In addition, the laws of some foreign countries, including several in which we operate or sell our products, do not protect proprietary rights to as great an extent as do the laws of the United States and it may take longer to receive a remedy from a court outside of the United States. Also, some of our products are licensed under shrink-wrap license agreements that are not signed by licensees and therefore may not be binding under the laws of certain jurisdictions.

From time to time, litigation may be necessary to defend and enforce our proprietary rights. As a result, we could incur substantial costs and divert management resources, which could harm our business, regardless of the final outcome. Despite our efforts to safeguard and maintain our proprietary rights both in the United States and abroad, we may be unsuccessful in doing so. Also, the steps that we take to safeguard and maintain our proprietary rights may be inadequate to deter third parties from infringing, misusing, misappropriating, or independently developing our technology or intellectual property rights, or to prevent an unauthorized third party from misappropriating our products or technology.

The trading price of our stock has been volatile, and may fluctuate due to factors beyond our control.

The trading price of our common stock is subject to significant fluctuations in response to numerous factors, including the following:

- significant stockholders may sell some or all of their holdings of our stock;
- investors may be concerned about our ability to develop additional customers for our products and services; and
- volatility in our stock price may be unrelated or disproportionate to our operating performance.

Any of these factors could have a negative impact on the market price of our stock.

Voluntary standards and governmental regulatory actions in our markets could limit our ability to sell our products.

Standards bodies, which are formal and informal associations that attempt to set voluntary, non-governmental product standards, are influential in many of our target markets. We participate in many voluntary standards organizations around the world in order to both help prevent the adoption of exclusionary standards and to promote voluntary standards for our products. However, we do not have the resources to participate in all voluntary standards processes that may affect our markets.

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In addition, many of our products and the industries in which they are used are subject to U.S. and foreign regulation. For example, the power line medium, which is the communications medium used by some of our products, is subject to special regulations in North America, Europe and Japan. In general, these regulations limit the ability of companies to use power lines as a communication medium. In addition, some of our competitors have attempted to use regulatory actions to reduce the market opportunity for our products or to increase the market opportunity for their own products.

The adoption of voluntary standards or the passage of governmental regulations that are incompatible with our products or technology could limit the market opportunity for our products, which could harm our revenues, results of operations, and financial condition.

Our existing stockholders control a significant percentage of our stock, which will limit other stockholders ability to influence corporate matters.

As of October 31, 2008, our directors and executive officers, together with certain entities affiliated with them (including, for this purpose, Enel, which has the right to nominate a director to our board of directors), beneficially owned 31.0% of our outstanding stock.

When we sold 3.0 million newly issued shares of our common stock to Enel on September 11, 2000, we granted Enel the right to nominate a director to our board of directors, although a nominee of Enel does not currently sit on our board. In connection with the stock sale, our directors and our Chief Financial Officer agreed to enter into a voting agreement with Enel in which each of them agreed to vote in favor of Enel s nominee to our board of directors. In addition, Enel agreed to vote for our board s recommendations for the election of directors, approval of accountants, approval of Echelon s equity compensation plans, and certain other matters. As a result, our directors and executive officers, together with certain entities affiliated with them, may be able to control substantially all matters requiring approval by our stockholders, including the election of all directors and approval of certain other corporate matters.

Natural disasters, power outages, and other factors outside of our control such as widespread pandemics could disrupt our business.

We must protect our business and our network infrastructure against damage from earthquake, flood, hurricane and similar events, as well as from power outages. A natural disaster, power outage, or other unanticipated problem could also adversely affect our business by, among other things, harming our primary data center or other internal operations, limiting our ability to communicate with our customers, and limiting our ability to sell our products. We do not insure against several natural disasters, including earthquakes.

Any outbreak of a widespread communicable disease pandemic could similarly impact our operations. Such impact could include, among other things, the inability for our sales and operations personnel located in affected regions to travel and conduct business freely, the impact any such disease may have on one or more of the distributors for our products in those regions, and increased supply chain costs. Additionally, any future health-related disruptions at our third-party contract manufacturers or other key suppliers could affect our ability to supply our customers with products in a timely manner, which would harm our results of operations.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

We have not experienced any material change in our exposure to interest rate and foreign currency risks since the date of our Annual Report on Form 10-K/A for the year ended December 31, 2007.

