

ENVIRONMENTAL POWER CORP

Form 10-Q

May 08, 2009

Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, DC 20549

**FORM 10-Q**

(Mark one)

**QUARTERLY REPORT UNDER SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2009

OR

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

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

Commission file number 001-32393

**Environmental Power Corporation**

(Exact name of registrant as specified in its charter)

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-Q

**Delaware** **75-3117389**  
(State or other jurisdiction of **(IRS Employer**  
**incorporation or organization)** **Identification No.)**  
**120 White Plains Road, 6<sup>th</sup> Floor, Tarrytown NY 10591**  
(address of principal executive offices) (zip code)  
**(914) 631-1435**  
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition 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

Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

Number of shares of Common Stock outstanding at March 31, 2009: 15,614,604 shares

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

**Table of Contents**

**TABLE OF CONTENTS**

<u>Cautionary Statement Regarding Forward-Looking Statements</u>	3
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
Item 1. <u>Financial Statements</u>	
<u>Condensed Consolidated Balance Sheets as of March 31, 2009 (unaudited) and December 31, 2008</u>	4
<u>Condensed Consolidated Statements of Operations (unaudited) for the Three Months Ended March 31, 2009 and March 31, 2008</u>	5
<u>Condensed Consolidated Statements of Cash Flows (unaudited) for the Three Months Ended March 31, 2009 and March 31, 2008</u>	6
<u>Condensed Consolidated Statement of Equity (unaudited) for Three Months Ended March 31, 2009</u>	7
<u>Notes to Condensed Consolidated Financial Statements</u>	8
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	17
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	25
Item 4. <u>Controls and Procedures</u>	26
<b><u>PART II. OTHER INFORMATION</u></b>	
Item 1. <u>Legal Proceedings</u>	27
Item 1A. <u>Risk Factors</u>	27
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	39
Item 3. <u>Defaults upon Senior Securities</u>	39
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	39
Item 5. <u>Other Information</u>	39
Item 6. <u>Exhibits</u>	39
<b><u>SIGNATURES</u></b>	40

## **Table of Contents**

### **PART I. FINANCIAL INFORMATION**

#### **Cautionary Statement Regarding Forward-Looking Statements**

The Private Securities Litigation Reform Act of 1995, referred to as the PSLRA, provides a safe harbor for forward-looking statements. Certain statements contained or incorporated by reference in this Quarterly Report, such as statements concerning planned manure-to-energy systems, our sales pipeline, our backlog, our projected sales and financial performance, statements containing the words may, assumes, forecasts, positions, predicts, strategy, will, expects, estimates, anticipates, believes, projects, intends, plans, budgets, potential, variations thereof, and other statements contained in this Quarterly Report regarding matters that are not historical facts are forward-looking statements as such term is defined in the PSLRA. Because such statements involve risks and uncertainties, actual results may differ materially from those expressed or implied by such forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to:

uncertainties involving early-stage companies, including our need for additional financing to continue as a going concern,

uncertainties regarding the ability to obtain additional financing, and the timing, amount and terms of such financing,

the lack of binding commitments and the need to negotiate and execute definitive agreements for the construction and financing of facilities,

the lack of binding commitments for the purchase of gas produced by certain facilities,

the lack of binding commitments for, and other uncertainties with respect to, supplies of substrate,

uncertainties regarding the costs associated with substrate and other project inputs,

risks and uncertainties relating to the development of markets for carbon sequestration credits and other marketable renewable attributes, and the level of revenues we may achieve from such sources,

uncertainties regarding the amount and rate of growth in operating expenses,

unpredictable developments, including plant outages and repair requirements as well as risks related to weather and the unpredictability of extreme weather events,

risks related to performance on the part of suppliers of components, goods and services to our facilities,

financing and cash flow requirements and uncertainties,

inexperience with the design, construction, startup and operation of multi-digester facilities,

difficulties involved in developing and executing a business plan,

technological uncertainties, including those relating to competing products and technologies,

unpredictable developments, including plant outages and repair requirements,

commodity price volatility, particularly with respect to the price of natural gas,

the difficulty of estimating construction, development, repair, maintenance and operating costs and timeframes,

the uncertainties involved in estimating insurance and warranty recoveries, if any,

the inability to predict the course or outcome of any negotiations with parties involved with our projects,

uncertainties relating to general economic and industry conditions,

uncertainties relating to government and regulatory policies, the legal environment, intellectual property issues and the competitive environment in which Environmental Power Corporation and its subsidiaries operate, and other factors, including those described in Part II, Item 1A of this Quarterly Report on Form 10-Q under the heading "Risk Factors," as well as factors set forth in other filings we make with the Securities and Exchange Commission. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date that they are made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

**Table of Contents****Item 1. Financial Statements****ENVIRONMENTAL POWER CORPORATION AND SUBSIDIARIES**

Condensed Consolidated Balance Sheets (unaudited) as of March 31, 2009 and December 31, 2008

	March 31, 2009	December 31, 2008
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	\$ 4,759,819	\$ 3,157,938
Restricted cash	103,611,854	104,577,246
Receivables net of allowance of \$34,042 at March 31, 2009 and December 31, 2008	447,351	373,039
Other current assets	100,822	60,210
<b>Total Current Assets</b>	<b>108,919,846</b>	<b>108,168,433</b>
Restricted cash, non current	553,958	553,014
Property, plant, and equipment, net	25,983,225	23,932,073
Construction in progress	20,863,824	20,101,314
Licensed technology rights, net	2,282,921	2,329,296
Notes receivable, net	1,588,745	1,608,500
Deferred financing costs, net	5,624,106	5,122,995
Other assets	320,981	197,569
<b>TOTAL ASSETS</b>	<b>\$ 166,137,606</b>	<b>\$ 162,013,194</b>
<b>LIABILITIES, PREFERRED STOCK AND SHAREHOLDERS EQUITY</b>		
Current Liabilities		
Accounts payable and accrued expenses	\$ 6,720,626	\$ 4,322,896
<b>Total Current Liabilities</b>	<b>6,720,626</b>	<b>4,322,896</b>
Other Liabilities	366,770	340,706
Long term debt	134,467,259	129,475,023
<b>Total Liabilities</b>	<b>141,554,655</b>	<b>134,138,625</b>
Minority Interests	100	100
Preferred Stock (1)	10,156,021	10,156,021
Shareholders' Equity		
Preferred stock (2)	100	100
Common stock (3)	157,030	157,030
Additional paid-in capital	86,236,772	89,986,923
Accumulated deficit	(70,943,451)	(71,401,984)
Treasury stock (4)	(385,402)	(385,402)
Notes receivable from officers and board members	(638,219)	(638,219)
<b>Total Common Shareholders' Equity</b>	<b>14,426,730</b>	<b>17,718,348</b>
<b>TOTAL LIABILITIES, PREFERRED STOCK AND SHAREHOLDERS EQUITY</b>	<b>\$ 166,137,606</b>	<b>\$ 162,013,194</b>

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-Q

- (1) Preferred stock, \$.01 par value, 2,000,000 shares authorized; 281,241 shares issued as of March 31, 2009 and December 31, 2008. Stated value at March 31, 2009 and December 31, 2008 of \$52.71 per share or \$14,824,213.
- (2) Preferred stock of subsidiary, no par value, 10 shares authorized; 10 shares issued as of March 31, 2009 and December 31, 2008, respectively.
- (3) \$.01 par value; 50,000,000 shares authorized; 15,703,034 issued and 15,614,604 outstanding as of March 31, 2009 and as of December 31, 2008.
- (4) 88,430 shares at cost, as of March 31, 2009 and December 31, 2008.

**See Notes to Consolidated Financial Statements.**

**Table of Contents****ENVIRONMENTAL POWER CORPORATION AND SUBSIDIARIES**

Condensed Consolidated Statements of Operations (unaudited) for the Three Months Ended March 31, 2009 and March 31, 2008

	Three Months Ended	
	March 31, 2009	March 31, 2008
<b>REVENUES</b>	<b>\$ 742,478</b>	<b>\$ 970,542</b>
<b>COSTS AND EXPENSES:</b>		
Operations and maintenance	1,013,510	1,316,643
General and administrative	2,117,912	3,261,147
Depreciation and amortization	396,218	260,774
<b>TOTAL COSTS AND EXPENSES</b>	<b>3,527,640</b>	<b>4,838,564</b>
<b>OPERATING LOSS</b>	<b>(2,785,162)</b>	<b>(3,868,022)</b>
<b>OTHER INCOME (EXPENSE):</b>		
Interest income	17,043	246,907
Interest expense	(296,650)	(176,755)
Other income (expense)	130,255	(13,477)
<b>TOTAL OTHER INCOME (EXPENSE)</b>	<b>(149,352)</b>	<b>56,675</b>
<b>NET LOSS FROM CONTINUING OPERATIONS</b>	<b>(2,934,514)</b>	<b>(3,811,347)</b>
LOSS FROM DISCONTINUED OPERATIONS, NET OF TAXES OF \$0		(1,010,534)
GAIN ON DISPOSAL OF DISCONTINUED OPERATIONS, NET OF TAXES OF \$0		7,999,858
<b>NET INCOME (LOSS)</b>	<b>(2,934,514)</b>	<b>3,177,977</b>
Preferred Securities Dividend Requirements	(333,544)	(337,500)
(Loss) Income Applicable to Common Shareholders	\$ (3,268,058)	\$ 2,840,477
<b>BASIC INCOME (LOSS) PER SHARE</b>		
CONTINUING OPERATIONS	\$ (0.21)	\$ (0.27)
DISCONTINUED OPERATIONS		0.45
<b>NET INCOME (LOSS) PER SHARE</b>	<b>\$ (0.21)</b>	<b>\$ 0.18</b>
<b>DILUTED INCOME (LOSS) PER SHARE</b>		
CONTINUING OPERATIONS	\$ (0.21)	\$ (0.20)
DISCONTINUED OPERATIONS		0.37
<b>NET INCOME (LOSS) PER SHARE</b>	<b>\$ (0.21)</b>	<b>\$ 0.17</b>
<b>SHARES USED TO CALCULATE INCOME(LOSS) PER SHARE</b>		
BASIC	15,579,354	15,667,784
DILUTED	15,579,354	18,730,155

See Notes to Consolidated Financial Statements.



**Table of Contents****ENVIRONMENTAL POWER CORPORATION AND SUBSIDIARIES**

Condensed Consolidated Statements of Cash Flows (unaudited) for the Three Months Ended March 31, 2009 and March 31, 2008

	Three Months Ended	
	March 31, 2009	March 31, 2008
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income (loss)	\$ (2,934,514)	\$ 3,177,977
<i>Non-cash adjustments</i>		
Results of discontinued operations		(6,989,324)
Depreciation and amortization	396,218	260,774
Stock based compensation expense	143,817	289,835
Non-cash income from adjustment to fair value of warrants	(130,255)	
<i>Changes in operating assets and liabilities:</i>		
Increase in receivables	(74,312)	(47,607)
(Increase) Decrease in other current assets	(40,612)	34,539
Decrease in notes receivable	19,755	170,838
Increase in accounts payable and accrued expenses	472,761	1,057,576
Net cash provided by (used in) operating activities	(2,147,142)	(2,045,392)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Disposal of discontinued operations		375,000
Decrease (increase) in restricted cash	964,448	(622,419)
Construction of projects	(743,930)	(2,084,807)
(Increase) decrease in other assets	(123,412)	29,650
Purchases of property, plant and equipment	(103,891)	(178,479)
Net cash used for investing activities	(6,785)	(2,481,055)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Dividends on preferred stock	(667,090)	(675,000)
Payment of financing costs	(558,280)	
Proceeds from long term debt	5,000,000	
Payments on long-term debt	(7,764)	(16,971)
Decrease in other liabilities	(11,058)	
Net cash provided by (used in) financing activities	3,755,808	(691,971)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	1,601,881	(5,218,418)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	3,157,938	26,069,198
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 4,759,819	20,850,780
<b>Supplemental disclosure of cash flow information</b>		
Cash paid for interest (Net of amount capitalized)	\$ 1,019	\$ 1,753
<b>Income Taxes</b>		
Non-cash investing and financing activity		
Non-cash accrued dividend requirement of Series A Preferred Stock Holders	(333,544)	(337,500)
Capitalized interest	2,258,515	332,470
Capitalized amortization of deferred financing costs	42,680	33,356
<b>See Notes to Consolidated Financial Statements.</b>		



**Table of Contents****ENVIRONMENTAL POWER CORPORATION AND SUBSIDIARIES**

Condensed Consolidated Statement of Equity (unaudited) for Three Months Ended March 31, 2009

	Common Stock - Shares	Common Stock - Amount	Additional Paid-in Capital	Accum. Deficit	Treasury Stock - Shares	Treasury Stock - Amount	Receivable - Officers & Directors	Total
<b>Balance at December 31, 2008</b>	<b>15,703,034</b>	<b>\$ 157,030</b>	<b>\$ 89,986,923</b>	<b>\$ (71,401,984)</b>	<b>88,430</b>	<b>\$ (385,402)</b>	<b>\$ (638,219)</b>	<b>\$ 17,718,348</b>
Cumulative effect of change in accounting principle - January 1, 2009 reclassification of equity-linked financial instruments to derivative liabilities			(3,893,968)	3,726,591				(167,377)
Dividends on preferred stock				(333,544)				(333,544)
Stock based compensation expense			143,817					143,817
Net loss				(2,934,514)				(2,934,514)
<b>Balance at March 31, 2009</b>	<b>15,703,034</b>	<b>\$ 157,030</b>	<b>\$ 86,236,772</b>	<b>\$ (70,943,451)</b>	<b>88,430</b>	<b>\$ (385,402)</b>	<b>\$ (638,219)</b>	<b>\$ 14,426,730</b>

See Notes to Consolidated Financial Statements.

---

**Table of Contents**

**Notes to Condensed Consolidated Financial Statements**

**NOTE A BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements of Environmental Power Corporation ( we , us , EPC , or the Company and our subsidiaries have been prepared in accordance with the instructions to Form 10-Q and with Article 10 of Regulation S-X and include all of the information and footnotes required by generally accepted accounting principles for interim financial information. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The results of operations for the three months ended March 31, 2009 are not necessarily indicative of results to be expected for the year ending December 31, 2009. The information in this quarterly report should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and footnotes included in our Annual Report on Form 10-K for the year ended December 31, 2008 ( Annual Report ).

The Annual Report includes important information necessary or useful to understanding the Company's business and financial statement presentation. In particular, the Company's significant accounting policies and procedures are presented as Note C Significant Accounting Policies to the consolidated financial statements included in the Annual Report.

**NOTE B GOING CONCERN**

The Company's consolidated financial statements have been prepared on a going concern basis, which contemplates continuity of operations, realization of assets and satisfaction of liabilities in the ordinary course of business. As a predominately development oriented company, we have experienced substantial losses since the year ended December 31, 2002. For the three months ended March 31, 2009 we incurred a net loss applicable to common shareholders of \$3,268,000 and used cash from operating activities of \$2,147,000. For the year ended December 31, 2008, we incurred a net loss applicable to common shareholders of \$17,333,000 and used cash of \$13,100,000 in operating activities. We anticipate incurring losses at least through 2010 as we continue the construction of our portfolio of announced projects which we anticipate completing at varying times in 2010, subject to the availability of funding and the operational ramp up of our Huckabay Ridge facility and completion of construction and then operation of our Swift Grand Island facility during 2009. As of March 31, 2009, we had an accumulated deficit of \$70,943,451 and our unrestricted cash and cash equivalents amounted to \$4,760,000. Currently, our facility at Huckabay Ridge, Texas, which is operating reliably, is anticipated to generate cash flow over the balance of the year. However, the cash we project to be generated from Huckabay Ridge, by itself, will be insufficient to meet our short-term and long-term corporate and project-related capital requirements

In the past, we have been able to obtain outside financing to fund our losses and meet our capital requirements with the anticipation that once our portfolio of projects are complete and operational, they would contribute to future liquidity needs. While we have implemented steps to reduce our general and administrative expenses, we will need to raise substantial funds during the first half of 2009 in order to fund ongoing general and administrative expenses as well as interest and dividend requirements. We are currently actively seeking additional sources of capital to meet these financing needs. To that end, on March 13, 2009 we closed on a sale of \$5.0 million original principal amount of our 14% convertible notes due January 1, 2014 for net proceeds of approximately \$4.5 million, and we continue to work with our financial advisors to identify and explore various opportunities to raise the capital we require. However, we cannot assure you that we will be able to raise sufficient capital on acceptable terms, or at all. The level of funds we are able to raise, if any, will determine the level of development and construction activity that we can pursue and whether we will be able to continue as a going concern.

The accompanying consolidated financial statements have been prepared assuming that we will continue as a going concern. The uncertainties described in the preceding paragraph raise substantial doubt at March 31, 2009 about our ability to continue as a going concern without additional financing. The accompanying consolidated financial statements do not include any adjustments relating to the recoverability and classification of the carrying amount of recorded assets or to the amount and classification of liabilities that might result should we be unable to continue as a going concern.

**Table of Contents**

**NOTE C THE COMPANY**

We are a developer, owner, and operator of renewable energy production facilities. Our goal is to produce Energy that is Beyond Renewable<sup>®</sup>, which we define as energy that not only uses waste materials instead of limited resources, but that also is clean, reliable, and cost-effective. We own and operate the Huckabay Ridge facility in Stephenville, Texas, a large-scale, multi-digester facility for the production of pipeline-grade natural gas which began commercial operation in the first quarter of 2008, and have several similar facilities in varying stages of development. We also operate three digester facilities in Wisconsin utilizing the same technology that is employed at Huckabay Ridge.

In the past, we have operated in two major segments through Microgy, Inc., as a developer of renewable energy facilities for the production and commercial application of methane-rich biogas from agricultural and food industry wastes, and through EPC Corporation and its subsidiary Buzzard Power Corporation, as holder of a leasehold interest in a waste-coal fired generating facility in Pennsylvania known as the Scrubgrass facility. On May 31, 2007, our board of directors authorized management to enter into negotiations regarding the disposition of the leasehold interest in the Scrubgrass facility. On February 29, 2008, we completed the disposition of the leasehold interest. As a result, for financial reporting purposes, we reported the results of Buzzard as discontinued operations. We thus now operate only in Microgy's segment.

Microgy Holdings, LLC was formed in 2006 as a subsidiary of Environmental Power Corporation in connection with the \$60 million tax-exempt debt financing we completed in November 2006 relating to the construction and operation of four RNG<sup>®</sup> facilities in Texas. The assets financed by the debt financing are pledged as collateral to the Gulf Coast Industrial Development Authority of Texas, the lender. The obligations of Microgy Holdings, LLC related to this financing are non recourse to Environmental Power, although Environmental Power is required to provide at least 20% of the construction costs of these facilities, as well as to cover any cost overruns in construction and start up and commissioning expenses prior to commercial operation. Microgy Holdings, LLC is also the obligor on \$62.425 million in tax-exempt debt financing from the California Statewide Communities Development Authority we completed in September 2008 on terms similar to those of the Texas financing. Microgy Grand Island, LLC is the obligor on \$7.0 million in tax-exempt debt financing from the City of Grand Island, Nebraska, relating to the construction of our facility at the flagship beef processing plant of JBS Swift & Company, located in Grand Island. The obligations of Microgy Grand Island, LLC related to this financing are non recourse to Environmental Power, although Environmental Power is required to provide at least 20% of the construction costs of these facilities, as well as to cover any cost overruns in construction and start up and commissioning expenses prior to commercial operation. In certain cases of redemption of the California bonds, Environmental Power may also be liable for financing costs paid from bond proceeds.

**Discontinued Operations**

In May 2007, our board of directors authorized management to pursue negotiations for the disposition of Buzzard Power Corporation's leasehold interest in the Scrubgrass facility, referred to as Scrubgrass. Buzzard is a subsidiary of our wholly owned subsidiary, EPC Corporation. Scrubgrass located on a 600-acre site in Venango County, Pennsylvania, is an approximate 83 megawatt waste coal-fired electric generating station. We decided to seek the disposition of Buzzard's leasehold interest in the Scrubgrass facility to allow management to focus its attention and resources on the development and growth of Microgy. On February 29, 2008 we completed all transactions necessary to terminate the leasehold interest held by Buzzard in the Scrubgrass generating facility and the related financial obligations of Buzzard's immediate parent company, EPC Corporation. We recorded net income from discontinued operations in 2008 of \$6,989,000 reflecting a loss from operations for the months of January and February 2008 of \$1,011,000 and a one-time gain from disposal of \$8,000,000. The gain of approximately \$8,000,000, with the exception of a cash payment of \$375,000, was non-cash in nature. The components of the gain included \$3,456,000 in forgiveness of indebtedness, \$2,570,000 for the recognition of a previously deferred gain and \$1,630,000 for the relief of net obligations of Buzzard. The disposition was recorded net of a tax obligation of \$0 because it is anticipated that existing net operating loss carryforwards will offset any federal or state tax liabilities.

The assets and liabilities of Buzzard have been accounted for as discontinued operations for sale for all periods presented in accordance with the criterion established in Statement of Financial Accounting Standard (SFAS) No. 144 *Accounting for Impairment or Disposal of Long-Lived Assets*. We do not have a continuing involvement with the Buzzard business since the closing of the disposition of the leasehold interest in the Scrubgrass facility and do not continue any revenue or cost-generating

**Table of Contents**

activities related to Buzzard. In accordance with SFAS No. 144, the accompanying consolidated balance sheets report the assets and liabilities of Buzzard as discontinued and the consolidated statements of operations report the operations of Buzzard as discontinued operations.

**NOTE D PROPERTY, PLANT AND EQUIPMENT**

Property, plant and equipment is stated at cost less accumulated depreciation. The cost of maintenance, repairs and minor renewals that do not materially prolong the useful life of the asset are expensed. Major maintenance projects, repairs, improvements, renewals or betterments that extend the useful life of the asset, increase the usefulness or output of the asset, lower the operating costs of the asset, increase the value of the asset or fulfill a new or upgraded regulatory requirement are capitalized. The cost and accumulated depreciation for property, plant and equipment disposals are removed from the balance sheet and any resulting gains or losses are reported in the statement of operations at the time of the asset disposition. We depreciate property plant and equipment using the straight-line method over the estimated useful lives of the assets. Operating commercial facilities are depreciated based on the useful lives of their component parts which vary in length from 15 to 30 years. We record depreciation for office equipment and furniture using the straight-line method over periods from three to five years and we depreciate leasehold improvements over the lesser of the useful life of the asset or the length of the lease. We evaluate the impairment of property, plant and equipment based on the projection of undiscounted cash flows whenever events or changes in circumstances indicate that the carrying amounts of such assets may not be recoverable. If such cash flows are not expected to be sufficient to recover the recorded value of the assets, the assets are written down to their estimated fair values.

**NOTE E NET INCOME OR LOSS PER COMMON SHARE**

We follow SFAS No. 128, Earnings Per Share, for computing and presenting net income or loss per share information. Basic income or loss per common share for continuing and discontinued operations is computed by dividing net income or loss applicable to common stockholders by the weighted average number of common shares outstanding for the period. Diluted income or loss per common share excludes common stock equivalent shares and unexercised stock options if their effect would be antidilutive.

**NOTE F STOCK-BASED COMPENSATION**

We maintain equity incentive compensation plans under which restricted stock awards, stock options, stock appreciation rights and other stock-based awards may be granted to employees, directors, consultants and advisors. To date, we have granted stock options, stock appreciation rights, and restricted stock awards. Stock options under the plans may be either nonqualified stock options or incentive stock options. Stock options are granted with an exercise price at least equal to the market price on the date of grant and generally vest at a rate of 25%-33% per year. The stock options generally expire 10 years from the date of grant. We generally issue new, previously unissued shares of common stock upon exercise of stock options, though we may issue treasury shares.

For the three months ended March 31, 2009 and 2008, \$144,000 and \$290,000, respectively of non-cash compensation expense was recorded in accordance with SFAS 123R. The total future compensation cost related to unvested stock-based awards not yet recognized is \$491,000 at March 31, 2009. This amount will be charged against income as the awards vest over the next three years.

Valuation Assumptions: We did not grant any stock options or stock appreciation rights for the three months ended March 31, 2009. Therefore the table below only presents information for the three months ended March 31, 2008. The fair value of stock options and stock appreciation rights granted during the three months ended March 31, 2008 was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

	<b>Three Months Ended</b>
	<b>March 31,</b>
	<b>2008</b>
Fair Market Value Per Share	\$ 2.95
<i>Assumptions</i>	
Risk-free rate of return	2.78%
Volatility	70.38%
Expected annual dividend yield	0.00%
Option Life (years)	5.00



**Table of Contents**

The risk-free interest rate assumption is based upon the U.S. Treasury yield curve in effect at the time of grant for periods corresponding with the expected life of the option. The expected volatility is based on our historical stock price. The dividend yield assumption is based on our history and expectation of future dividend payouts. The expected life of employee stock options represents the weighted-average period the stock options are expected to remain outstanding.

**NOTE G GOODWILL AND INTANGIBLE ASSETS**

Intangible assets are recorded at cost and consist of licensed technology rights. Licensed technology rights are being amortized using the straight-line method over a useful life of 20 years.

Accumulated amortization of licensed technology rights was \$1,427,079 as of March 31, 2009 and \$1,380,704 as of December 31, 2008. Amortization expense for licensed technology rights was \$46,375 for the three months ended March 31, 2009 and March 31, 2008. The future estimated amortization expense for licensed technology rights is as follows:

**Estimated Amortization Expense for Licensed Technology Rights**

<b>Remaining 2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>Thereafter</b>	<b>Total</b>
\$ 139,125	185,500	185,500	185,500	185,500	1,401,796	\$ 2,282,921

In 2008, we determined that our goodwill resulting from the acquisition of Microgy was impaired and the entire balance of \$4,913,000 was written off in the fourth quarter of 2008. This impairment was a non-cash, non-recurring charge. We annually perform tests to determine the appropriate value of goodwill. The results of these tests in 2008 resulted in our determination that the entire balance of \$4,913,000 was impaired, due primarily to the stock price of our common stock relative to its book value, projections of future cash flow and other factors. Previously, the market price of our common stock and consequently our market capitalization were relatively high compared to the book value of our common stock. However in 2008 our market value was substantially below our book value due principally to the current market price of our common stock. As a result accounting standards require us to determine whether there is enough market value after covering other net assets on a book basis to cover any of the goodwill. We determined that market value was insufficient to cover goodwill and determined that the write-off was required. This calculation is not a reflection of the economics of the projects we are undertaking, which we continue to stand behind, but is simply the application of accounting requirements associated with goodwill.

**NOTE H LONG-TERM OBLIGATIONS AND CONTRACTUAL OBLIGATIONS****Issuance of Long-Term Debt**

On March 13, 2009, we closed on the sale of \$5,000,000 original principal amount of our 14% convertible notes due January 1, 2014, referred to as the notes, for net proceeds of approximately \$4,464,000. The notes are unsecured obligations of Environmental Power Corporation and pay interest semi-annually on January 1 and July 1, with principal due at maturity. The notes are convertible into shares of our common stock of the Company beginning at an initial conversion price of \$5.40 a share through December 31, 2009, then increasing to \$6.33 per share from January 1, 2010 through December 31, 2010, \$7.65 per share from January 1, 2011 through December 31, 2011, \$9.75 per share from January 1, 2012 through December 31, 2012 and \$11.00 per share from January 1, 2013 to December 31, 2013.



**Table of Contents**

The terms of the notes are governed by an Indenture, dated as of March 1, 2009, as supplemented by a First Supplemental Trust Indenture, dated as of March 1, 2009, between us and Wells Fargo Bank, National Association, as Trustee, together referred to as the indenture. The indenture contains covenants which include restrictions and limitations on our ability and that of our subsidiaries to incur indebtedness and issue certain types of capital stock and engage in certain transactions. In certain instances described in the indenture, the holders of the notes can require us to repurchase or redeem the notes, and we can require holders of the notes to convert into common stock or redeem their notes. The proceeds of these notes can only be used for the costs and expenses associated with the construction and operation of our projects, as described in more detail in the indenture. The First Supplemental Indenture provides for the issuance of notes in an aggregate original principal amount of up to \$53,000,000.

**Contractual Obligations**

The following table shows our known future contractual obligations of the types specified in Item 303(a) (5) of Regulation S-K. The table also includes interest payments on the tax-exempt bonds and convertible notes over the assumed life of the related debt.

Commitments	2009	2010	2011	2012	2013	Thereafter	Total
Operating Leases(1)	\$ 252,504	\$ 336,672	\$ 298,500	\$ 111,078			\$ 998,754
Microgy Commitments(2)	3,000,000						3,000,000
14% convertible notes(3)	560,000	700,000	700,000	700,000	700,000	\$ 5,000,000	8,360,000
Tax-Exempt Bonds(4)	10,308,250	10,308,250	10,658,250	11,603,750	11,606,350	285,661,450	340,146,300
Security Deposit(5)	250,000	100,000	100,000	100,000	100,000		650,000
Vehicle Loan and Other Capital Leases(6)	23,022	19,814					42,836
<b>TOTAL</b>	<b>\$ 14,393,776</b>	<b>\$ 11,464,736</b>	<b>\$ 11,756,750</b>	<b>\$ 12,514,828</b>	<b>\$ 12,406,350</b>	<b>\$ 290,661,450</b>	<b>\$ 353,197,890</b>

- (1) We are obligated under various non-cancelable operating leases for office space and automobiles. Rent expense for these operating leases was \$371,637, \$424,765, and \$286,501 in 2008, 2007 and 2006, respectively. For the three months ended March 31, 2009 and March 31, 2008 our rent expense for operating leases was \$73,908 and \$78,996, respectively.
- (2) These commitments relate to various purchase agreements, and include amounts expected to be claimed by SouthTex Treaters for gas treatment and conditioning equipment, in connection with our Microgy facilities.
- (3) The entire balance of the 14% convertible notes is due January 1, 2014
- (4) In 2007, Microgy Holdings began scheduled interest payments on the tax exempt bonds. Mandatory redemption of principal amounts begins in 2011 for the Nebraska tax-exempt bonds, 2012 for the Texas tax-exempt bonds and 2014 for the California tax-exempt bonds.
- (5) In December 2008, Microgy signed a contract with a customer that required security deposits to protect against failure to deliver product in certain instances.
- (6) We are obligated under various non-cancelable capital leases for automobiles and computer equipment.

**Table of Contents**

The following table describes our debt obligations as of March 31, 2009 and December 31, 2008:

	March 31, 2009	December 31, 2008
<b>Secured Promissory Notes Payable and Other Obligations</b>		
Automobile loan & capital leases	\$ 42,259	\$ 50,023
14% convertible notes	5,000,000	0
California loan related to tax-exempt bonds	62,425,000	62,425,000
Nebraska loan related to tax-exempt bonds	7,000,000	7,000,000
Texas loan related to tax-exempt bonds	60,000,000	60,000,000
<b>TOTAL</b>	<b>\$ 134,467,259</b>	<b>\$ 129,475,023</b>
<b>NOTE I NOTES RECEIVABLE</b>		

*Notes Receivable from Officers and Directors* We have outstanding notes receivable from former and current officers and directors for shares purchased in connection with stock option plans that amounted to \$638,219 as of March 31, 2009 and December 31, 2008. These notes, partially secured by the underlying shares of stock purchased thereby, are payable upon demand and bear interest at a floating rate which is payable monthly. In accordance with company policy and applicable law, we no longer make loans to our officers or directors.

In 2005, we completed construction of the digester projects at Five Star Dairy, Wild Rose Dairy, and Norswiss Dairy. Each digester had a purchase price of \$1,037,000, of which Microgy agreed to provide 100% seller financing. The notes issued by the purchasers of the digester projects each bear simple interest at 5% per annum, to be paid monthly after the first month that revenues are received under the purchasers respective biogas supply agreement with Dairyland Power Cooperative. Each maker of these notes is only required to make interest and principal payments from the revenues under the applicable biogas supply agreement with Dairyland Power Cooperative, to the extent that the operation of the facility, which we manage and operate, provides sufficient funds to pay. Each note matures 11 years after the bill of sale for the facility to which it relates has been executed. Because we have limited operating history, we have set up a reserve on these notes in the amount of \$750,000 to allow for any future cash flow deficiencies that would impair the full value of the notes. We also do not expect to record interest income from these notes. As we gain operations and maintenance experience and develop a track record, we will evaluate this allowance and make adjustments accordingly. The following table shows the balance on these notes receivable on March 31, 2009 and December 31, 2008:

	March 31, 2009	December 31, 2008
<b>Notes Receivable</b>		
Notes receivable	\$ 2,338,745	\$ 2,358,500
Reserve for any future cash flow deficiencies	(750,000)	(750,000)
<b>Notes receivable, net</b>	<b>\$ 1,588,745</b>	<b>\$ 1,608,500</b>

Beginning in the third quarter of 2007, we sold the greenhouse gas sequestration credits generated from the Wisconsin facilities. Pursuant to our agreements with the owners of these facilities, 50% of these sales were recognized by us as revenue and 50% was applied to the balance of the notes. During the first three months of 2009 and 2008, the balance of the notes receivable was reduced by \$18,000 and \$171,000, respectively due to the sale of greenhouse gas sequestration credits. The sales for the three months ended March 31, 2008 included revenues for credits generated by vintage years 2005 to 2007 but the sales for the three months ended March 31, 2009 includes credits generated only during the first six months of 2008.

**NOTE J INCOME TAXES**

We account for income taxes in accordance SFAS No. 109, *Accounting for Income Taxes*. Under SFAS No. 109, deferred tax assets and liabilities are determined based on differences between the financial reporting and tax reporting bases of assets and liabilities and are measured by applying the enacted tax rates and laws to taxable years in which the differences are expected to reverse. We recognize a deferred tax asset for the tax benefit of net operating loss carry forwards when it is more likely than not that the tax benefits will be realized and reduce the deferred tax asset with a valuation reserve when it is more likely than not that some portion of the tax benefits will not be realized.



**Table of Contents**

It is our policy to recognize interest and penalties related to uncertain tax positions in income tax expense. As of March 31, 2009 and 2008, we did not have any accrued interest or penalties related to uncertain tax positions. Uncertain tax positions are defined by Interpretation No. 48

Accounting for Uncertainty in Income Taxes ( FIN48 ). We determined that we had no tax positions that met the definition of uncertainty under the provisions of FIN48.

We file income tax returns with federal, state, and local authorities. The 2002 federal and state returns were examined and closed in 2007 and no material adjustments to any of our tax positions were identified. Our federal and state tax returns subsequent to 2002 remain subject to possible future examinations by relevant tax authorities.

**NOTE K PREFERRED STOCK AND SHAREHOLDERS EQUITY**

On November 9, 2006, we issued 281,241 units, consisting of (i) one share of series A 9% cumulative convertible preferred stock, referred to as the series A preferred stock, with each share initially convertible into 10 shares of common stock, and (ii) detachable warrants to purchase five shares of common stock exercisable at a price of \$5.522 per share, for a purchase price of \$53.335 per unit. We received approximately \$14,100,000 in proceeds from this offering after paying fees and expenses. As a result of the issuance of common shares in the public offering completed in October 2007 the applicable conversion price of the preferred stock was reduced and is now convertible into 2,823,660 shares of common stock.

With respect to each of these offerings, as well as other sales of shares of our capital stock, we deem an amount equal to the par value of the shares sold to be capital for purposes of the Delaware General Corporation Law.

**NOTE L ASSET RETIREMENT OBLIGATIONS**

On January 1, 2003, we adopted Statement of Financial Accounting Standards No. 143, Accounting for Asset Retirement Obligations ( SFAS No. 143 ), which provides accounting requirements for retirement obligations associated with tangible long-lived assets, including the timing of liability recognition, initial measurement of the liability, allocation of asset retirement costs to expense, subsequent measurement of the liability, and financial statement disclosures. SFAS No. 143 requires that asset retirement costs be capitalized along with the cost of the related long-lived asset. The asset retirement costs should then be allocated to expense using a systematic and rational method. We have determined that we have asset retirement costs of \$174,000 associated with substrate removal at the Huckabay Ridge facility. This amount is included in property, plant and equipment and other liabilities on our balance sheet and is amortized over the life of the related asset.

**NOTE M RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS****Change in accounting principle**

In June 2008, the FASB ratified Emerging Issues Task Force ( EITF ) Issue No. 07-5, *Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity's Own Stock* ( EITF 07-5 ). EITF 07-5 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Paragraph 11(a) of SFAS No. 133 - specifies that a contract that would otherwise meet the definition of a derivative but is both (a) indexed to the Company's own stock and (b) classified in stockholders' equity in the statement of financial position would not be considered a derivative financial instrument. EITF 07-5 provides a new two-step model to be applied in determining whether a financial instrument or an embedded feature is indexed to an issuer's own stock and thus able to qualify for the SFAS No. 133 paragraph 11(a) scope exception. The Company's adoption of EITF 07-5 effective January 1, 2009, resulted in the identification of certain warrants that were determined to require liability classification because of certain provisions that may result in an adjustment to their exercise price. Accordingly, these warrants were retroactively reclassified as liabilities upon the effective date of EITF 07-5 as required by the EITF. The result was a decrease in additional paid in capital as of January 1, 2009 of \$ 3,893,968, an increase in retained earnings of \$3,726,591, and a liability of \$167,377. The liability was then marked to fair value as of March 31, 2009, resulting in a decrease in the liability and other income of \$130,255 for the quarter ended March 31, 2009.

The Company uses the Black-Scholes pricing model to calculate fair value of its warrant liabilities. Key assumptions used to apply these models are as follows:

	January 1, 2009	March 31, 2009
Risk free interest rate	1%	1%

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-Q

Expected life	2.8 years	2.5 years
Expected volatility of common share price	66%	93%
Common share price	\$ 0.63	\$ 0.36

**Table of Contents**

Below is a summary of our fair value measurements at March 31, 2009:

Assets and liabilities measured at fair value as of March 31, 2009 are as follows:

Other liabilities

	Value at March 31, 2009	Quoted prices in active markets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Warrant liabilities	\$ 37,122	\$	\$ 37,122	\$

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The provisions of SFAS 157 were effective for financial statements issued for fiscal years beginning after November 15, 2007. However, the FASB deferred the effective date of SFAS 157, as it relates to fair value measurement requirements for non-financial assets and liabilities that are not remeasured at fair value on a recurring basis. These assets include goodwill and other non-amortizable intangible assets. We adopted SFAS 157 as of January 1, 2008.

The fair value framework requires a categorization of assets and liabilities into three levels based upon the assumptions (inputs) used to price the assets and liabilities. Level 1 provides the most reliable measure of fair value, whereas Level 3 generally requires significant management judgment. The three levels are defined as follows:

*Level 1:* Unadjusted quoted prices in active markets for identical assets and liabilities.

*Level 2:* Observable inputs other than those included in Level 1. For example, quoted prices for similar assets or liabilities in active markets or quoted prices for identical assets or liabilities in inactive markets.

*Level 3:* Unobservable inputs reflecting management's own assumptions about the inputs used in pricing the asset or liability. As of March 31, 2009 and December 31, 2008, other than cash, cash equivalents restricted cash and fair value of warrants, none of our assets or liabilities were being reported at fair value.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* ( SFAS No. 160 ). This statement requires that noncontrolling interests be reported as stockholders equity, a change that will effect our financial statement presentation of minority interests in our consolidated subsidiaries. SFAS No. 160 also establishes a single method of accounting for changes in a parent's ownership interest in a subsidiary as long as that ownership change does not result in deconsolidation. This statement is effective for fiscal years beginning after December 15, 2008. SFAS 160 did not have a material impact on our financial position or results of operations.

In March 2008, The FASB issued SFAS 161, *Disclosures about Derivative Instruments and Hedging Activities* ( SFAS No. 161 ). SFAS 161 amends and expands the disclosure requirements of SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, and requires entities to provide enhanced qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair values and amounts of gains and losses on derivative contracts, and disclosures about credit-risk-related contingent features and derivative agreements. This statement applies to all entities and all derivative instruments. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. SFAS 161 did not have a material impact on our financial position or results of operations.

**Table of Contents**

**NOTE N SUBSEQUENT EVENT**

On April 23, 2009, The Company and Microgy entered into a Cooperation Agreement (the Agreement) with Danish Biogas Technology, A.S. ( DBT ) and its parent, Xergi, A.S. ( Xergi ). The Agreement is intended to replace and terminate the Technology Licensing Agreement dated May 12, 2000 between Microgy and DBT, as amended by Addendum of April 14, 2003 and Addendum No. 2 of March 7, 2005, between DBT and Microgy (collectively, the Prior Agreements ). The Agreement, while maintaining many of the original business concepts contained in the Prior Agreements, restructures the Prior Agreements to reflect the Company s shift to a build, own and operate business model from the original digester equipment sales model and better defines the respective roles of the parties to enable them more efficiently to interface going forward. The termination of the Prior Agreements will not impair any prior grants of rights by DBT to Microgy or its affiliates, or any collateral assignments of such rights, or any prior payments to DBT or Xergi under the Prior Agreements.

The Agreement addresses anaerobic-digester plants incorporating above-ground digesters with mixers (the DBT Technology ). Pursuant to the Agreement, DBT grants to Microgy an irrevocable and perpetual right and license to utilize the DBT Technology in the design, construction, and/or operation by the Company, Microgy and their affiliates of anaerobic-digesters and related systems. This grant is exclusive as to North America for the Term (as defined below) and is non-exclusive as to North America thereafter, excludes Europe during the Term but is non-exclusive as to Europe thereafter. As in the Prior Agreements, the grant is non-exclusive as to the rest of the world, leaving each party free to pursue projects outside of North America and Europe. The Agreement further provides that commencing as of the Effective Date (defined below), Microgy may utilize digester technologies other than the DBT Technology throughout the world.

The Agreement becomes effective upon DBT s receipt of an up-front payment of certain license fees for certain Microgy projects of Microgy s choosing, which will be paid for by the Company s issuance of its 14% Convertible Notes due January 1, 2014 (the Notes ) in the original principal amount of \$3,000,000 (the Consideration ). The Agreement has a term commencing on the date the Company tenders the Consideration to DBT (the Effective Date ), which must occur within forty-five (45) days of the date of the Agreement, and continues until the fifth anniversary of the Effective Date (the Term ).

For additional details regarding this subsequent event, please refer to our Current Report on Form 8-K dated April 23, 2009 filed with the United States Securities and Exchange Commission on April 28, 2009 (File No. 001-32393).

---

**Table of Contents**

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*You should read the following discussion together with our financial statements and accompanying notes included in this quarterly report and our audited financial statements included in our annual report on Form 10-K for the year ended December 31, 2008 which is on file with the Securities and Exchange Commission. In addition to historical information, the following discussion contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results could differ materially from those anticipated by the forward-looking statements due to important factors and risks including, but not limited to, those set forth in Part II, Item 1A – Risk Factors of this Quarterly Report on Form 10-Q and other filings we make with the Securities and Exchange Commission.*

**Overview**

Environmental Power is a developer, owner and operator of renewable energy production facilities. Our goal is to produce energy that is Beyond Renewable, which we define as energy that not only is derived from waste materials instead of precious resources, but energy that is also clean, reliable and cost-effective. Environmental Power and its subsidiaries develop and own facilities that, unlike many renewable energy facilities, are intended to be profitable without the need for subsidies or other governmental assistance. Any such government assistance would, however, benefit our facilities by increasing their potential for profitability, while at the same time expanding opportunities for the profitable deployment of such facilities. We believe that a number of factors, including volatile energy prices, greater desire for renewable energy sources, more stringent environmental and waste management requirements imposed on farmers and food industry waste producers, and greater revenue opportunities from carbon sequestration credits will continue to provide favorable market conditions for its business.

In the past, we have operated in two major segments, through Microgy, Inc., as a developer of renewable energy facilities for the production and commercial application of methane-rich biogas from agricultural and food industry wastes, and through EPC Corporation and its subsidiary, Buzzard Power Corporation, referred to as Buzzard, which was the holder of a leasehold interest in a waste-coal fired generating facility in Pennsylvania known as the Scrubgrass facility. On May 31, 2007, our board of directors authorized management to enter into negotiations regarding the disposition of the leasehold interest in the Scrubgrass facility. On February 29, 2008, we completed the disposition of the leasehold interest. As a result, for financial reporting purposes, we are now consolidating all segments of continuing operations and reporting the results of Buzzard as discontinued operations. We thus now operate only in Microgy's segment.

Microgy is a developer of renewable energy facilities for the production and commercial application of methane-rich biogas produced from animal and food industry wastes. The biogas can be sold to end-users or used to produce pipeline-grade methane, which Microgy refers to as renewable natural gas, or our RNG<sup>®</sup> product, liquefied natural gas, or LNG, compressed natural gas, or CNG, renewable electrical energy or thermal energy, as well as other useful by-products. Microgy's systems utilize a proven European biogas production technology that Microgy believes is superior to other such technologies. Microgy owns the perpetual, exclusive North American license to this technology. In addition, Microgy has developed significant engineering, construction and process knowledge regarding these systems.

Due to the increased focus on renewable energy, Microgy believes its RNG<sup>®</sup> offerings will be positively received by numerous environmentally responsible entities seeking renewable energy sources. While we do not have subsidies, rebates, grants or other credits available as to this renewable source of energy, Microgy believes that tax credits, renewable energy credits, pollution offset credits, carbon sequestration credits and other such incentives may be available now or in the future to Microgy's facilities, and such incentives would serve to enhance the addressable market and potential profitability of its facilities. Many states have either passed or are considering legislation requiring utilities to obtain or generate a certain percentage of their power from renewable sources.

In addition to the value generated from the production and sale of renewable gas, we believe that our facilities can generate additional environmental benefits with significant economic and social value by providing a valuable waste management solution for farms and other producers of organic wastes, such as those in the food industry. Federal and state agencies have either passed or are considering regulations that require concentrated animal feeding operations, referred to as CAFOs, to implement changes to their current waste management practices. We believe that these increasingly stringent environmental regulations will be another significant factor creating opportunities for the deployment of our systems.



---

**Table of Contents**

Microgy intends to continue to focus on its strategy of developing large-scale, standardized facilities utilizing an ownership model, pursuant to which Microgy will construct, own and operate facilities and profit from the ongoing sale of biogas or RNG<sup>®</sup> produced by such facilities as well as sales of carbon sequestration credits or other marketable environmental benefits. This strategy encompasses the construction and operation of stand-alone plants like the Huckabay Ridge facility described below, as well as facilities dedicated to the needs of a single customer at one or more customer locations, such as the Grand Island facility described below. By pursuing this strategy, Microgy intends to accumulate gas production and carbon sequestration capacity over time. In addition, Microgy continues to standardize and streamline both its system design and its approach to the marketplace in order to allow for rapid and cost-effective scale-up of its business.

Having constructed both the multi- and single-tank system in four currently operating installations, Microgy intends to own the digester systems it develops. Our multi-digester facilities will primarily produce pipeline-quality renewable natural gas, although we will also consider opportunities to produce and sell conditioned biogas, electricity, CNG or LNG from our facilities. Microgy's development efforts are focused on applications of its technology that are resource efficient. Development of smaller scale and single-digester facilities will be targeted toward customers that have multiple sites and opportunities that have shorter development cycles. Microgy's goal with all projects is to maximize the profitability of every project by implementing the right technology and most profitable off-take arrangements.

Microgy's efforts have resulted, most recently, in the start of commercial operations at the Huckabay Ridge facility in Stephenville, Texas, which began commercial operations in the first quarter of 2008. Huckabay Ridge consists of eight 916,000-gallon digesters which operate together to process the manure from approximately 10,000 cows. The gas is treated and compressed to produce pipeline-grade methane that is sold and delivered directly into nearby natural gas pipelines. Huckabay Ridge is expected to produce approximately 635,000 million British Thermal Units, or MMBtus, of pipeline-grade methane per year.

We have announced three other multi-digester facilities in development in Texas having the same expected output as the Huckabay Ridge facility. We have also announced three proposed multi-digester RNG<sup>®</sup> facilities in California that are in advanced stages of development. We completed \$60 million in tax-exempt bond financing in November 2006 relating to the construction and operation of the four RNG<sup>®</sup> facilities in Texas. Furthermore, we completed \$62.425 million in tax-exempt bond financing in September 2008 to finance a portion of the construction costs of two of our three proposed California facilities, and we currently anticipate pursuing a further \$26.02 million in such financing for the third proposed California facility once financial market conditions improve.

Construction at Microgy's Swift Grand Island biogas facility has progressed with major equipment procurement nearly complete. Operations are expected to commence in 2009. Microgy's Grand Island biogas facility will consist of two 1.2 million gallon digesters that will process wastes generated by the Swift Grand Island processing facility. The plant is expected to produce 235,000 MMBtu per year of biogas that will be purchased by Swift under a fifteen year gas purchase agreement to offset natural gas consumption at Swift Grand Island. Swift is providing all the necessary feedstock material, both manure and substrate required by our process. We completed \$7.0 million in tax-exempt bond financing in Nebraska in July 2008 to finance a portion of the construction costs of the Swift Grand Island facility.

In October 2006, we entered into a business development agreement, referred to as the BDA, with Cargill, Incorporated, referred to as Cargill. We are leveraging our relationship with Cargill to accelerate our identification and development of both facilities for the production of our RNG<sup>®</sup> product and smaller-scale, multi-digester facilities dedicated to a single customer.

Microgy is also operating three single digester facilities in Wisconsin. Microgy sold these projects to the farms on which they are located, and developed them in conjunction with Dairyland Power Cooperative, an electric cooperative utility, referred to as Dairyland. The biogas from these projects is used by Dairyland to generate electricity.

---

**Table of Contents**

**Discontinued Operations**

The disposition of Buzzard's leasehold interest in the Scrubgrass facility was completed on February 29, 2008. Buzzard leased its generating facility from Scrubgrass Generating Company, L.P. The Scrubgrass plant, referred to as Scrubgrass, located on a 600-acre site in Venango County, Pennsylvania, is an approximate 83 megawatt waste coal-fired electric generating station. We decided to seek the disposition of Buzzard's leasehold interest in the Scrubgrass facility to allow management to focus its attention and resources on the development and growth of Microgy. As a result of Buzzard's disposition of its leasehold interest, we are now consolidating all segments of continuing operations for financial reporting purposes and reporting the results of Buzzard as discontinued operations.

We no longer have a continuing involvement with the Buzzard business since we disposed of the leasehold interest in the Scrubgrass facility and do not continue any revenue or cost-generating activities related to Buzzard. The accompanying consolidated statements of operations prior to disposition of Buzzard reports the operations of Buzzard as discontinued.

**RESULTS OF OPERATIONS**

The following Management's Discussion and Analysis of Financial Condition and Results of Operations compares the results of operations for the three month periods ended March 31, 2009 with the results of operations for the three month periods ended March 31, 2008. Historical results and trends that might be discussed below should not be taken as indicative of the results for the full year or for future operations generally.

**Three Months Ended March 31, 2009 Compared to Three Months Ended March 31, 2008**

**Overview.** For the three months ended March 31, 2009, we had a net loss applicable to common shareholders of \$3,268,000 or a loss per share of \$0.21, compared to net income applicable to common shareholders of \$2,840,000 or income per share of \$0.18 for the three months ended March 31, 2008. The decline in results is primarily due to the fact that we had net income from discontinued operations of \$6,989,000 recorded in the first quarter of 2008 because we disposed of our interest in the Scrubgrass facility during that quarter and recorded a gain on disposal of \$8,000,000. This gain was partially offset during the three months ended March 31, 2008 by a loss from discontinued operations of \$1,011,000.

Results from continuing operations improved in the first quarter of 2009. The net loss from continuing operations was \$2,935,000 for the three months ended March 31, 2009 as compared to a net loss from continuing operations of \$3,811,000 for the three months ended March 31, 2008. The reduction in the net loss from continuing operations was primarily due to a decline in general and administrative expenses of \$1,143,000 and a decrease in operating losses before depreciation at our Huckabay Ridge facility during the first quarter of 2009 of \$214,000.

**Revenues.** Revenue for the three months ended March 31, 2009 decreased to \$742,000 from \$971,000 for the three months ended March 31, 2008. The decrease in revenues of \$229,000 is primarily attributable to a reduction in sales of greenhouse gas sequestration credits in the first quarter of 2009 at our Wisconsin facilities. During the first quarter of 2009 we recorded \$18,000 in revenues from sales of such credits, as opposed to \$171,000 in such revenues for the prior year. In 2008 we received revenues from the sale of credits for vintage years 2005 to 2007 but for the first three months of 2009 we only received revenues for the first six months of 2008. We currently expect revenues to increase in future periods as our Grand Island facility is completed and becomes operational later this year.

**Operations and maintenance expenses.** Operations and maintenance expense was \$1,014,000 for the three months ended March 31, 2009 as compared to \$1,317,000 for the same period in 2008, a decrease of \$303,000. The decrease was primarily due to a reduction in operations and maintenance expense at Huckabay Ridge of \$358,000 as start up and non-recurring costs were reduced, although the three months ended March 31, 2009 included three months of operating expenses and the three months ended March 31, 2008 included two months of operating expenses at Huckabay Ridge. We currently expect non-recurring and start up costs at Huckabay Ridge to decrease as operations at this facility become more reliable now that the improvements to the biogas collection and conditioning areas have been completed. We expect an overall increase in operations and maintenance expenses in future periods when the Grand Island facility is completed.

**Table of Contents**

**General and administrative expenses.** General and administrative expenses from continuing operations declined by \$1,143,000 to \$2,118,000 for the three months ended March 31, 2009, as compared to \$3,261,000 for the same period in 2008. The decline is attributable primarily to lower salary expenses in 2009, reflecting the reductions in staffing, lower non-cash compensation expense in the 2009 period due to reduced expense from stock options and stock appreciation rights and reductions in development expense in the 2009 period as we slowed development efforts to conserve cash pending our fundraising initiatives. Without the inclusion of non-cash compensation expense, general and administrative expenses would have been \$1,974,000 and \$2,971,000 for the three months ended March 31, 2009 and 2008, respectively.

**Depreciation and amortization expenses.** The increase in depreciation and amortization expense was principally due to the fact that the first quarter of 2009 included three months of depreciation at the Huckabay Ridge facility and the first quarter of 2008 included two months depreciation for Huckabay Ridge because the facility began commercial operations in February 2008 which is when we began to recognize depreciation expense for this facility.

**Operating loss.** As a result of the changes described above, our operating loss from continuing operations decreased to \$2,785,000 in the first quarter of 2009 from \$3,868,000 in the same period in 2008.

**Interest income.** Interest income on unrestricted cash for the three months ended March 31, 2009 was \$17,000 as compared to \$247,000 for the three months ended March 31, 2008. Interest income decreased due both to lower invested cash balances and lower interest rates on such balances.

**Interest expense.** Interest expense increased to \$297,000 for the three months ended March 31, 2009, as compared to \$177,000 for the three months ended March 31, 2008. This increase was due principally to the fact that we ceased the capitalization of interest expense related to the Huckabay Ridge facility when it began commercial operations in February 2008. The interest expense related to the portion of the bonds allocated to finance the Huckabay Ridge facility is now recorded as interest expense. Therefore we had three full months of interest expense relating to the Huckabay Ridge facility in the first quarter of 2009, whereas we had only two months of such interest expense related to Huckabay Ridge in the first quarter of 2008. In the first quarter of 2009, we also accrued \$37,000 in interest expense on \$5,000,000 original principal amount of our 14% convertible notes which were issued in March 2009.

**Other income (expense).** We had other income of \$130,000 for the three months ended March 31, 2009, as compared to other expense of \$13,000 for the three months ended March 31, 2008. The other income for the three months ended March 31, 2009 reflects a reduction in the market value of certain outstanding warrants. The other expense in the first quarter of 2008 was the result of the disposal of assets associated with the relocation of our corporate headquarters from Portsmouth, New Hampshire to Tarrytown, New York.

**Income tax expense (benefit).** Because we are not assured of realizing the benefits of operating losses for tax purposes, we did not record an income tax benefit for losses incurred for the three months ended March 31, 2009 or 2008.

**Income from discontinued operations, net of taxes.** The results for the three months ended March 31, 2009 do not include the results of discontinued operations because these operations were disposed of in February 2008. The loss from discontinued operations of \$1,011,000 in 2008 reflects the operations of Buzzard for the first two months of 2008 before it was disposed of. On February 29, 2008 we disposed of Buzzards interest in the Scrubgrass facility and recognized a one time gain of \$8,000,000. With the exception of a cash payment of \$375,000 the gain was non-cash and consisted primarily of recognition of a previously deferred gain in the amount of \$2,570,000, forgiveness of indebtedness in the amount of \$3,456,000 and elimination of other obligations of \$1,630,000. There was no tax provision provided on the disposition because we believe that we have sufficient net operating loss carry-forwards at the federal and state levels to offset any potential tax liability with respect to the gain on disposition. Therefore the net result of income from discontinued operations for the three months ended March 31, 2008 was income of \$6,989,000.

---

**Table of Contents****Liquidity and Capital Resources*****Going Concern***

Our consolidated financial statements have been prepared on a going concern basis, which contemplates continuity of operations, realization of assets and satisfaction of liabilities in the ordinary course of business. As a predominately development oriented company, we have experienced substantial losses since the year ended December 31, 2002. For the three months ended March 31, 2009 we incurred a net loss applicable to common shareholders of \$3,268,000. For the year ended December 31, 2008, we incurred a net loss applicable to common shareholders of \$17,333,000 and used cash of \$13,100,000 in operating activities. We anticipate incurring losses at least through 2010 as we continue the construction of our portfolio of announced projects which we anticipate completing at varying times in 2010, subject to the availability of funding and completion of construction and then operation of our Grand Island facility during 2009. As of March 31, 2009, we had an accumulated deficit of \$70,943,000, and our unrestricted cash and cash equivalents amounted to \$4,760,000. Our facility at Huckabay Ridge, Texas, which is nearing full production, will not generate sufficient positive cash flow, by itself, to meet our short-term and long-term corporate and project-related capital requirements.

In the past, we have been able to obtain outside financing to fund our losses and meet our capital requirements with the anticipation that once our portfolio of projects are complete and operational, they would contribute to future liquidity needs. While we have implemented steps to reduce our general and administrative expenses, we will need to raise substantial funds during the first half of 2009 in order to fund ongoing general and administrative expenses as well as interest and dividend requirements. We are currently actively seeking additional sources of capital to meet these financing needs. To that end, on March 13, 2009 we closed on a sale of \$5.0 million original principal amount of our 14% convertible notes due January 1, 2014 for net proceeds of approximately \$4.5 million, and we continue to work with our financial advisors to identify and explore various opportunities to raise the capital we require. However, we cannot assure you that we will be able to raise sufficient capital on acceptable terms, or at all. The level of funds we are able to raise, if any, will determine the level of development and construction activity that we can pursue and whether we will be able to continue to meet our corporate and subsidiary debt and other obligations and continue as a going concern.

The accompanying consolidated financial statements have been prepared assuming that we will continue as a going concern. The uncertainties described in the preceding paragraph raise substantial concern at March 31, 2009 about our ability to continue as a going concern without additional financing. The accompanying consolidated financial statements do not include any adjustments relating to the recoverability and classification of the carrying amount of recorded assets or to the amount and classification of liabilities that might result should we be unable to continue as a going concern.

***Certain Balance Sheet Items***

**Cash.** The increase in our cash position is primarily due to the issuance of \$5,000,000 original principal amount of our 14% convertible notes due January 1, 2014 during March 2009 for net proceeds of approximately \$4.5 million.

**Restricted Cash.** The decrease in the restricted cash balance is the result primarily of draws related to construction expenditures at our Grand Island, Nebraska facility.

**Property, plant and equipment, net and construction in progress.** The property plant and equipment balances were \$25,983,000 and \$23,932,000 as of March 31, 2009 and December 31, 2008, respectively. The increase in property, plant and equipment is principally due to completion of capital additions at the Huckabay Ridge facility and the reclassification of the completed construction costs to property plant and equipment from construction in progress at December 31, 2008. The total additions to the Huckabay Ridge facility, added to property plant and equipment during the first quarter of 2009, were \$2,418,000, of which \$2,283,000 was included in construction in progress at December 31, 2008. In the construction in progress account, this reclassification of costs associated with the Huckabay Ridge facility of \$2,283,000 was offset by additions of \$3,045,000, resulting in net increase to the construction in progress account of \$762,000. Of total capital additions to the construction in progress account in the first quarter of 2009, \$2,259,000 reflects capitalized interest on our Texas, California and Nebraska projects and \$622,000 reflects construction expenditures at our Grand Island facility.

## **Table of Contents**

### ***Operating Activities***

Our net cash used by operating activities was \$2,147,000 for the three months ended March 31, 2009, compared to cash used in operating activities of \$2,045,000 for the same period in 2008. We reported a net loss of \$2,935,000 for the three months ended March 31, 2009. The following adjustments need to be considered in order to reconcile our net loss in the three months ended March 31, 2009 to our net cash used in operating activities:

**Depreciation and amortization.** During the three months ended March 31, 2009, we recognized depreciation of property plant and equipment of \$335,000 amortization expense for licensed technology rights of \$46,000 and amortization of deferred financing costs of \$15,000.

**Stock-based compensation.** Accounting for options, restricted stock and stock appreciation rights issued to employees resulted in non-cash compensation expenses of \$144,000 for the three months ended March 31, 2009, as compared to \$290,000 in such expenses for the same period in 2008.

### ***Investing Activities***

Our cash used for investing activities was \$7,000 for the three months ended March 31, 2009, as compared to \$2,481,000 in the same period in 2008. Our investing activities were concentrated primarily in the following areas:

**Restricted cash.** The decrease in restricted cash for the three months ended March 31, 2009 of \$964,000 reflects principally the draws for costs of construction for the Grand Island, Nebraska facility.

**Construction of projects.** For the three months ended March 31, 2009 we incurred expenditures of \$744,000 related to the construction of projects excluding capitalized interest on our Texas, California and Nebraska projects of \$2,259,000. Of total capital expenditures \$622,000 was for construction expenditures on our Swift project at Grand Island, Nebraska.

**Property, plant and equipment.** Property, plant and equipment expenditures reflect principally capital expenditures at Huckabay.

**Other Assets:** The use of funds in the first quarter of 2009 is principally due to deposits the Company made in conjunction with long term contracts to sell our RNG<sup>®</sup> product.

### ***Financing Activities***

Our cash provided by financing activities was \$3,756,000 for the three months ended March 31, 2009, compared to cash used for financing activities of \$692,000 in the three months ended March 31, 2008. We offer the following information concerning the financing activities for our business:

**Dividends on preferred stock.** Our Series A cumulative convertible preferred stock has a 9% dividend payable semi-annually. We paid \$667,000 in such dividends on January 1, 2009.

**Payment of financing costs.** The \$558,000 used for financing costs for the first three months of 2009 resulted primarily from the costs of issuance of our 14% convertible notes due January 1, 2014.

**Proceeds from long-term debt.** EPC issued \$5,000,000 original principal amount of our 14% convertible notes due January 1, 2014 for net proceeds of approximately \$4.5 million in March 2009.

---

## **Table of Contents**

### **2009 Outlook**

#### ***Operations***

The following forward-looking information concerning our anticipated results of operations for the full year 2009 is being compared to our historical results of operations for 2008.

We expect increased revenues during 2009 from increased sales of our RNG<sup>®</sup> product produced by our Huckabay Ridge facility in Texas due to higher capacity factors than we experienced in 2008. Our revenues related to the Dairyland sites are expected to be approximately even with revenues from such facilities in 2008. Also, we expect our Grand Island facility to generate revenues when it is placed in service later this year.

At Huckabay Ridge, we have completed comprehensive upgrades to process-instrumentation and controls, the gas conditioning system, and the gas-collection system. These upgrades bring the facility into conformity with the third-generation project design that we are utilizing on our next round of facilities, and we are pleased with the results to date of those upgrades as Huckabay Ridge is currently operating reliably and we expect that it will continue to maintain a high availability factor.

Huckabay Ridge produced salable gas 89% of the time during the month of April and 99% of the time for the first 5 days of May. Production levels have been trending upward as a result of improved operational processes designed to maximize RNG<sup>®</sup> output.

Attributes of improved operations include consistency in meeting specifications for removal of CO<sub>2</sub>, H<sub>2</sub>S and H<sub>2</sub>O, the convergence of production as predicted by our operating model and actual results, and, importantly, the ability of the systems to manage fluctuations in biogas-generation as well as varying ambient conditions.

With enhanced system stability, we have turned our attention to managing other key aspects of this facility to maximize plant RNG<sup>®</sup> product output and profitability. While we are achieving expected biogas production based on substrate concentration being received, we have witnessed a decline in the level of volatile solids contained in our suppliers' substrate materials. Volatile solids in substrates contribute directly to overall biogas production, and hence lower volatile solid concentrations negatively impact production of our pipeline-grade finished product. We believe that the decline in the level of volatile solids is directly related to recessionary forces, as, for example, facilities from which we have been receiving highly concentrated glycerin have temporarily suspended or curtailed operations due to economic forces in their industry and we are receiving reduced shipments of grease trap waste from suppliers as restaurant patronage has declined.

Our current facility design at Huckabay Ridge accommodates a certain volume of substrate, so that if there is a decrease in the level of volatile solids in the volume of substrate material, aggregate gas production also declines.

We are, therefore, undertaking a number of measures at Huckabay Ridge to address substrate quality. Obviously, in cooperation both with existing vendors and with potential new suppliers, we have expanded our reach for higher-grade materials to offset what we believe to be these temporary reductions in supply. In addition, we are pursuing an expanded environmental licensing capability to accept a broader scope of substrate materials, working on material handling designs and capacities that can accept varying substrate consistencies, and working to develop additional strategic relationships with larger and potentially long-term substrate providers that will assist us at Huckabay Ridge and our other Texas facilities. We believe that all of these efforts will not only address current market conditions but will also allow us greater operating flexibility in the future.

While we believe that the reduced availability of highly concentrated substrates is directly related to recessionary forces, and we fully expect their availability to improve along with an improved economy, designs at all future facilities now take into account the ability to handle lower concentrations of substrate materials. Therefore, should we experience these same type of market conditions, RNG<sup>®</sup> output will not be affected. On the other hand, should substrate quality return to the higher volatile solid concentrations as previously experienced, the resulting output of RNG<sup>®</sup> will be higher than previously targeted levels.

We expect to meet with the bondholders of our Texas and California tax-exempt debt over the coming weeks to discuss our progress toward confirmation that the Huckabay Ridge facility is capable of achieving its intended performance levels.

## **Table of Contents**

We expect our operation and maintenance expenses at Huckabay Ridge to reflect the full year of commercial operations during 2009 at increased capacity. We expect the Dairyland sites' operations and maintenance expenses to remain approximately even with 2008 levels. Additionally, we expect to start incurring operations and maintenance expenses associated with the Grand Island facility once it commences commercial operation in 2009.

In 2008 and early 2009 we instituted a number of steps to reduce or eliminate certain general and administrative costs. General and administrative expenses should decline relative to 2008 and were reduced in the first quarter of 2009 from amounts for the same period in 2008. These measures will result in additional reduced general and administrative costs as the full annual impact of these measures take effect.

In addition to the Huckabay Ridge facility, our other planned Texas and California projects are in various stages of development. Our Cnossen and Rio Leche projects are in the engineering and early stages of construction and initial site work has been completed. We are currently seeking capital to fund our required equity contributions for these projects to complement the equity we have invested to date. We have commenced construction on the biogas facility located at the JBS Swift & Co. beef processing plant in Grand Island, Nebraska. In July 2008 we received \$7,000,000 in tax-exempt bond financing, less certain closing costs for the project. The construction account funds have been disbursed to cover certain documented project expenses. The terms of this financing are set forth in greater detail in our Current Report on Form 8-K, dated July 22, 2008, as filed with the Securities and Exchange Commission on July 25, 2008.

All requisite water and air permits required by the California Environmental Quality Act for the Riverdale, Hanford and Bar 20 projects in California have been approved. We have closed on \$62.425 million of tax-exempt bond financing in California for the Riverdale and Hanford facilities, and expect to pursue an additional \$26.02 million of such financing for the Bar 20 facility, though we do not yet have any binding commitments for such additional financing. The terms of our California financing are set forth in greater detail in our Current Report on Form 8-K, dated August 28, 2008, as filed with the Securities and Exchange Commission on September 4, 2008.

## ***Cash Flow Outlook***

During early 2009, we expect to fund our business activities principally from available cash balances, raising additional funds through debt and/or equity financings by Environmental Power, Microgy or their affiliates and project-specific financing, to the extent available. The requirement for additional financing will be in direct proportion to the number of projects on which we begin construction, as well as our construction schedule. In addition, during 2009 we will need to meet significant interest and preferred dividend obligations as well as fund general and operating expenses. We will require significant additional capital over the next twelve months in order to meet these obligations and continue to fund our planned construction program on its current schedule.

We have raised gross proceeds from the California tax-exempt bond issuance of \$62.425 million to date, and currently expect to seek additional tax-exempt bond financing in California of \$26.02 million. The proceeds from these financings will be used to cover not only construction costs but also debt-service and other customary reserves. Terms of the bond financings require that we first invest equity in an amount equal to at least 20% of the estimated costs of construction (similar to the terms of the bond-financings for our Texas projects) before bond funds become available to us, that Environmental Power or its subsidiaries raise at least \$45.0 million in additional capital prior to June 30, 2009, of which at least \$17.5 million is available to fund construction of the California facilities (with these amounts being proportionately reduced should the closing of the Bar 20 project bonds not occur), and that the Huckabay Ridge facility meet certain gas production and financial performance tests over a continuous 60-day period prior to June 30, 2009. We currently plan on pursuing the full \$45.0 million in additional capital prior to June 30, 2009 in accordance with the draw conditions on the California bonds, and have initiatives pending to secure required capital amounts. However, if we are unable to meet these conditions, holders of the California bonds have the option to require Microgy Holdings to purchase all of the California bonds at par, and, if Microgy Holdings does not do so, to cause the California bonds to be redeemed out of funds held by the trustee. In the event of such redemption, Environmental Power has agreed with the bondholders to contribute an amount equal to the original cost of issuance of the bonds paid out of bond proceeds, or approximately \$1,248,500.

---

## **Table of Contents**

With the closing on the tax-exempt bond issue for the Microgy Grand Island project in July 2008, debt financing of that project is complete. We will, however, need to raise additional money to complete the project.

We will need to augment these cash resources by additional capital in the first half of 2009 to meet the draw conditions on the California bonds described above, as well as to fund ongoing general and administrative expenses associated with our corporate overhead and interest and dividend requirements.

On March 31, 2009 our unrestricted cash balance was \$4,760,000, as compared to \$3,158,000 as of December 31, 2008. In addition, our current restricted cash balances were \$103,612,000 and \$104,577,000, at March 31, 2009 and December 31, 2008, respectively. The restricted cash represents primarily the remaining proceeds of our \$60 million tax-exempt bond financing in Texas and proceeds from our \$62.425 million tax exempt financing in California. For each of the three additional planned RNG<sup>®</sup> facilities in Texas, we are able to spend up to \$15,000,000 from restricted cash, subject to certain restrictions and provided that we have first funded at least 20% of the expected cost of each such facility.

We believe that our current cash balance, will be sufficient to fund our minimum lease and debt obligations, current contractual commitments, and our corporate overhead requirements into June 2009. However, we will require substantial additional financing, at both the project and parent company levels, to complete the construction of currently planned facilities, as noted above, including those already under construction, as well as for ongoing interest and dividend payments as well as general and administrative expenses. We have engaged independent financial advisors to assist us in exploring project financing opportunities. We currently have no commitments for any additional financing, and we cannot assure you that such financing will be available on reasonable terms or in a timely fashion, or at all, particularly in the current economic environment, in which capital raising activities are especially challenging. Our inability to obtain adequate financing would likely result in the need to curtail or cease our business operations.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Our most significant risk exposure is changing interest rates which may affect our short term investments generally and would also impact future debt financing costs. The gas production of future projects, to the extent not subject to fixed price off take agreements or other hedging arrangements, has the potential to expose us to risk associated with fluctuating gas prices. These risks are described in more detail below.

#### ***Short-term investments***

We invest cash balances that are in excess of our normal operating requirements in short term investments generally with maturities of three months or less. Because of the credit quality and short duration of these investments, we do believe our short-term investments are subject to normal market risks associated with high quality, low duration money market investments. A portion of our restricted cash balance is invested in highly rated, highly liquid government securities. We believe that those instruments are not subject to material potential near-term losses in future earnings from reasonably possible near-term changes in market rates or prices.

#### ***Debt***

We have financed and expect to continue to finance Microgy's projects with debt financing, including tax-exempt financing, to the extent available. Any such debt financing will be subject to prevailing interest rates.

#### ***Commodity Price Risk***

As Microgy establishes multi-digester projects for the production of our RNG<sup>®</sup> product we could become exposed to market risk with respect to natural gas prices, to the extent that this risk is not mitigated by long term off-take agreements. Historically, natural gas prices have been volatile, and we expect such volatility to continue. Fluctuations in the commodity price of natural gas may have a materially adverse impact on the profitability of some of our facilities; particularly where we do not have a long-term contract for the sale of the facility's output at a fixed or predictable price. At such time as Microgy's facilities begin to produce commercial quantities of gas for sale as a commodity, we intend to explore various strategies, including hedging transactions and the like, in order to mitigate the associated commodity price risk. In connection with our tax-exempt bond financings, we are required to maintain certain gas price protection arrangements for the gas output of our facilities.



## **Table of Contents**

### ***Substrate Costs***

We rely on significant quantities of substrate materials that provide proteins, fats, and carbohydrates that enhance the biological process in our digesters. Notwithstanding any supply agreements we may have, we are currently unable to forecast the costs associated with transporting substrate, and are exposed to market risk relating to availability of these materials. Substrate availability is affected by industry supply and demand, including competition by other users and recyclers of these materials, weather, and many other factors. Fluctuations in the availability of substrate and the cost to transport it to our projects are expected and could have a materially adverse effect on the profitability of our facilities. For example, Microgy has recently experienced a decline in the volume of high quality substrate used by its Huckaby Ridge facility as a result of current economic conditions. In the absence of substrate of sufficient quality at an affordable cost, our anaerobic digester facilities would operate less efficiently, which would materially and adversely affect our overall profitability. A substantial portion of the gas production of Microgy's facilities is derived from the co-digestion contribution enabled by substrate. We are aggressively pursuing efforts to secure reliable substrate supplies on cost-effective terms for projects.

### **Item 4. Controls and Procedures**

The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by the company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by the Exchange Act Rule 13a-15(b) as of March 31, 2009. Based on that evaluation the Chief Executive Officer and the Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended March 31, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **Table of Contents**

### **PART II. OTHER INFORMATION**

#### **Item 1. Legal Proceedings**

We are not a party to any material legal proceedings.

#### **Item 1A. Risk Factors**

Investing in our securities, involves a high degree of risk. You should carefully consider the risks and uncertainties described below before purchasing our securities. The risks and uncertainties described below are not the only ones facing our company. Additional risks and uncertainties may also impair our business operations and adversely affect our prospects. The order in which such risks are presented does not necessarily reflect the relative importance of such risks or the likelihood that any of the events or circumstances described below will occur or exist.

If any of the following risks actually occur, our business, financial condition or results of operations would likely suffer. In that case, the trading price of our common stock could fall and you may lose all or part of the money you paid to buy our common stock.

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

*We have experienced losses to date, and we anticipate that we will continue to experience losses through at least 2010, which means that we will have to raise significant additional financing in the first half of 2009 in order to continue our business operations.*

We are a company in the process of pursuing an aggressive and novel business approach to the construction and operation of renewable energy facilities and the production of renewable natural gas. As noted below, our sole operating business, Microgy, is in the early stages of its development. As a result, we have a history of losses. For the three months ended March 31, 2009, we incurred a net loss from continuing operations of \$2,935,000. For the year ended December 31, 2008, we incurred a net loss from continuing operations of \$22,996,000 which includes a non-cash, non-recurring expense for the impairment of goodwill of \$4,913,000. For the years ended December 31, 2007 and 2006, we incurred net losses from continuing operations of \$11,161,000, and \$11,399,000, respectively. We expect to continue to incur losses, reduce our earnings or, as the case may be, add to our earnings deficit as we seek to further develop our business. We currently expect that these ongoing losses will adversely affect our financial condition through at least 2010. As a result of these losses, we anticipate that we will, in all likelihood, have to rely on external financing for most of our capital and operational requirements. We will need to raise substantial financing in the first half of 2009 in order to fund ongoing general and administrative expenses associated with our corporate overhead as well as interest and dividend requirements and to continue as a going concern. We currently have no commitments for any such financing. We cannot assure you such financing will be available on reasonable terms or in a timely fashion, or at all, particularly in the current economic environment, in which capital raising activities are especially challenging. Future losses are likely to continue unless we successfully implement our business plan. If we are not successful in reaching and maintaining profitable operations, we may not be able to attract sufficient capital to continue our operations and avoid defaulting on our corporate and subsidiary debt and other obligations. Our inability to obtain adequate financing would likely result in the need to reduce the number of projects we construct and even to curtail or cease our business operations and would materially impair the value of your investment in our securities.

*Our sole operating business, Microgy, has limited operating history from which to evaluate its business and products.*

Our sole operating business, Microgy, was formed in 1999 and remains in the early stages of its development. Microgy is developing facilities that use environmentally friendly anaerobic digestion and other technologies to produce biogas from animal and organic wastes. Although Microgy has developed and is operating three single digester facilities in Wisconsin and the multi-digester Huckabay Ridge facility, Microgy still has limited experience in the construction and operation of multiple digester facilities such as those Microgy is currently constructing or intends to construct, and limited experience in gas conditioning or the sale of gas as a

**Table of Contents**

commodity. In addition, Microgy has experienced challenges during the startup and initial operation of the Huckabay Ridge facility that have resulted in outages for corrective measures. We took advantage of such an outage to complete comprehensive upgrades to process-instrumentation and controls, the gas conditioning system, and the gas-collection system in order to achieve anticipated performance levels. While we gained valuable knowledge as to our processes and incorporated the lessons learned into future projects, we cannot assure you that similar challenges will not be encountered with respect to future facilities. Because of Microgy's limited experience, there is a risk that Microgy may never be profitable.

***Microgy cannot predict when any facility will be completed, what Microgy's costs will be or, consequently, whether Microgy or any facility developed by Microgy will be profitable.***

Development of Microgy's facilities is an inherently risky activity, subject to significant uncertainties and a lengthy development cycle. Uncertainties and risks include those relating to costs and availability of supplies and labor, costs and quality of facility components and installation services, fluctuations in the prices available for the sale of facility output and timing of completion of construction and commencement of commercial operations. Furthermore, obtaining the large number of agreements, permits and approvals necessary to develop, install, operate and manage any of Microgy's facilities, as well as to market the energy and other co-products and to provide necessary related resources and services, involves a long development cycle and decision-making process. Microgy is required to enter into or obtain some or all of the following in connection with the development of its facilities:

Off-take interconnection agreements;

Site agreements;

Supply contracts;

Design/build or other construction-related agreements;

Off-take agreements for gas produced;

Power sales contracts for facilities dedicated to the generation of electricity;

Agreements for the sale of greenhouse gas sequestration credits or other tradable environmental attributes;

Various co-product sales agreements;

Waste disposal agreements;

Environmental and other permits and licenses;

Government approvals; and

## Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-Q

Financing commitments required for the successful completion of facilities under consideration.

Microgy's failure to accomplish any of these objectives could materially increase the cost, or prevent the successful completion of, development or operation of facilities and incur the loss of any investment made. Many of these objectives are dependent upon decisions by third parties. Delays in such parties' decision-making process are outside of our control and may have a negative impact on our development costs, cost of operations, receipt of revenue and revenue projections. We expect that, in some cases, it may take a year or more to obtain decisions on permits and approvals and to negotiate and close these complex agreements. Such delays could harm our operating results and financial condition.

As a result of the foregoing uncertainties we are unable to project with certainty Microgy's organizational, structural, staffing or other overhead costs, the construction or operating costs associated with any facility, or whether any facility, or Microgy as a whole, will generate a profit. If Microgy fails to generate a profit, your investment in our securities will be materially adversely affected.

***If we are unable to obtain needed financing for Microgy's facilities, the value of our Microgy investment may be reduced significantly.***

Because we have not yet generated sufficient positive cash flow, and do not expect to do so until at least 2011, we do not have adequate funds on hand to complete construction of the facilities we currently have planned. We are seeking and will require

---

**Table of Contents**

corporate, project or group financing to fund the cost of any development we may decide to pursue for Microgy's facilities. This financing may be difficult or impossible for us to obtain particularly in the current economic environment, in which capital raising activities are especially challenging. If we are unable to obtain such financing, the value of our Microgy investment may be reduced significantly, and we may be required to substantially curtail our business or completely cease construction or operation of any facilities. The availability of additional financing will depend on prospective lenders' or investors' review of our financial capabilities as well as specific facilities and other factors, including their assessment of our ability to construct and manage each facility successfully and the current state of the economy. Such financing may not be available to us on acceptable terms, or at all. If we are unable to obtain the required financing, we will have to reduce the number of projects we construct and may even have to curtail or cease our business operations, which would have a material adverse effect on your investment in our securities.

***If Microgy is unable to obtain sufficient manure and substrate for its facilities at an acceptable cost, such facilities, and Microgy as a whole, will likely not be profitable.***

The performance of Microgy's facilities is dependent on the availability of large quantities of animal manure and substrates derived from animal and other organic waste resources to produce raw energy and meet performance standards in the generation of renewable natural gas. A substantial portion of the gas production of Microgy's facilities is derived from the co-digestion contribution enabled by substrate. While Microgy has or is expected to have agreements relating to the supply of manure and substrate, these agreements may not cover all of Microgy's requirements for such resources, and Microgy will be subject to the ability of the counterparties to such agreements to perform their obligations thereunder. Lack of manure or substrate or adverse changes in the nature or quality of such waste resources or the cost to supply or transport them would seriously affect the ability of Microgy's facilities to produce gas at profitable levels and, consequently, its ability to develop and finance facilities and to operate efficiently and generate income. As a result, its revenue and financial condition would be materially and negatively affected. For example, Microgy has recently experienced a decline in the volume of high quality substrate used by its Huckabay Ridge facility as a result of current economic conditions, which has had a negative impact on that facility's operations. We cannot assure you that the waste resources Microgy's facilities require will be available in the future in acceptable quantity or quality, for free or at prices that make them affordable or accessible.

***Microgy is expected to derive a significant portion of its revenues from the sale of renewable natural gas; as a result it may have some exposure to volatility in the commodity price of natural gas.***

Microgy is expected to derive a significant portion of its revenues from the sale of renewable natural gas. Microgy typically enters into medium-to-long-term off-take arrangements for the gas produced by its facilities as part of the planning and development of such facilities, and may enter into other hedging arrangements, in order to mitigate the associated commodity price risk. Furthermore, our subsidiary, Microgy Holdings, is required by the terms of its tax-exempt bonds to maintain certain gas price protection arrangements for specified periods of time. We believe that these arrangements will be considered normal purchases and sales and will not be subject to derivative accounting. However, there may be times when such off-take and hedging arrangements expire or otherwise terminate before new arrangements are put in place, and such arrangements are subject to the creditworthiness of the counterparties to them. In addition, we cannot assure you that any such risk management vehicles will always be available or successful. Because renewable natural gas commands a premium over, but still tracks prices for, conventional natural gas, Microgy will be exposed, to the extent not covered by long-term contracts, to market risk with respect to the commodity pricing of conventional natural gas. Historically, natural gas prices have been volatile and Microgy expects such volatility to continue.

***We expect revenues from sales of greenhouse gas sequestration credits and other environmental attributes, but the market for such attributes is nascent and may not develop in a manner that allows us to profit from the sales of such credits to the level projected, or at all.***

The multiple digester facilities that we plan to implement through Microgy Holdings and our other subsidiaries are expected to produce greenhouse gas sequestration credits and other marketable environmental attributes. While there exist trading markets for these attributes, and additional trading markets or other commercial avenues may develop, the existing trading markets are new and experience thin trading and price volatility, which can hinder sales of credits and make their value unpredictable. The quantity of credits that may be generated are a function of the carbon credit offset characteristics as determined by protocols used to document and verify the carbon offset value. These protocols continue to evolve, and changes in these protocols could substantially diminish further carbon credit eligibility. Furthermore, much of the participation in these markets is voluntary, in response to social and environmental concerns, as opposed to being driven by regulatory requirements. While many states and the federal government are

**Table of Contents**

pursuing or are considering carbon emissions limits and related initiatives that may spur greater development of and participation in these markets, we are unable to determine the effect of these initiatives on these markets. We cannot assure you that these trading markets will develop further, or even that they will continue to exist. In addition, many of our agreements with our business partners and investors require us to share such credits or any revenues we derive from sales of such credits, and agreements we negotiate in the future may also include such requirements. As a result of the foregoing, we may recognize significantly smaller revenues than we anticipate from the sale of greenhouse gas sequestration credits or other environmental attributes.

***We have pledged all of our interest in our facilities in Texas and California as security for the loans relating to Microgy Holdings tax-exempt bond financings in those jurisdictions, and our subsidiary, Microgy Grand Island, LLC, has entered into a financing lease with respect to the Grand Island facility.***

We have invested, and expect to invest, substantial funds and resources in the Huckabay Ridge facility and the other multi-digester, renewable natural gas facilities in Texas, California and Nebraska. We have pledged all of our interest in the Huckabay Ridge facility, as well as the Rio Leche, Cnossen and Mission facilities in Texas as collateral security for the loan to our subsidiary, Microgy Holdings, from the Gulf Coast Industrial Development Authority of Texas relating to the \$60 million tax-exempt bond financing we completed in November 2006. We have pledged all of our interest in the Riverdale and Hanford facilities in California as collateral security for the loan to our subsidiary, Microgy Holdings, from the California Statewide Communities Development Authority relating to the \$62.425 million tax-exempt bond financing we completed in September 2008, and we expect to pledge all of our interest in the proposed Bar 20 facility in California if we are successful in closing the anticipated \$26.02 million second tranche of such financing. While these loans are non-recourse to Environmental Power, Environmental Power is required to provide at least 20% of the construction costs of these facilities, as well as to cover any cost overruns in construction and certain other significant costs, which represents a substantial investment of corporate resources. If Microgy Holdings were to default on these loans, we would lose some or all of our investment in the Texas and California facilities, which would have a material adverse effect on our business, financial condition and results of operations. In addition, our subsidiary, Microgy Grand Island, LLC, has entered into a \$7.0 million sale and leaseback transaction with the City of Grand Island, Nebraska in connection with its tax-exempt bond financing in Nebraska to finance the construction of the Grand Island facility, and has guaranteed the City's obligations under the tax-exempt bonds. Environmental Power has equity contribution and support obligations with respect to the Grand Island facility that are substantially similar to those under the Texas and California financings. If Microgy Grand Island defaults on its lease and guarantee obligations to the City of Grand Island, we would lose some or all of our investment in the Grand Island facility, which would have a material adverse effect on our business, financial condition and results of operations.

***Microgy faces competition in the renewable energy market as well as for the resources necessary to operate its facilities.***

Microgy plans to generate revenue from the development and ownership of facilities that market renewable, green energy in addition to providing pollution control features to the agricultural and food industry markets.

Microgy's green competitors include other energy producers using biomass combustion, biomass anaerobic digestion, geothermal, solar, wind, new hydro and other renewable sources. These companies represent a significant class of competitors because they will compete with Microgy for sale of marketable renewable energy credits and participation in various renewable portfolios and other programs.

Competition in the traditional energy business from electric utilities and other energy companies is well established, with many substantial entities having multi-billion dollar, multi-national operations. Many of these companies are beginning to compete in the alternative fuels and renewable energy business with the growth of the industry and the advent of many new technologies. Larger companies, due to their greater financial and other resources, will be better positioned than Microgy to develop new technologies and to install existing or more advanced renewable energy facilities, which could harm Microgy's business.

Microgy also faces many forms of competition with respect to the resources required to operate its facilities. Such competition includes other providers of pollution control, including environmental engineers, providers of pollution control systems, private

---

**Table of Contents**

companies, public companies, associations, cooperatives, government programs, foreign companies, and educational pilot programs. Furthermore, there are many companies that offer anaerobic digester systems. A number of these competitors have more mature businesses and have successfully installed anaerobic digester systems in the United States. Microgy may be forced to compete with any of these competitors for access to equipment, construction supplies, skilled labor for the construction and operation of its facilities and the supplies of manure and substrate required to operate its facilities. In addition, Microgy may also have to compete for access to substances that make desirable substrates with other users of these substances, such as recyclers of waste grease and producers of biodiesel and other biofuels. The effect of such competition could be reflected in higher costs associated with obtaining access to these resources, as well as an insufficient supply of these resources for the profitable operation of Microgy's facilities. If Microgy cannot obtain and maintain these supplies, or cannot obtain or maintain them at reasonable costs, the profitability of Microgy's business will be adversely affected.

***Extreme weather events may have a material adverse effect on the operation on our facilities.***

Microgy's facilities and sites are sensitive to extreme weather events. For instance, the anaerobic digestion process requires temperatures within a certain band, and extreme cold or heat may negatively impact the process or increase operating costs as a result of the need to counter such temperatures. This was the case in early 2007, when Texas experienced record cold temperatures that hindered startup of the Huckabay Ridge facility. Also, our sites contain retention ponds that have been designed with ample capacity to collect and retain storm water run-off, but, despite applying best maintenance practices, that capacity on rare occasions can be strained by severe rainfall. Thus, in August 2008, a 25-year record rainfall event caused a storm water retention pond breach and spill that required cleanup of a dry creek bed and reporting to the local environmental authorities. While Microgy considers typical local weather conditions in the design of its facilities and maintains appropriate insurance to mitigate associated risks to the extent commercially feasible, Microgy cannot anticipate all unusual weather events, and such events have had and may in the future have a material adverse effect on the operation of its facilities.

***It is possible that we may expend large sums of money on individual projects to bring Microgy's products to market and that the revenue that Microgy derives from these products from new projects may be insufficient to fund our operations.***

Microgy's business approach to the renewable energy may not produce results as anticipated, be profitable or be readily accepted by the marketplace. We cannot estimate whether the gas produced by facilities based on Microgy's technology will materialize at anticipated prices, or whether satisfactory profit margins will be achieved. If such pricing levels are not achieved or sustained, or if Microgy's technologies and business approach to Microgy's markets do not achieve or sustain broad acceptance, our business, operating results and financial condition will be materially and negatively impacted.

***Because we have not filed patents to protect Microgy's intellectual property, we might not be able to prevent others from using Microgy's technology; conversely, others who have filed for patent or other protection might be able to prevent Microgy from using its technology.***

Microgy has not filed any patent applications on any of its intellectual property. Should Microgy decide to file patent applications, we cannot assure you that any patent applications relating to Microgy's existing or future products or technologies will result in patents being issued, that any issued patents will afford adequate protection to Microgy, or that such patents will not be challenged, invalidated, infringed or circumvented. Furthermore, we cannot assure you that others have not developed, or will not develop, similar technologies that will compete with Microgy's without infringing upon Microgy's intellectual property rights or those of its licensor.

Third parties, including potential competitors, may already have filed patent applications relating to the subject matter of Microgy's current or future technology. In the event that any such patents are issued to such parties, such patents may preclude Microgy or its licensor from obtaining patent protection for its technologies, products or processes. In addition, such patents may hinder or prevent Microgy from commercializing its technology and could require Microgy to enter into licenses with such parties. We cannot assure you that any required licenses would be available to us on acceptable terms, or at all.

## **Table of Contents**

Microgy relies on confidentiality agreements and licensing agreements to maintain the proprietary nature of its technology. To compete effectively, Microgy may have to defend the rights to its intellectual property from time to time. Such defense costs may be significant and have a negative impact on our financial condition. In addition, we may lack the financial resources to adequately defend Microgy's intellectual property.

### ***Microgy's facilities are likely to be subject to numerous governmental regulations.***

We expect that Microgy's facilities are likely to be subject to various local, state and federal government regulations, including regulations covering air and water quality, solid waste disposal and related pollution issues. These regulations are mandated by the United States Environmental Protection Agency, or EPA, and state and local governments and are usually implemented through a permitting process, with ongoing compliance requirements thereafter. For example, grease-trap waste from restaurants and other food service providers is a desirable and highly available form of substrate for our facilities in Texas. However, the Texas environmental authorities required that we obtain a solid-waste permit for each of our planned facilities in Texas to the extent we desire to use grease-trap waste as substrate in the operation of such facilities. Furthermore, we have had to obtain water discharge permits for our planned California facilities, which typically involve a lengthy process. We expect that all of our facilities will be required to obtain various environmental and other permits and approvals, which will vary from location to location. In addition, our activities will fall under a number of health and safety regulations and laws and regulations relating to farming and zoning. Compliance with these regulations and permitting requirements could delay the development of facilities and could be costly and harm our financial condition.

### ***Microgy's facilities may become subject to regulations or taxes based on carbon or other emissions.***

Microgy's facilities produce and emit into the atmosphere carbon dioxide and hydrogen sulfide as a result of the anaerobic digestion gas conditioning processes that they employ. While such facilities capture and thereby reduce the amount of methane, a potent greenhouse gas, that would otherwise enter the atmosphere, there are direct emissions of carbon dioxide, another greenhouse gas. As such, Microgy's facilities may still be subject to future federal or state legislation or regulation, or the implementation of international treaties, which seek to limit or impose a cost on greenhouse gas emissions. If any such legislation, regulations or treaties were implemented, Microgy may be required to expend resources to capture the carbon dioxide it produces, pay a tax on its carbon dioxide emissions, purchase greenhouse gas sequestration credits, reduce the greenhouse sequestration credits claimed for such facilities or take similar actions. In addition, Microgy could become subject to federal, state and local taxes and regulations regarding its other emissions. Any of the foregoing could harm the profitability of Microgy's facilities.

### ***Our operating results are difficult to predict in advance and may fluctuate significantly, which may result in a substantial decline in our stock price.***

Our operating results are difficult to predict in advance and may fluctuate significantly, and a failure to meet the expectations of analysts or our stockholders would likely result in a substantial decline in our stock price.

Factors that are likely to cause our results to fluctuate include the following:

the amount and timing of our operating expenses and capital expenditures;

the success or failure of the facilities currently underway;

our ability to specify, develop and complete facilities, and to introduce and market the energy created by such facilities and bring them to volume production in a timely manner;

the rate of adoption and acceptance of new industry standards in our target markets; and



Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-Q

other unforeseen activities or issues.

If our operating results fluctuate greatly, our business may be materially adversely affected and our stock price will likely decline.

*If, by June 30, 2009, the Huckabay Ridge facility fails to meet certain performance tests, and we and our subsidiaries fail to achieve certain capital raising targets, Microgy Holdings may be required to repurchase or redeem the California bonds, making the funds from such financing unavailable for the planned California projects.*

---

**Table of Contents**

The terms of Microgy Holdings tax-exempt bond financing in California require that the following conditions be met before the proceeds of the financing can be drawn for the planned California projects:

the Huckabay Ridge facility has produced an average of 1,525 MMBtu of RNG<sup>®</sup> per day for a period of 60 consecutive days and a gross profit of at least \$350,000 during such period; and

Environmental Power, Microgy Holdings or its subsidiaries has raised an aggregate of at least \$45 million in additional capital after September 3, 2008, of which at least \$17.5 million is available for investment in the planned California facilities, with such amounts being reduced by the amount of the anticipated equity contribution for the planned Bar 20 facility in California should there be no further bond financing for such facility.

If the foregoing conditions are not met, the holders of a majority of the California bonds have the right, exercisable by written notice to Microgy Holdings on or before July 31, 2009, to require Microgy Holdings to purchase all of the California bonds on or before August 31, 2009 at a purchase price of \$62.425 million (the par amount of such bonds) plus accrued interest to the purchase date. If Microgy Holdings does not purchase the California bonds, it will be deemed to have abandoned construction of the planned California facilities, and the bondholders may cause the California bonds to be called for redemption to the extent of funds then held by the trustee. If the California bonds are called for redemption, Environmental Power has agreed to contribute an amount equal to the portion of the proceeds of the California bonds used to pay costs of issuance, which was approximately \$1,248,500.

We are currently in the last 60-day period prior to June 30, 2009, and while we have substantially increased confidence in the reliability of the Huckabay Ridge facility, we cannot assure you that the foregoing conditions will be met, particularly as current economic conditions have led to decreased availability of optimal substrate supplies which has had an adverse impact on the performance of the Huckabay Ridge facility. If the foregoing conditions are not met and the holders of the California bonds require purchase or redemption of their bonds, then, assuming there are no defenses available to such actions and obligations, the proceeds of the California bonds would not be available for Microgy Holdings planned California projects and Environmental Power would have an obligation to pay approximately \$1,248,500. We believe the loss of the proceeds of the California bonds and the payment by Environmental Power could have a material adverse effect on our financial condition, our results of operations and our ability to continue as a going concern if ongoing alternative financing efforts are not successful.

In addition, we have agreed with the holders of the bonds issued to finance the Texas facilities that we will not draw any proceeds from the Texas bonds to pay costs of the planned Mission project until the Huckabay Ridge facility has reached the production and profitability tests described above.

**Risks Relating to Our Capital Stock**

*We have numerous outstanding shares of restricted common stock, as well as options, warrants and shares of preferred stock exercisable or convertible into a substantial number of shares of our common stock; the resale of outstanding restricted shares, as well as the exercise or conversion of these securities and the resale of the underlying shares, may adversely affect the price of our common stock.*

The resale by our stockholders of shares of our restricted common stock or securities exercisable for or convertible into shares of our common stock could cause the market price of our common stock to decline.

A significant portion of our outstanding shares of common stock had been restricted from immediate resale, but is now available for sale in the market pursuant to Rule 144 under the Securities Act of 1933. As of March 31, 2009, we had approximately:

15,614,604 shares of our common stock issued and outstanding, of which 1,212,726 shares of common stock outstanding are restricted securities within the meaning of Rule 144 and 35,250 shares are subject to vesting pursuant to restricted stock awards granted to certain employees; and

2,823,659 shares of common stock issuable upon conversion of our series A preferred stock;



---

**Table of Contents**

all of which shares, other than employee restricted stock awards subject to vesting, are eligible for resale without volume and manner of sale restrictions in accordance with Rule 144, except to the extent held by our affiliates. We are currently authorized to issue 50,000,000 shares of common stock.

We also currently have on file with the Securities and Exchange Commission an effective registration statement that permits the resale of up to 100,000 shares of our common stock subject to warrants exercisable at a price of \$6.33 per share by the holders of such warrants. In addition, in connection with our sale of shares of our series A preferred stock and common stock warrants on November 9, 2006, we filed a registration statement to permit the resale of up to 4,387,360 shares of common stock issuable upon conversion of such shares of series A preferred stock and exercise of such warrants, which registration statement is currently effective. The shares of series A preferred stock were convertible at a conversion price of \$5.27 per share, and the common stock warrants were exercisable at a price of \$5.52 per share as to 1,406,205 of the warrants, and \$5.27 per share as to 168,745 of the warrants. In October 2007, the exercise price of the warrants was reduced to \$5.25 per share, and the preferred stock conversion price was reduced to \$5.25 per share as a result of anti dilution adjustments triggered by the issuance of common stock in the October 2007 public offering, resulting in an increase of 11,250 in the number of shares of our common stock issuable upon conversion of the series A preferred stock.

In addition, pursuant to our business development agreement with Cargill, Incorporated, we may issue warrants to Cargill from time to time to acquire up to an aggregate of 4.99% of our outstanding common stock on a fully diluted basis, at an exercise price equal to 75% of the closing price of our common stock on the date on which such warrants are issued. In May 2007, we issued to Cargill warrants to purchase 175,912 shares of our common stock at an exercise price of \$5.37 per share, representing 1% our fully diluted common stock at the time, as required by the business development agreement.

On March 13, 2009, we closed on the sale of \$5 million original principal amount of our 14% convertible notes due January 1, 2014. These notes are convertible into an aggregate of up to approximately 925,926 shares of our common stock, based upon the minimum conversion price of the notes, all of which shares may be sold by the holders thereof without restriction, except to the extent held by our affiliates.

We have entered into an agreement with the licensor of Microgy's technology to issue an additional \$3,000,000 original principal amount of the notes as payment for certain license fees in a private placement transaction. These notes would be convertible into up to approximately 555,556 shares of common stock, based upon the minimum conversion price. These shares would be restricted securities within the meaning of Rule 144.

As of March 31, 2009, we had outstanding options, SARs and warrants to acquire up to approximately 4,668,978 shares of our common stock at prices ranging from \$1.75 to \$8.89 per share, with a weighted average exercise price of \$5.18 per share and an average remaining contractual term of 4 years. The shares of common stock issuable upon exercise of these options will be freely transferable without restriction, except to the extent that they are held by our affiliates. Any shares held by our affiliates may only be sold in compliance with the volume limitations of Rule 144. These volume limitations restrict the number of shares that may be sold by an affiliate in any three-month period to the greater of 1% of the number of shares then outstanding, which equals approximately 156,000 shares as of March 31, 2009, or the average weekly trading volume of our common stock during the four calendar weeks preceding the filing of a notice on Form 144 with respect to the sale.

As a result of the resale of outstanding shares of our common stock, including restricted shares and shares issuable upon exercise or conversion of the foregoing securities, the price of our common stock may be adversely affected.

***The issuance of preferred stock may adversely affect the value of our common stock or make it more difficult for a party to acquire a controlling interest in our company.***

We are authorized to issue up to 2,000,000 shares of preferred stock, of which 281,241 shares have been designated as series A 9% cumulative convertible preferred stock, referred to as the series A preferred stock, and which are currently issued and outstanding. The preferred stock not already designated and issued may be issued in series from time to time with such designations, rights, preferences and limitations as our board of directors may determine by resolution without stockholder approval. While the terms of the series A preferred stock do not currently allow for the issuance of preferred stock having dividend and liquidation preferences greater than or senior to the series A preferred stock, any future issuances of preferred stock may enjoy dividend and liquidation preferences over our common stock, thereby diminishing the value of our common stock. Furthermore, the issuance of preferred stock, as well as any authorized but unreserved common stock, while providing flexibility in connection with possible future financings or acquisitions and other corporate purposes, could have the effect of making it more difficult for a third party to acquire, or could discourage a third party from seeking to acquire, a controlling interest in our company.

## **Table of Contents**

***Our management and directors, as well as the holders of our series A preferred stock, are able to exercise significant control over our management and affairs.***

As of December 31, 2008, executive officers and directors, including Richard E. Kessel, Joseph E. Cresci, Roger Ballentine, Kamlesh R. Tejwani, Robert I. Weisberg, John R. Cooper, August Schumacher, Jr., Lon Hatamiya, Steven Kessner, Michael E. Thomas and Dennis Haines, beneficially owned approximately 17.46% of our outstanding common stock. In addition, the three holders of our series A preferred stock, two of which are affiliated with each other, control approximately 18.3% of the total number of votes currently entitled to be cast at any meeting of our stockholders. While there are no voting agreements among them, such persons, as a group, may be able to exercise some level of control over the outcome of matters submitted for stockholder action, including the election of members to our board of directors and the approval of significant change in control transactions. This may have the effect of delaying or preventing a change in control of our company and, therefore, your opportunity to sell your shares in such a transaction. Furthermore, the holders of our series A preferred stock have special approval rights with respect to certain changes to our certificate of incorporation and certain other corporate actions.

***The lack of a developed trading market may make it difficult for you to sell shares of our common stock.***

While our common stock is currently listed for trading on the NASDAQ Capital Market, trading activity in our common stock has fluctuated and has at times been limited. For example, for the one-month period from March 1, 2009 to March 31, 2009, our daily trading volume ranged from a low of 14,500 shares to a high of 497,500 shares, and averaged 83,500 shares. We cannot guarantee that a consistently active trading market will develop in the future. As a result, a holder of our common stock may find it difficult to dispose of our common stock.

***If we fail to continue to meet all applicable continued listing requirements of The NASDAQ Capital Market and NASDAQ determines to delist our common stock, the market liquidity and market price of our common stock could decline.***

Our common stock is currently listed on The NASDAQ Capital Market. In order to maintain that listing, we must satisfy minimum financial and other listing requirements. Among these requirements is that our common stock maintain a minimum closing bid price of at least \$1.00 per share. If our common stock fails to maintain a minimum closing bid price of at least \$1.00 per share for thirty consecutive business days, we will have a 180-day period to regain compliance with the minimum bid price rule. If we fail to regain compliance within such period, our common stock may be subject to delisting from the NASDAQ Capital Market. NASDAQ temporarily suspended its minimum bid price rule effective October 16, 2008 until January 16, 2009, due to overall conditions affecting the stock markets. This suspension was recently extended to April 19, 2009. Our common stock has not had a minimum closing bid price of \$1.00 per share since October 20, 2008. If we fail to continue to meet all applicable listing requirements of The NASDAQ Capital Market and NASDAQ determines to delist our common stock, an active trading market for our common stock may not be sustained and the market price of our common stock could decline. In addition, the delisting of our common stock would also trigger a right on the part of the holders of our outstanding shares of series A preferred stock to increase the cumulative dividend rate on such shares from 9% per year to 16% per year. We cannot assure you that we will not ultimately fail to comply with the minimum bid price rule or other NASDAQ listing standards.

***The market price for our common stock has been and may continue to be volatile.***

The market price for our common stock has been volatile, and it is likely to continue to be so. For instance the closing price of our common stock reached a high of \$6.25 in the first quarter of 2008 and a low of \$0.28 in the fourth quarter of 2008 and has varied from a low of \$0.36 to a high of \$0.92 in the first quarter of 2009. While we cannot state with any certainty the specific reasons for the recent volatility of our stock price, we believe that such volatility could be due to the current financial recession and related economic uncertainties and their impact on the stock market generally as well as on the stock prices of early stage companies such as ours, in addition to the risks and uncertainties regarding our business described elsewhere in this report. In addition, the market price for our common stock could be subject to significant fluctuations in response to variations in quarterly operating results, announcements of technological innovations or new facilities and products by us or our competitors, or our failure to achieve operating results consistent with any securities analysts' projections of our performance. Furthermore, the stock market has

---

**Table of Contents**

experienced extreme price and volume fluctuations and volatility that have particularly affected the market price of many emerging growth and development stage companies such as ours. Such fluctuations and volatility have often been unrelated or disproportionate to the operating performance of such companies. As a result of fluctuations related or unrelated to our performance, the value of our common stock may be materially adversely affected.

*We will require and are actively seeking significant additional financing, which may result in our issuing a significant number of shares of our common stock or preferred stock, which in turn may dilute the value of your shares.*

We have historically needed to raise capital to fund our operating losses. We expect to continue to incur operating losses through at least 2010. In November 2006, we completed a tax-exempt bond financing in Texas to finance a portion of the construction costs of our Texas facilities, as well as a \$15 million private placement of our series A preferred stock and common stock warrants. In October 2007, we completed a public offering resulting in net proceeds to us of approximately \$26.6 million. In July 2008, we completed a \$7.0 million tax-exempt bond financing in Nebraska to finance a portion of the construction costs of our Grand Island facility. In September 2008, we completed a \$62.425 million first tranche tax-exempt bond financing in California to finance a portion of the constructions costs of our proposed California facilities, and anticipate pursuing a proposed \$26.02 million second tranche financing. On March 13, 2009 we closed on a sale of \$5.0 million original principal amount of our 14% convertible notes due January 1, 2014 for net proceeds of approximately \$4.5 million, and we continue to work with our financial advisors to identify and explore various opportunities to raise the capital we require. However, we cannot assure you that we will be able to raise sufficient capital on acceptable terms, or at all. The level of funds we are able to raise, if any, will determine the level of development and construction activity that we can pursue and whether we will be able to continue as a going concern. We will require and will continue to seek corporate and project financing to fund our ongoing overhead and growth plans as well as the cost of any development we may decide to pursue for our facilities. Without limiting the foregoing, as described elsewhere in this annual report, we will have to raise significant additional capital in the first half of 2009 in order to fund ongoing general and administrative expenses associated with our corporate overhead as well as interest and dividend requirements. We cannot assure you that such capital will be available in sufficient amounts or on terms acceptable to us, if at all. Any such financing could be in the form of debt or equity instruments or a combination of debt and equity instruments. To the extent any such financing involves equity or convertible debt, we may issue a significant number of shares of our common stock or preferred stock, which will dilute an existing investment in our common stock, and we may issue such shares at prices that may be lower than the price paid for our common stock by our stockholders. In addition, if we issue shares of preferred stock, such preferred stock may have rights and preferences that are superior to those of our common stock. Indeed, the shares of our series A preferred stock issued in our November 2006 private placement have rights and preferences that are superior to those of our common stock. Because we are authorized to issue shares of additional series of preferred stock, as designated by our board of directors, subject to certain limitations included in the terms of our series A preferred stock, we may issue more shares of preferred stock in the future.

Issuances of common stock or securities convertible into common stock in the future could dilute existing stockholders and adversely affect the market price of our common stock. Of the 50,000,000 shares of authorized common stock, 15,703,034 are issued, 15,614,604 are outstanding and 4,668,978 have been reserved for issuance upon the exercise of options, SARS and warrants outstanding as of March 31, 2009. An additional 2,823,660 shares have been reserved for issuance in connection with the conversion of shares of our series A preferred stock issued in our November 2006 private placement. We may also issue warrants to purchase up to 4.99% of our common stock, on a fully diluted basis, to Cargill, Incorporated pursuant to the terms of our business development agreement. In May 2007, we issued warrants to purchase 175,912 shares of our common stock at an exercise price \$5.37 per share, representing 1% of our fully diluted common stock at the time to Cargill as required by the business development agreement. Additionally, in October 2007, we issued 5,400,000 shares of common stock in an underwritten public offering. We also have the authority to issue preferred stock as previously described, debt securities convertible into common stock, and options and warrants to purchase shares of our common stock. We may issue shares of common stock or securities convertible into common stock at values below our market price up to a maximum of 19.9% of our outstanding common stock without stockholder approval, which values may be substantially below the price paid for our common stock by our stockholders. We also do not need stockholder approval to issue an unlimited number of shares of common stock or securities convertible into common stock (provided sufficient shares of common stock are authorized and unreserved) at or above the market price for our common stock pursuant to certain NASDAQ Capital Market requirements. Any such issuances could be at values below the price paid for our common stock by our stockholders.

---

**Table of Contents**

*Our outstanding series A preferred stock has rights and preferences superior to that of our common stock, may impair our ability to raise additional financing, may harm our financial condition if we are required to redeem it and could have the effect of discouraging an acquisition or reducing the amount of proceeds available to common stockholders upon such an acquisition.*

Our shares of series A preferred stock have rights and preferences which are superior to those of our common stock, including:

an accruing dividend of 9% on the stated value of each outstanding share of series A preferred stock, payable before the payment of any dividends on our common stock;

a preference upon liquidation, dissolution or winding up of Environmental Power equal to 200% of the stated value of each share of preferred stock, plus any accrued but unpaid dividends;

the right to consent to certain changes to our certificate of incorporation and bylaws, and certain other significant corporate actions; and

the right to a payment equal to 150% of the stated value of each outstanding share of Series A preferred stock upon certain change-in-control events.

Our series A preferred stock may also have a material adverse effect on our financial condition and results of operations. With certain exceptions, including exceptions for permitted indebtedness, as defined, we have agreed to limit our ability to incur additional indebtedness while such preferred stock is outstanding. Subject to other exceptions, we have also agreed with series A holders not to issue stock senior to or on a par with series A preferred stock. These constraints could materially and adversely affect our ability to raise funds necessary to continue our business. In addition, the series A preferred stock provides for various triggering events, such as our common stock not being listed for trading on the American Stock Exchange, NASDAQ Global Market, NASDAQ Capital Market or New York Stock Exchange, the failure to deliver shares of our common stock upon conversion and specified change of control transactions. Several other triggering events are described in the certificate of designations, preferences and rights of the series A preferred stock. If one of these triggering events occurs, we may be required to redeem all or part of the outstanding shares of series A preferred stock at 120% of their stated value (150% in the case of certain change in control transactions), including payment of accrued dividends and penalties, or the dividend rate on the series A preferred stock may be increased from 9% per year to 16% per year, depending on the triggering event and the elections made by the holders of the series A preferred stock. Some of the triggering events include matters over which we may have some, little, or no control. Any such redemption could leave us with little or no working capital for our business. Furthermore, by virtue of their voting power and other rights and preferences, the outstanding series A preferred stock could have the effect of blocking or discouraging certain acquisitions of our company or reducing the proceeds available to common stockholders as a result of any such acquisitions.

*We do not intend to pay cash dividends on our common stock.*

We have not paid cash dividends on our common stock since 2001, and we do not expect to pay cash dividends on our common stock at any time in the foreseeable future. The future payment of dividends directly depends upon the future earnings, capital requirements, financial requirements and other factors that our board of directors will consider, and is subject to the prior payment of all accrued but unpaid dividends on our series A preferred stock. Furthermore, the terms of our series A preferred stock prohibit the payment of dividends on our common stock while any shares of our series A preferred stock are outstanding. Because we do not anticipate paying cash dividends on our common stock, the return on any investment in our common stock will depend solely on a change, if any, in the market value of our common stock.

**Risks Relating to Our 14% Convertible Notes due January 1, 2014**

*Our subsidiaries have incurred and may in the future incur substantial indebtedness or issue equity interests to third party investors which are structurally senior to the notes and the terms of which limit the ability of such subsidiaries to distribute cash to Environmental Power.*

## **Table of Contents**

Because we are a holding company, our right to participate in any distribution of assets of any of our subsidiaries upon any subsidiary's liquidation or reorganization or otherwise, is subject to the prior claims of their creditors, except to the extent we may be recognized as a creditor of that subsidiary. Our subsidiaries may also issue equity interests to third party investors. Accordingly, our obligations under our 14% convertible notes due January 1, 2014, referred to as the notes, will be effectively subordinated to all existing and future indebtedness and liabilities of our subsidiaries, and may be limited by the terms of third party equity interests in our subsidiaries, and holders of the notes should look only to our assets for payment thereunder. In particular, our subsidiaries, Microgy Holdings, LLC and Microgy Grand Island, LLC, have incurred substantial indebtedness in connection with the financing of their facilities and proposed facilities. As of December 31, 2008, this indebtedness amounted to approximately \$129.4 million. As previously noted, the terms of this indebtedness provide for a security interest in all of the assets of such entities and their subsidiaries, and also set forth certain conditions and limitations on the ability of such entities to distribute cash to Environmental Power. As a result, such indebtedness is structurally senior to the indebtedness represented by the notes. These entities, as well as other subsidiaries we may form to own and operate our projects, may incur additional indebtedness, issue equity interests to third party investors or enter into other agreements which similarly may be structurally senior to the notes and may otherwise limit the ability of such entities to distribute cash to Environmental Power.

***There is no established trading market for the notes.***

The notes are not listed for trading on any national securities exchange, and we have no plans to list the notes on any exchange. While there is currently outstanding \$5,000,000 aggregate original principal amount of the notes, these notes were recently issued, and there is no established trading market for the notes. We have been advised by the underwriter that it intends to make a market in the notes but is not obligated to do so and may discontinue market making at any time without notice. No assurance can be given as to the liquidity of any trading market for the notes that may develop.

***We cannot assure you that the IRS or a court will agree with the characterization of the notes as indebtedness for U.S. federal income tax purposes.***

The notes are novel financial instruments, and there is no statutory, judicial or administrative authority that directly addresses the U.S. federal income tax treatment of an instrument similar to the notes. We cannot assure you that the IRS or a court will agree with the characterization of the notes as indebtedness for U.S. federal income tax purposes. If the notes were recharacterized as equity, we would not be entitled to deduct interest payments on the notes, which may result in an increase in our U.S. federal income tax liability.

***Holders should consider the U.S. federal income tax consequences of owning and converting the notes.***

The U.S. federal income tax treatment of the notes and the conversion of the notes into shares of our common stock is uncertain. Holders are urged to consult their tax advisors with respect to the U.S. federal income tax consequences resulting from the conversion of the notes into shares of our common stock.

***Holders may have to pay taxes with respect to distributions on our common stock that holders do not receive.***

The conversion rate of the notes is subject to adjustment for certain events arising from stock splits and combinations, stock dividends and other actions we take that modify our capital structure. If the conversion rate is adjusted, under certain circumstances holders may be deemed to have received a constructive dividend from us, which may result in ordinary income to holders for U.S. federal income tax purposes, even though such holders would not receive any cash related to that adjustment and even though such holders might not exercise their conversion rights.

***The holders will have a right to tender their notes, and we will have the right to repurchase the notes, following a change in control.***

A change in control of Environmental Power could give rise to both an obligation and a right on our part to repurchase the notes at the request of the holders. We cannot assure you that sufficient monies will be available to pay the principal, accrued interest and premium due on the notes in the case of a voluntary tender by the holders. We cannot assure you that a refinancing to pay such amounts could be obtained. In the absence of such refinancing, we could be forced to dispose of assets or the assets of our subsidiaries in order to make payments due on our indebtedness under circumstances that might not be favorable to realizing the highest price for such assets. We cannot assure you that a refinancing of the notes can be obtained quickly enough or for sufficient amounts to enable us to meet our obligations, including our obligations with respect to the notes.



**Table of Contents**

*Upon a conversion of the notes, holders of notes will cease to have certain rights.*

The holders of the notes have the right to elect to convert, and, under certain circumstances, we have the right to require the conversion of, outstanding notes into shares of our common stock. Should either the holders or we elect to effect such a conversion, holders will cease to have the protections afforded under the indenture governing the notes, including, among other things:

the right to be paid principal, interest, and other amounts at maturity and at certain other times;

the right to be paid principal, interest and other amounts on the notes in preference to any payments to holders of our common or preferred stock or holders of any of our subordinated indebtedness; and

the rights associated with the various covenants and default provisions set forth in the indenture.

*If the notes are redeemed, converted or repurchased, you may not receive the return on your investment that you anticipate.*

The notes are subject to redemption, repurchase and conversion prior to their maturity date, both at the election of the holders and at our election, under certain circumstances described in the indenture relating to the notes. If any such redemption, conversion or repurchase occurs, the total return you receive on your investment in the notes may be materially less than the return you would have received had you held the notes to maturity

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Not applicable.

**Item 3. Defaults Upon Senior Securities**

Not applicable.

**Item 4. Submission of Matters to a Vote of Security Holders**

Not applicable

**Item 5. Other Information**

Not applicable

**Item 6. Exhibits**

The exhibits listed in the accompanying exhibit index are filed as part of this Quarterly Report on Form 10-Q and are incorporated herein by reference.

**Table of Contents**

**SIGNATURES**

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.

ENVIRONMENTAL POWER CORPORATION

By: /s/ Michael E. Thomas  
Michael E. Thomas  
Senior Vice President, Chief Financial Officer and Treasurer  
(principal financial and accounting officer and authorized officer)

May 8, 2009

**Table of Contents**

**Exhibit Index**

**Exhibit No. Description**

- 4.1 Indenture for Senior Debt Securities, dated as of March 1, 2009, between Environmental Power Corporation, as Issuer, and Wells Fargo Bank, National Association, as Trustee (Incorporated by reference to Exhibit 4.1 to the Registrant's Current Report on Form 8-K, dated March 10, 2009 (SEC File No. 001-32393)).
- 4.2 First Supplemental Trust Indenture for 14% Convertible Notes due January 1, 2014, dated as of March 1, 2009, between Environmental Power Corporation, as Issuer, and Wells Fargo Bank, National Association, as Trustee (Incorporated by reference to Exhibit 4.2 to the Registrant's Current Report on Form 8-K dated March 10, 2009 (SEC File No. 001-32393)).
- 4.3 Form of the 14% Convertible Notes due January 1, 2014 (contained in Exhibit 4.2).
- 31.1 Rule 13a-14(a)/15(d)-14(a) Certifications of Registrant's Chief Executive Officer
- 31.2 Rule 13a-14(a)/15(d)-14(a) Certifications of Registrant's Chief Financial Officer
- 32.1 Section 1350 Certifications of the Registrant's Chief Executive Officer
- 32.2 Section 1350 Certifications of the Registrant's Chief Financial Officer