Market Risk Disclosures. The following discussion about our market risk disclosures involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. We are exposed to market risk related to changes in interest rates and foreign currency exchange rates. We do not use derivative financial instruments to hedge these exposures.

Interest Rate Sensitivity. We maintain a short-term investment portfolio consisting mainly of fixed income securities with a weighted average maturity of less than one year. These available-for-sale securities are subject to interest rate risk and will fall in value if market interest rates increase. If market rates were to increase immediately

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and uniformly by 10% from levels at September 30, 2008, and December 31, 2007, the fair value of the portfolio would decline by an immaterial amount. We currently intend to hold our fixed income investments until maturity, and therefore we would not expect our operating results or cash flows to be affected to any significant degree by a sudden change in market interest rates. If necessary, we may sell short-term investments prior to maturity to meet the liquidity needs of the company.

Foreign Currency Exchange Risk. We have international subsidiaries and operations and are, therefore, subject to foreign currency rate exposure. To date, our exposure to exchange rate volatility has not been significant. If foreign exchange rates were to fluctuate by 10% from rates at September 30, 2008, and December 31, 2007, our financial position and results of operations would not be materially affected. However, we could experience a material impact in the future.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Effectiveness of Disclosure Controls and Procedures

We have designed our disclosure controls and procedures to ensure that information we are required to disclose in reports that we file or submit under the Securities and Exchange Act of 1934 is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure, and that such information is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. As of the end of the period covered by this Quarterly Report on Form 10-Q, under the supervision of our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures, as such terms are defined in Rule 13a-15(e) and Rule 15d-15(e) under the Securities and Exchange Act of 1934. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of September 30, 2008.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal controls over financial reporting (as defined in Rule 13a-15(e) of the Exchange Act) that occurred during the quarter ended September 30, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

For a discussion regarding our legal proceedings and matters, please refer to the Legal Actions section of Note 7, Commitments and Contingencies, to our condensed consolidated financial statements included under Item 1 of Part I, Financial Information, which information is incorporated herein by reference.

ITEM 1A. RISK FACTORS

A restated description of the risk factors associated with our business is included under Factors That May Affect Future Results Of Operations in Management s Discussion and Analysis of Financial Condition and Results of Operations, contained in Item 2 of Part I of this report. This restated description includes any material changes to and supersedes the description of the risk factors associated with our business previously disclosed in Part I Item 1A of our 2007 Annual Report on Form 10-K/A and in Part II Item 1A of our Quarterly Reports on Form 10-Q for the quarters ended March 31, 2008 and June 30, 2008, and is incorporated herein by reference.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

In April 2008, the Company s board of directors approved a stock repurchase program, which authorizes the Company to repurchase up to 3.0 million shares of the Company s common stock. During the three months ended September 30, 2008, the Company repurchased 533,250 shares at a cost of $6.2 million. Since inception, we have repurchased a total of 750,000 shares under the program at a cost of $8.9 million. As of September 30, 2008, 2,250,000 shares were available for repurchase. The stock repurchase program will expire in April 2011. The following table provides information about the repurchase of our common stock during the quarter ended September 30, 2008:

	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (1)
July 1- July 31	2,337	$ 12.59		2,783,250
August 1- August 31	423,861	$ 11.48	398,713	2,384,537
September 1- September 30	162,443	$ 12.65	134,537	2,250,000
Total	588,641	$ 11.81	533,250	2,250,000

(1) Shares purchased that were not part of our publicly announced repurchase program represent those shares surrendered to us by employees in order to satisfy stock-for-stock option exercises and/or withholding tax obligations related to stock-based compensation. These purchases do not reduce the number of shares that may yet be purchased under our publicly announced repurchase program.

ITEM 6. EXHIBITS

Exhibit No.	Description of Document
31.1	Certificate of Echelon Corporation Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certificate of Echelon Corporation Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32	Certification by the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

ECHELON CORPORATION

Date: November 10, 2008

By: /s/ Oliver R. Stanfield
Oliver R. Stanfield,
Executive Vice President and Chief Financial Officer

(Duly Authorized Officer and Principal Financial and

Accounting Officer)

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32	Certification by the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith