

ENVIRONMENTAL POWER CORP  
Form 10-Q  
November 14, 2007  
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 September 30, 2007

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)

\_\_\_\_\_

Delaware  
(State or other jurisdiction of

incorporation or organization)

One Cate Street 4<sup>th</sup> Floor, Portsmouth, New Hampshire 03801

(address of principal executive offices) (zip code)

75-3117389  
(IRS Employer

Identification No.)

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-Q

(603) 431-1780

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

Number of shares of Common Stock outstanding at September 30, 2007: 10,267,784 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**

	<b>Page</b>
<u>Cautionary Statement Regarding Forward-Looking Statements</u>	3
 <b><u>PART I. FINANCIAL INFORMATION</u></b>	
Item 1. <u>Financial Statements</u>	4
<u>Condensed Consolidated Balance Sheets (unaudited) as of September 30, 2007 and December 31, 2006</u>	4
<u>Condensed Consolidated Statements of Operations (unaudited) for the Three and Nine Months Ended September 30, 2007 and September 30, 2006</u>	5
<u>Condensed Consolidated Statements of Cash Flows (unaudited) for the Nine Months Ended September 30, 2007 and September 30, 2006</u>	6
<u>Condensed Consolidated Statement of Equity (unaudited) for Nine Months Ended September 30, 2007</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>	12
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	17
Item 4. <u>Controls and Procedures</u>	18
 <b><u>PART II. OTHER INFORMATION</u></b>	
Item 1. <u>Legal Proceedings</u>	18
Item 1A. <u>Risk Factors</u>	18
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	23
Item 3. <u>Defaults Upon Senior Securities</u>	23
Item 4. <u>Submission of Matters to a Vote of Security Holders</u>	23
Item 5. <u>Other Information</u>	23
Item 6. <u>Exhibits</u>	23
<b><u>SIGNATURES</u></b>	23

**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 development-stage companies,

uncertainties regarding 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,

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

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,

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

difficulties and uncertainties regarding acquisitions, including risks relating to managing and integrating acquired businesses,

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 September 30, 2007 and December 31, 2006

	September 30, 2007 (unaudited)	December 31, 2006 (unaudited)
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	\$ 3,884,372	\$ 13,794,091
Restricted cash	47,195,080	52,243,710
Receivables	1,040,174	332,335
Common stock subscription	26,199,000	0
Other current assets	43,055	78,361
Current assets of discontinued operations	17,945,333	17,479,998
<b>Total Current Assets</b>	<b>\$ 96,307,014</b>	<b>\$ 83,928,495</b>
Property, Plant, and Equipment, net	\$ 290,453	\$ 312,747
Construction in progress	24,745,321	14,074,353
Goodwill	4,912,866	4,912,866
Licensed technology rights, net	2,561,171	2,700,296
Notes receivable, net	1,841,740	1,917,704
Deferred financing costs, net	2,594,534	2,661,251
Other assets	23,551	23,453
Long term assets of discontinued operations	69,657,978	75,336,300
<b>TOTAL ASSETS</b>	<b>\$ 202,934,628</b>	<b>\$ 185,867,465</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current Liabilities		
Accounts payable and accrued expenses	\$ 3,612,108	\$ 2,762,450
Current liabilities of discontinued operations	19,290,900	14,739,895
<b>Total Current Liabilities</b>	<b>\$ 22,903,008</b>	<b>\$ 17,502,345</b>
Other Liabilities	204,485	
Long Term Debt	60,119,361	60,717,099
Long Term Liabilities of Discontinued Operations	73,830,688	78,970,988
<b>Total Liabilities</b>	<b>\$ 157,057,542</b>	<b>\$ 157,190,432</b>
Minority Interests	\$ 100	\$ 100
Preferred stock (1)	\$ 10,156,021	\$ 10,156,021
Shareholders Equity		
Preferred stock (2)	100	100
Common stock (3)	102,677	97,404
Additional paid-in capital	86,855,866	54,640,990
Accumulated deficit	(50,214,057)	(35,193,961)
Treasury stock (4)	(385,402)	(385,402)
Notes receivable from officers and board members	(638,219)	(638,219)
<b>Total Shareholders Equity</b>	<b>\$ 35,720,965</b>	<b>\$ 18,520,912</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	<b>\$ 202,934,628</b>	<b>\$ 185,867,465</b>

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

See Notes to Consolidated Financial Statements.

---

- (1) Preferred stock, \$.01 par value, 2,000,000 shares authorized; 281,241 shares issued as of September 30, 2007 and December 31, 2006.
- (2) Preferred stock of subsidiary, no par value, 10 shares authorized; 10 shares issued as of September 30, 2007 and December 31, 2006, respectively.
- (3) \$.01 par value; 50,000,000 shares authorized; 10,267,784 issued and 10,179,354 outstanding as of September 30, 2007; 21,400,000 shares authorized; 9,740,455 issued and 9,652,025 outstanding as of December 31, 2006.
- (4) 88,430 shares at cost, as of September 30, 2007 and December 31, 2006.

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

Condensed Consolidated Statements of Operations (unaudited) for the Three and Nine Months Ended September 30, 2007 and September 30, 2006

	3 Months Ended		9 Months Ended	
	September 30, 2007 (unaudited)	September 30, 2006 (unaudited)	September 30, 2007 (unaudited)	September 30, 2006 (unaudited)
<b>REVENUES</b>				
Microgy revenues	343,607	595,040	885,829	1,768,311
<b>TOTAL REVENUES</b>	<b>\$ 343,607</b>	<b>\$ 595,040</b>	<b>\$ 885,829</b>	<b>\$ 1,768,311</b>
<b>COSTS AND EXPENSES:</b>				
Cost of goods sold	312,997	515,853	774,057	1,625,725
General and administrative (1)	3,775,864	2,749,848	9,776,918	7,061,507
Depreciation and amortization	78,169	74,257	226,334	217,263
<b>TOTAL COSTS AND EXPENSES</b>	<b>\$ 4,167,030</b>	<b>\$ 3,339,958</b>	<b>\$ 10,777,309</b>	<b>\$ 8,904,495</b>
<b>OPERATING LOSS</b>	<b>\$ (3,823,423)</b>	<b>\$ (2,744,918)</b>	<b>\$ (9,891,480)</b>	<b>\$ (7,136,184)</b>
<b>OTHER INCOME (EXPENSE):</b>				
Interest income	\$ 109,624	79,786	\$ 400,402	362,985
Interest expense	(3,326)	(2,164)	(9,528)	(7,533)
Other income			583,116	
<b>TOTAL OTHER INCOME</b>	<b>\$ 106,298</b>	<b>\$ 77,622</b>	<b>\$ 973,990</b>	<b>\$ 355,452</b>
<b>LOSS BEFORE TAXES</b>	<b>\$ (3,717,125)</b>	<b>\$ (2,667,296)</b>	<b>\$ (8,917,490)</b>	<b>\$ (6,780,732)</b>
<b>INCOME TAX EXPENSE</b>	<b>\$ 100</b>	<b>37</b>	<b>\$ 900</b>	<b>837</b>
<b>NET LOSS, FROM CONTINUING OPERATIONS</b>	<b>\$ (3,717,225)</b>	<b>\$ (2,667,333)</b>	<b>\$ (8,918,390)</b>	<b>\$ (6,781,569)</b>
<b>LOSS FROM DISCONTINUED OPERATIONS, NET OF TAX</b>	<b>\$ (2,040,648)</b>	<b>\$ (738,352)</b>	<b>\$ (4,941,121)</b>	<b>\$ (969,818)</b>
<b>NET LOSS, CONTINUING AND DISCONTINUED OPERATIONS</b>	<b>\$ (5,757,873)</b>	<b>\$ (3,405,685)</b>	<b>\$ (13,859,511)</b>	<b>\$ (7,751,387)</b>
Preferred Securities Dividend Requirements	\$ (336,274)	\$ (1,250)	\$ (1,006,034)	\$ (3,750)
Beneficial Conversion Feature of Preferred Stock	(57,148)		(57,148)	
Change in Value of Modified Warrants	(97,404)		(97,404)	
<b>Loss Available to Common Shareholders</b>	<b>\$ (6,248,699)</b>	<b>\$ (3,406,935)</b>	<b>\$ (15,020,097)</b>	<b>\$ (7,755,137)</b>
<b>Weighted Average Common Shares Outstanding</b>				
Basic & Diluted	10,172,973	9,647,829	9,970,088	9,629,726
<b>Loss Per Common Share from Continuing Operations</b>				
Basic & Diluted	\$ (0.41)	\$ (0.27)	\$ (1.01)	\$ (0.71)
<b>Loss Per Common Share from Discontinued Operations</b>				
Basic & Diluted	\$ (0.20)	\$ (0.08)	\$ (0.50)	\$ (0.10)
<b>Loss Per Common Share from Continuing and Discontinued Operations</b>				
Basic & Diluted	\$ (0.61)	\$ (0.35)	\$ (1.51)	\$ (0.81)

(1) General and administrative expenses include non-cash compensation, labor expenses including severance, travel & entertainment expenses, insurance costs, and professional service fees.

See Notes to Consolidated Financial Statements.





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

Condensed Consolidated Statements of Cash Flows (unaudited) for the Nine Months Ended September 30, 2007 and September 30, 2006

	Nine Months Ended	
	September 30, 2007	September 30, 2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES: (Continuing and Discontinued Operations)</b>		
Net loss	(13,859,511)	(7,751,387)
<i>Non-cash adjustments</i>		
Depreciation and amortization	349,778	376,903
Amortization of deferred gain	(231,309)	(231,308)
Non-cash interest expense	441,441	361,024
Stock based compensation expense	2,112,180	1,197,798
Write-off of Sunnyside liability	(583,030)	
Accrued power generation revenues	5,350,430	3,184,651
Accrued lease expenses	(5,350,430)	(3,184,651)
<i>Changes in operating assets and liabilities:</i>		
Increase in receivables	(2,348,574)	(4,961,260)
Increase in fuel inventory	271,635	(136,265)
Decrease in unbilled revenues		58,448
Decrease in other current assets	(28,343)	494,309
Decrease in notes receivable	75,964	288,296
Decrease in other assets	204,350	10,518
Decrease in billings in excess of revenues		(457,719)
Increase in accounts payable and accrued expenses	5,649,887	2,920,602
Net cash used in operating activities	\$ (7,945,532)	\$ (7,830,041)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Decrease (increase) in restricted cash	\$ 6,016,370	\$ (882,252)
Construction of projects	(7,831,876)	(6,044,651)
Capitalized financing costs	(1,962,839)	
Property, plant and equipment, and capital lease expenditures	(72,143)	(137,011)
Net cash used for investing activities	\$ (3,850,488)	\$ (7,063,914)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Dividend payments on preferred stock	\$ (869,760)	\$ (3,750)
Net borrowing of secured notes	189,775	60,664
Exercise of stock options	2,951,786	692,998
Net borrowings under working capital loan	(385,500)	3,441,000
Net cash provided by financing activities	\$ 1,886,301	\$ 4,190,912
<b>(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>(9,909,719)</b>	<b>(10,703,043)</b>
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	<b>13,794,091</b>	<b>14,840,230</b>
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	<b>\$ 3,884,372</b>	<b>\$ 4,137,187</b>

See Notes to Consolidated Financial Statements.

**Supplemental disclosure of cash flow information**

Cash paid for interest (Net of amount capitalized)	(225,068)	(141,767)
Non-cash investing and financing activity		

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-Q

Non Cash dividend to Series A Preferred Stock Holders	<b>(333,945)</b>
Beneficial conversion feature of preferred stock	<b>(57,148)</b>
Change in value of modified warrants	<b>(97,404)</b>
Warrant capitalized in construction in progress	<b>(802,632)</b>
Common stock subscription	<b>26,199,000</b>

**Table of Contents**

**ENVIRONMENTAL POWER CORPORATION AND SUBSIDIARIES**

Condensed Consolidated Statement of Equity (unaudited) for Nine Months Ended September 30, 2007

	Preferred Stock - Shares	Preferred Stock - Amount	Common Stock - Shares	Common Stock - Amount	Additional Paid-in Capital	Accum. Deficit	Accum. Other Comp. Loss	Treasury Stock - Shares	Treasury Stock - Amount	Deferred Compensation	Receivable - Officers & Directors	Total
<b>Balance at January 1, 2007</b>	10	\$ 100	3,894,821	\$ 38,949	\$ 9,304,816	\$ (1,368,166)	\$ (324,815)	88,430	\$ (385,402)	\$	\$ (645,948)	\$ 6,619,548
Dividends paid												
Dividends paid subsidiary						(5,000)						(5,000)
Retirement of common stock			1,007,085	10,071	5,057,948							5,068,024
Exercise of stock options			55,371	554	535,865					1,783,745		2,320,165
Exercise of stock options			14,285	143	47,857							48,045
Principal payment on senior note											5,838	5,838
Provision for liability							119,957					119,957
Loss						(3,958,181)						(3,958,181)
<b>Balance at September 30, 2007</b>	10	\$ 100	4,971,417	\$ 49,714	\$ 14,946,486	\$ (5,331,347)	\$ (204,858)	88,430	\$ (385,402)	\$ 1,783,745	\$ (640,110)	\$ 10,218,333
Dividends paid												
Dividends paid subsidiary						(5,000)						(5,000)
Exercise of stock options					264,730					635,240		899,970
Exercise of stock options			61,931	619	282,357							282,976
Retirement of common stock			4,600,000	46,000	25,961,264							26,007,264
Principal payment on senior note											1,891	1,891
Provision for liability							(294,537)					(294,537)
Loss						(11,413,620)						(11,413,620)
<b>Balance at September 30, 2008</b>	10	\$ 100	9,633,348	\$ 96,333	\$ 41,454,837	\$ (16,749,967)	\$ (499,395)	88,430	\$ (385,402)	\$ 2,418,985	\$ (638,219)	\$ 25,697,233
Dividends on preferred stock						(197,715)						(197,715)
Exercise of stock options			2,053	21	2,036,087							2,036,101
Exercise of stock options												

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-Q

ices											
rcise of											
ck options		105,054	1,050	706,092						707,1	
e of											
ferred stock	281,241	10,156,021		3,893,968						3,893,9	
lass of											
ferred option											
ense				2,418,985				(2,418,985)			
eficial											
version											
ure of											
ferred stock				4,131,022	(4,131,022)						
sion											
ility											
stment, net							499,395			499,3	
loss						(14,115,257)				(14,115,2	
<b>alance at</b>											
<b>ember 31,</b>											
<b>6</b>	<b>281,251</b>	<b>10,156,121</b>	<b>9,740,455</b>	<b>\$ 97,404</b>	<b>\$ 54,640,991</b>	<b>\$ (35,193,961)</b>		<b>\$ 88,430</b>	<b>\$ (385,402)</b>	<b>\$ (638,219)</b>	<b>18,520,9</b>
idends on											
ferred stock						(1,006,033)				(1,006,0	
ance											
ons &											
rrants for											
ices				2,914,811						2,914,8	
rcise of											
ck options		527,329	5,273	2,946,512						2,951,7	
mmon Stock											
scription				26,199,000						26,199,0	
eficial											
version											
ure of											
ferred stock				57,148	(57,148)						
ification of											
rrants				97,404	(97,404)						
loss						(13,859,511)				(13,859,5	
<b>alance at</b>											
<b>ember 30,</b>											
<b>7</b>	<b>281,251</b>	<b>10,156,121</b>	<b>10,267,784</b>	<b>\$ 102,677</b>	<b>\$ 86,855,866</b>	<b>\$ (50,214,057)</b>		<b>\$ 88,430</b>	<b>\$ (385,402)</b>	<b>\$ (638,219)</b>	<b>\$ 35,720,9</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 and nine months ended September 30, 2007 are not necessarily indicative of results to be expected for the year ending December 31, 2007. The information in this quarterly report should be read in conjunction with Management Discussion and Analysis of Financial Condition and Results of Operations and consolidated financial statements and footnotes included in our Annual Report on Form 10-K for the year ended December 31, 2006.

**NOTE B 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 precious resources, but energy that is also clean, reliable, and cost-effective. Since inception, we have been an independent developer and owner of non-commodity, renewable and alternative energy facilities that produce biofuels or electricity by utilizing fuel derived from our waste management processes or alternative fuel sources such as waste coal. Such fuel sources generally are not subject to the pricing and market fluctuations of commodity fuels and, in some instances, are considered renewable energy fuels. We have developed three anaerobic digesters, seven hydroelectric plants, two municipal waste projects, and three waste coal-fired generating facilities. We sold or transferred all of these projects either in development or after completion. Also, we have substantially completed construction of the Huckabay Ridge facility in Stephenville, Texas, a large-scale, multi-digester facility for the production of pipeline-grade natural gas which we expect to achieve commercial operation in the fourth quarter of 2007. In the past, we have operated in two major segments, Microgy, a developer of renewable energy facilities, and also Buzzard, which owns a leasehold interest in a waste-coal fired generating facility in Pennsylvania known as the Scrubgrass facility, which is currently reported as Discontinued Operations . On May 31, 2007, our board of directors authorized management to enter into negotiations regarding the disposition of the leasehold interest in the Scrubgrass generating facility held by our subsidiary, Buzzard Power Corporation, known as Buzzard. 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 now operate in only one segment, as a developer of renewable energy facilities for the production and commercial application of methane-rich biogas from agricultural and food industry wastes.

Microgy is a developer of renewable energy facilities for the production and commercial application of methane-rich biogas from agricultural and other organic wastes. The biogas can be used to produce pipeline-grade methane, which we refer to as RNG<sup>®</sup>, marketable biogas, 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 we believe is superior to other such technologies. Microgy owns the exclusive North American license to this technology. In addition, Microgy has developed, for itself, significant engineering, construction and process knowledge regarding these systems.

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 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 either have passed or may be in the process of passing regulations that require concentrated animal feeding operations, referred to as AFOs, to implement changes to their current waste management practices. We believe that these increasingly stringent environmental regulations will be another significant factor driving adoption of our systems.

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 debt held by Microgy Holdings is not 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.

**Discontinued Operations**

Our board of directors has authorized management to pursue negotiations for the disposition of Buzzard s leasehold interest in the Scrubgrass facility. Buzzard Power Corporation, is a subsidiary of our wholly owned subsidiary, EPC Corporation. Buzzard leases 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,

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

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.

### **NOTE C DISCONTINUED OPERATIONS**

On May 31, 2007, our board of directors authorized management to enter into negotiations regarding the disposition of the leasehold interest in the Scrubgrass generating facility held by Buzzard. Based on the anticipated outcome, management does not expect a net loss on the sale. No impairment charges have been recorded to date.

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 will not have a continuing involvement with the Buzzard business after the closing of the disposition of the leasehold interest in the Scrubgrass facility and will not continue any revenue or active cost-generating 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. We currently record a valuation allowance against the deferred tax asset of Buzzard. Upon the completion of the termination of the Buzzard leasehold interest, we will hold no deferred tax assets or liabilities.

**Table of Contents**

The following table presents the major classes of assets and liabilities of the Buzzard segment reported as discontinued operations in the accompanying consolidated balance sheets:

	September 30, 2007	December 31, 2006
<b>Assets of Discontinued Operations</b>		
Cash and cash equivalents	\$ 518	\$ 234
Restricted cash	2,273,970	3,241,710
Receivables	14,515,915	12,875,138
Fuel inventory	917,688	1,189,323
Other current assets	237,242	173,593
<b>TOTAL CURRENT ASSETS</b>	<b>\$ 17,945,333</b>	<b>\$ 17,479,998</b>
Property, Plant, and Equipment, net	136,365	148,056
Lease Rights, net	1,304,730	1,416,483
Accrued Power Generation Revenues	67,981,637	73,332,067
Other Assets	235,246	439,694
<b>TOTAL ASSETS</b>	<b>\$ 87,603,311</b>	<b>\$ 92,816,298</b>
<b>Liabilities of Discontinued Operations</b>		
Accounts payable and accrued expenses	\$ 15,522,400	\$ 10,585,895
Working capital loan	3,768,500	4,154,000
<b>TOTAL CURRENT LIABILITIES</b>	<b>\$ 19,290,900</b>	<b>\$ 14,739,895</b>
Accrued Lease Expense	67,981,637	73,332,067
Secured Notes	3,150,458	2,709,020
Deferred Gain, Net	2,698,593	2,929,901
<b>TOTAL LIABILITIES</b>	<b>\$ 93,121,588</b>	<b>\$ 93,710,883</b>

The amounts reported on the consolidated balance sheets for December 31, 2006 have been reclassified from the amounts that were reported in the our Annual Report on Form 10-K for its fiscal year then ended to reflect the presentation of discontinued operations.

The following table presents the summarized financial information for the discontinued operations presented in the consolidated statements of operations:

	3 Months Ended		9 Months Ended	
	September 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
<b>Total Revenues</b>	12,738,775	13,390,762	37,992,848	39,834,001
Operating Expenses	7,869,015	7,831,992	25,222,888	21,899,869
Lease Expenses	6,057,221	5,609,400	15,392,534	16,682,570
General and Administrative Expenses	690,601	575,207	1,848,311	1,872,005
Depreciation and amortization	41,148	41,146	123,444	159,640
Total Costs and Expenses	14,657,985	14,057,745	42,587,177	40,614,084
<b>Operating Loss</b>	(1,919,210)	(666,983)	(4,594,329)	(780,083)
Other Expenses	(121,438)	(71,127)	(346,792)	(189,735)
Tax Expense (Benefit)		242		
<b>Net Loss</b>	(2,040,648)	(738,352)	(4,941,121)	(969,818)
<b>NOTE D NET LOSS PER COMMON SHARE</b>				

We follow SFAS No. 128, Earnings Per Share, for computing and presenting net loss per share information. Basic income or loss per common share for continuing and discontinued operations is computed by dividing net loss available to common stockholders by the weighted average



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

number of common shares outstanding for the period. Diluted loss per common share excludes common stock equivalent shares and unexercised stock options as the computation would be anti-dilutive.

For the nine months ended September 30, 2007 and 2006, we excluded 7,817,700 and 3,824,440 stock options, warrants, and convertible preferred stock shares, respectively, from the calculation of loss per share because of their anti-dilutive effect. The following tables set forth the computation of basic and diluted net loss per common share from continuing operations and discontinued operations for the three and nine months ended September 30, 2007 and September 30, 2006 (in thousands, except share and per share data):

On September 27, 2007 the company reached an agreement to sell 5,400,000 shares of our common stock at a price of \$5.25 per share in a firm commitment underwritten public offering. Total proceeds, net of expenses, of \$26.2 million were received on October 3, 2007 and are reflected as a common stock subscription receivable as of September 30, 2007. On September 30, 2007, the shares had not yet been issued, and are thus excluded from all outstanding shares calculations. The underwriters held an option to purchase up to an additional 810,000 shares of common stock which expired on October 27, 2007 without exercise.

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 4,398,610 shares of common stock issuable upon conversion of such shares of series A preferred stock and exercise of such warrants. 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 sale of common stock in the October 2007 public offering. The change in the conversion price of the preferred stock was recorded as a \$57,148 charge to Retained earnings. We recorded the change in the fair value of the warrants of \$97,404, which is treated as a loss available to common shareholders on our income statement.

LOSS PER SHARE	Three Months Ended		Nine Months Ended	
	9/30/2007	9/30/2006	9/30/2007	9/30/2006
<b>Continuing Operations</b>				
Net Loss from Continuing Operations	\$ (3,717,225)	\$ (2,667,333)	\$ (8,918,390)	\$ (6,781,569)
Dividends to Preferred Stock Holders	(336,274)	(1,250)	(1,006,034)	(3,750)
Beneficial Conversion Feature of Preferred Stock	(57,148)		(57,148)	
Change In Value of Modified Warrants	(97,404)		(97,404)	
Earnings (Numerator)	\$ (4,208,051)	\$ (2,668,583)	\$ (10,078,976)	\$ (6,785,319)
Weighted Average Number of Common shares outstanding	10,172,973	9,647,829	9,970,088	9,629,726
Basic and Diluted Net Loss per common share from continuing operations	\$ (0.41)	\$ (0.27)	\$ (1.01)	\$ (0.71)
<b>Discontinued Operations</b>				
Net Loss from Discontinued Operations	(2,040,648)	(738,352)	(4,941,121)	(969,818)
Weighted Average Number of Common Shares	10,172,973	9,647,829	9,970,088	9,629,726
Basic and Diluted Net Loss per common share from discontinued operations	(0.20)	(0.08)	(0.50)	(0.10)
Basic and Diluted EPS continued and discontinued operations	\$ (0.61)	\$ (0.35)	\$ (1.51)	\$ (0.81)

**Table of Contents****NOTE E 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 and independent contractors. 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 and/or pursuant to performance-based vesting criteria. 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.

Total stock-based compensation for the three and nine months ended September 30, 2007 was \$675,588 and \$2,112,180 respectively. In the three and nine months ended September 30, 2006 we recognized approximately \$520,692, and \$1,197,798 in non-cash compensation expense under SFAS 123R. The total compensation cost related to unvested awards for restricted stock not yet recognized is \$1.5 million. This amount will be charged against income over the next three years.

Valuation Assumptions: The fair value of stock options granted during the three months and nine months ended September 30, 2007 and September 30, 2006 was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Three Months Ended		Nine Months Ended	
	September 30, 2007	September 30, 2006	September 30, 2007	September 30, 2006
Fair Market Per Share	\$ 3.40	\$ 3.61	\$ 4.20	\$ 3.61
<i>Assumptions</i>				
Risk-free rate of return	4.08%	4.06%	4.37%	4.06%
Volatility	79.30%	59.67%	75.62%	59.67%
Expected annual dividend yield	0.00%	0.00%	0.00%	0.00%
Option Life (years)	5	6	4.43	6

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 F GOODWILL AND INTANGIBLE ASSETS**

Intangible assets are recorded at cost and consist of licensed technology rights and goodwill. Licensed technology rights are being amortized using the straight-line method over a useful life of 20 years. Goodwill represents the excess of cost over the fair value of tangible and identifiable intangible assets and liabilities acquired in a business combination and are not being amortized pursuant to SFAS No. 142 Goodwill and Other Intangible Assets.

Accumulated amortization of licensed technology rights was \$1,148,829 as of September 30, 2007 and \$1,009,704 as of December 31, 2006. Amortization expense for licensed technology rights was \$46,375 for the three months ended September 30, 2007 and \$139,125 for the nine months ended September 30, 2007. The future estimated amortization expense for licensed technology rights is as follows:

Estimated Amortization Expense for Licensed Technology Rights						
2007	2008	2009	2010	2011	Thereafter	Total
\$ 46,375	185,500	185,500	185,500	185,500	1,772,796	\$ 2,561,171

**NOTE G LONG TERM LIABILITIES****Contractual Obligations**

The following table shows our known future contractual obligations of the types specified in Item 303(a)(5) of Regulation S-K.

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-Q

<b>Commitments of Continuing Operations (\$ USD)</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>Thereafter</b>	<b>Total</b>
Operating Leases(1)	69,770	143,068	122,341	118,165	79,392		532,736
Relocation Costs(2)		600,000					600,000
Construction Commitments(3)		3,000,000					3,000,000
Separation Agreement Payments(4)	321,575	309,383					630,958
Tax Exempt Bonds(5)	2,100,000	4,200,000	4,200,000	4,200,000	4,200,000	132,673,200	151,573,200
Vehicle Loan and Other Capital Leases(6)	19,142	51,186	21,303	9,290			100,921
<b>Commitments of Discontinued Operations</b>							
Arflight Note(7)		1	1	1	1	3,150,456	3,150,460
Scrubgrass Lease Payments(8)	7,227,500	29,390,000	32,459,000	35,944,000	39,761,000	111,686,000	256,467,500
Scrubgrass Fuel Contracts(9)	735,633	3,033,907	3,125,322	3,217,262	3,313,430	3,412,655	16,838,209
<b>TOTAL</b>	<b>10,473,620</b>	<b>40,727,545</b>	<b>39,927,967</b>	<b>43,488,718</b>	<b>47,353,823</b>	<b>250,922,311</b>	<b>432,893,984</b>

- (1) We are obligated under various non-cancelable operating leases for office space and automotive vehicles. Rent expense for these operating leases was \$286,501, \$174,334, and \$157,932, in 2006, 2005 and 2004, respectively. In the nine months ended September 30,2007, our rent expense for operating leases was \$374,574.
- (2) These costs are comprised mainly of relocation costs associated with our planned relocation of company headquarters from Portsmouth, NH to the White Plains, NY area. These costs will be recognized as incurred.
- (3) These commitments relate to various purchase agreements, including minimum purchase agreements with SouthTex Treaters for gas treatment and conditioning equipment, made in connection with our Microgy facilities.
- (4) These commitments reflect payments for severance and separation agreements made to Messrs. Cresci, Livingston, O Neill and Tejwani, as well as certain other employees, and are included in our balance of accrued expenses.

**Table of Contents**

- (5) In 2007, Microgy began scheduled interest payments on the tax exempt bonds. Mandatory redemption of principal amounts begins in 2012.
- (6) We are obligated under various non-cancelable capital leases for automotive vehicles and computer equipment.
- (7) Discontinued obligations are reflected in their entirety in 2007 to reflect our plan to dispose of Buzzard leasehold interest in the Scrubgrass facility. Amount could be settled in 2007 upon disposition of Buzzard's leasehold interest in Scrubgrass. We anticipate that the obligations of EPC Corporation will be extinguished as part of the negotiated termination of our interest in the Scrubgrass project. Should we not reach agreement with Scrubgrass and Arclight, Arclight may make the claim that EPC Corporation is in default under the Note and demand the acceleration of payment of the balance due. As of September 30, 2007 the balance on the Note is \$3,150,460.
- (8) Buzzard is obligated under a facility lease related to the Scrubgrass plant. The estimated remaining lease term is 13.5 years. Our Scrubgrass plant lease expense was \$22,091,063, \$20,829,876, and \$22,065,685 in 2006, 2005 and 2004, respectively. In addition to scheduled base rent and additional rent payments, the Scrubgrass plant lease expense includes principal, interest and related fees on the Lessor's debt obligations. Since a portion of the Lessor's debt obligations have variable interest rates, we have estimated its future minimum lease payments using average interest rates of 3.27% for the tax-exempt bonds. Amount is expected to be settled in 2007 upon disposition of Buzzard's leasehold interest in Scrubgrass.
- (9) We have also been assigned various long-term non-cancelable obligations under contractual agreements for fuel handling and excavation, limestone supply, and waste disposal. The contractual terms are generally for 5 to 15 years and provide for renewal options. All such amounts are expected to be settled in 2007 upon disposition of Buzzard's leasehold interest in Scrubgrass.

The following table describes our debt obligations as of September 30, 2007 and December 31, 2006:

<b>Secured Promissory Notes Payable and Other Obligations</b>	<b>September 30, 2007</b>	<b>December 31, 2006</b>
Sunnyside project obligations		583,030
Vehicle loan & capital leases	119,361	134,069
Tax exempt bond financing	60,000,000	60,000,000
<b>TOTAL</b>	<b>60,119,361</b>	<b>60,717,099</b>

*Sunnyside Contingent Obligations* We had contingent obligations of \$1,218,078 on our consolidated balance sheet as of December 31, 2000. The contingent obligations were principally expenses for the sale of Sunnyside which were payable upon collection of certain obligations from the purchasers of Sunnyside. On April 10, 2001, we received aggregate proceeds of \$1,500,000 from the purchasers of Sunnyside and resolved litigation by executing a binding settlement agreement. In this agreement, we were formally released from contingent obligations of \$177,962. We have also been released by the statute of limitations or the terms of the underlying agreements from additional contingent obligations of \$457,086. We reported the settlement proceeds of \$1,500,000 and the released liabilities of \$635,048 as other income in our consolidated financial statements for 2001. In March 2007, we released the remaining liability of \$583,030 as the statute of limitations had expired, and recognized the amount in other income.

*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 September 30, 2007 and December 31, 2006. These notes, 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.

**NOTE H NOTES RECEIVABLE**

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 September 30, 2007 and December 31, 2006.

In the third quarter of 2007, we sold the carbon credits generated from these facilities. Pursuant to our agreements with the owners of these facilities, a portion of this sale was recognized by us as revenue and a portion was applied to the balance of their notes.

	September 30, 2007	December 31, 2006
<b>Notes Receivable</b>		
Notes receivable	\$ 2,591,740	\$ 2,667,704
Reserve for any future cash flow deficiencies	(750,000)	(750,000)
<b>Notes receivable, net</b>	<b>\$ 1,841,740</b>	<b>\$ 1,917,704</b>

**NOTE I INCOME TAXES**

We adopted the provisions of Financial Standards Accounting Board ( FASB ) Interpretation No. 48 Accounting for Uncertainty in Income Taxes ( FIN 48 ) an interpretation of FASB Statement No. 109 ( SFAS 109 ) on January 1, 2007. As a result of the implementation of FIN 48, we recognized no material adjustment in the valuation allowance or deferred tax assets. At the adoption date of January 1, 2007, we had \$10,462,459 of unrecognized tax benefits, all of which would affect our effective tax rate if recognized. At September 30, 2007, we have \$12,758,840 of unrecognized tax benefits primarily comprised of federal and state net operating losses.

It is our policy to recognize interest and penalties related to uncertain tax positions in income tax expense. As of September 30, 2007, we did not have any accrued interest or penalties related to uncertain tax positions.

We file income tax returns with federal, state, and local authorities. The 2004 federal and state returns were examined and closed in 2007 and no material adjustments were identified toward any of our tax positions. Our federal and state tax returns for 2005 and 2006 are subject to future examinations by relevant tax authorities.

---

**Table of Contents**

**NOTE J SHAREHOLDERS EQUITY**

**Preferred Stock**

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 \$14.1 million in proceeds from this offering after paying fees and expenses.

On October 3, 2007, we closed a firm commitment underwritten public offering of 5,400,000 shares of our common stock at a price to the public of \$5.25 per share. We received net proceeds from this offering of approximately \$26,199,000, after deducting underwriting discounts and commissions and costs and expenses associated with the offering. This amount appears as a receivable on the balance sheet as at September 30, 2007. The underwriters held an option to purchase up to an additional 810,000 shares which expired on October 27, 2007 without exercise.

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 4,398,610 shares of common stock issuable upon conversion of such shares of series A preferred stock and exercise of such warrants. 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 sale of common stock in the October 2007 public offering. The change in the conversion price of the preferred stock was recorded as a \$57,148 charge to retained earnings. We recorded a change in the fair value of the warrants of \$97,404, which change is treated as a loss available to common shareholders on our income statement

**NOTE K 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 associated with manure removal associated with the Huckabay Ridge facility. This amount is included in construction in progress and other liabilities on our balance sheet.

**NOTE L RECENT ACCOUNTING PRONOUNCEMENTS**

In September 2006, the FASB issued FASB Statement No. 157, Fair Value Measurements ( SFAS 157 ). The standard provides guidance for using fair value to measure assets and liabilities. The standard also responds to investors' requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. The standard applies whenever other standards require or permit assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances. SFAS 157 must be adopted prospectively as of the beginning of the year it is initially applied. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We do not believe the adoption of this standard will have a material impact on our financial position or results of operations.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. This statement gives entities the option to carry most financial assets and liabilities at fair value, with changes in fair value recorded in earnings. This statement, which will be effective first quarter of fiscal 2009, is not expected to have a material impact on our consolidated financial position or results of operations.

In June 2006, the Financial Accounting Standards Board ( FASB ) issued Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes ( FIN 48 ), an interpretation of FASB Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes ( SFAS No. 109 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in enterprises financial statements in accordance with SFAS No. 109. The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Also, the interpretation provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. We adopted this interpretation in the first quarter of 2007 (Note I).

**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, 2006, 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**

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 precious resources, but energy that is also clean, reliable, and cost-effective. Since inception, we have been an independent developer and owner of non-commodity, renewable and alternative energy facilities that produce biofuels or electricity by utilizing fuel derived from our waste management processes or alternative fuel sources such as waste coal. Such fuel sources generally are not subject to the pricing and market fluctuations of commodity fuels and, in some instances, are considered renewable energy fuels. We have developed three anaerobic digesters, seven hydroelectric plants, two municipal waste projects, and three waste coal-fired generating facilities. We sold or transferred all of these projects either in development or after completion. Also, we have substantially completed construction of the Huckabay Ridge facility in Stephenville, Texas, a large-scale, multi-digester facility for the production of pipeline-grade natural gas which we expect to achieve commercial operation in the fourth quarter of 2007. In the past, we have operated in two major segments, Microgy, a developer of renewable energy facilities, and also Buzzard, which owns a leasehold interest in a waste-coal fired generating facility in Pennsylvania known as the Scrubgrass facility, which is currently reported as Discontinued Operations. On May 31, 2007, our board of directors authorized management to enter into negotiations regarding the disposition of the leasehold interest in the Scrubgrass generating facility held by our subsidiary, Buzzard Power Corporation, known as Buzzard. 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 now operate in only one segment, as a developer of renewable energy facilities for the production and commercial application of methane-rich biogas from agricultural and food industry wastes.

Microgy is a developer of renewable energy facilities for the production and commercial application of methane-rich biogas from agricultural and other organic wastes. The biogas can be used to produce pipeline-grade methane, which we refer to as RNG<sup>®</sup>, marketable biogas, liquefied natural gas, or LNG, renewable electrical energy or thermal energy, as well as other useful by-products. Microgy's systems utilize a proven European biogas production technology that we believe is superior to other such technologies. Microgy owns the exclusive North American license to this technology. In addition, Microgy has developed, for itself, significant engineering, construction and process knowledge regarding these systems.

---

## **Table of Contents**

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 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 either have passed or may be in the process of passing regulations that require concentrated animal feeding operations, referred to as AFOs, to implement changes to their current waste management practices. We believe that these increasingly stringent environmental regulations will be another significant factor driving adoption of our systems.

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.

### **Discontinued Operations**

Our discontinued operations are comprised of Buzzard Power Corporation, referred to as Buzzard, and our wholly owned subsidiary, EPC Corporation, the parent of Buzzard. Buzzard leases 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 dispose 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 May 31, 2007, our board of directors authorized management to enter into negotiations regarding the disposition of the leasehold interest in the Scrubgrass generating facility held by our subsidiary, Buzzard Power Corporation. The contemplated disposition is expected to have a combined transaction value of approximately \$5.8 million, including cash payments to Buzzard to cover expenses, forgiveness of indebtedness of EPC Corporation, and recognition of deferred gain.

We expect to receive a cash payment to cover expenses. The lease for the Scrubgrass facility will be terminated or assigned and all obligations of all parties relative to the lease arrangement will be cancelled. The anticipated agreement would resolve all issues relating to possible present and future defaults by Buzzard under the lease for the Scrubgrass facility and related forbearance, as described in our filings with the Securities and Exchange Commission.

It is contemplated that our subsidiary, EPC Corporation, will enter into a contemporaneous agreement with Crystal Creek Coalpower Funding LLC, an affiliate of ArcLight Capital Partners, L.P., to cancel \$3.2 million of EPC Corporation indebtedness.

Closing is expected to be conditioned on obtaining normal project financing consents, none of which is expected to be withheld or materially delayed. We expect the closing to occur in the fourth quarter of 2007.

In the course of their negotiations, Scrubgrass and Buzzard have entered into interim agreements to amend the Forbearance Agreement between them dated as of December 11, 2006, in order to provide for an extension of the Forbearance Termination Date (as defined therein) to November 30, 2007. As reported in Form 8-K dated December 11, 2006, as filed with the U.S. Securities and Exchange Commission, under the Forbearance Agreement, Scrubgrass agrees that, until the Forbearance Termination Date, it will forbear from exercising its rights and remedies under the Lease Agreement with respect to certain missed rental payments. Should the parties not reach agreement by November 30, 2007, Scrubgrass may elect to pursue its remedies for default based on the missed rental payment and, in addition, Crystal Creek Coalpower may pursue a claim of default against EPC Corporation related to its alleged failure to make payments of interest when due in connection with the EPC Corporation 20.0% Senior Secured Note Due December 31, 2012. Default by Buzzard under the Lease Agreement and by EPC Corporation in connection with the referenced Note is without recourse against Environmental Power Corporation.

Prior to the Board's decision to authorize management to enter into negotiations regarding the disposition of the lease on the Scrubgrass facility, we were reporting financial results in three operating segments, Buzzard, Microgy, and All Other Segments, the last of which is comprised of corporate items that are not directly tied to either the Buzzard or Microgy operating segments. Upon disposition of the lease for the Scrubgrass facility, we will have only one reporting segment, Microgy. The assets and liabilities of Buzzard have been reported as discontinued operations on the accompanying consolidated balance sheets and consolidated statements of operations of Environmental Power.

Approximately \$51.7 million, or 95.9%, of our \$53.9 million in total consolidated revenues for the fiscal year ended December 31, 2006 were derived from Buzzard. The disposition of Buzzard's leasehold interest in the Scrubgrass facility will substantially reduce our revenue base and continue our trend of operating losses and uses of cash until the revenue base for Microgy grows to sufficient levels to support our expense base.

### **RESULTS OF OPERATIONS**



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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations compares the results of operations for the three and nine month periods ended September 30, 2007 with the results of operations for the three and nine month periods ended September 30, 2006. Unless otherwise indicated, all references to 2007 pertain to the three months ended September 30, 2007 and all references to 2006 pertain to the three months ended September 30, 2006. Historical results and trends that might be discussed below should not be taken as indicative of future operations.

### **Continuing and Discontinued Operations**

#### **Nine months ended September 30, 2007 compared to nine months ended September 30, 2006**

For the nine months ended September 30, 2007, we had a net loss available to common shareholders of \$15.0 million, or loss available per common share of \$1.51, compared to net loss available to common shareholders of \$7.8 million, or loss per common share of \$0.81, for the nine months ended September 30, 2006. The increase in net loss available to common shareholders was primarily attributable to an increase in costs and expenses of \$1.9 million, a decrease in revenue of \$882,000, and a \$1.0 million increase in preferred dividend requirements, as discussed in more detail below. These amounts were partially offset by a \$619,000 increase in other income primarily related to the release of the Sunnyside contingent liabilities. These changes are discussed in more detail below.

### **Continuing Operations**

Revenues from continuing operations decreased by \$882,000, or 50%, to \$886,000 for the nine months ended September 30, 2007, as compared to \$1.8 million for the same period in 2006. This decrease in revenue is due mainly to the change in business model from a model where we sell facilities to third parties, to the current ownership model, where we build, own, and operate facilities for our own account. Revenues from the operation and maintenance of facilities increased to \$818,000 for the nine months ended September 30, 2007, compared to \$528,000 for the same period in the prior year. The increase in operations and maintenance revenue in the nine months ended September 30, 2007 is a result of the three Wisconsin facilities being fully operational in 2007 as opposed to 2006, when only two facilities were fully operational. During the third quarter of 2007, we recognized carbon credit sales of \$68,000 which were verified and sold during the third quarter of 2007. The credits themselves were associated with operations of the Wisconsin facilities from January-May of 2007. Pursuant to our agreements with the owners of these facilities, a portion of

---

**Table of Contents**

this sale was recognized by us as revenue and a portion was applied to the balance of the notes we hold in respect of the purchase price of these facilities. We did not recognize any revenue from the sale of carbon credits in the nine months ended September 30, 2006. In the nine months ended September 30, 2006, we recognized \$1.2 million from the sale of the digester equipment to the Wisconsin facilities, whereas there were no such sales in the same period in 2007.

Our cost of revenue decreased to \$774,000 for the nine months ended September 30, 2007, as compared to \$1.6 million for the same period in 2006. This decrease is due primarily to the shift in emphasis from a sales model to an ownership model, as discussed above. In the nine months ended September 30, 2006, \$707,000 of the \$1.6 million in costs of revenue was related to the construction of electric generating facilities constructed for sale to Dairyland. Operations and maintenance costs decreased from \$999,000 in the nine months ended September 30, 2006 to \$774,000 in the nine months ended September 30, 2007, due primarily to lower repair and maintenance costs at the Wisconsin facilities.

General and administrative expenses from continuing operations increased by \$2.7 million to \$9.8 million for the nine months ended September 30, 2007, as compared to \$7.1 million for the same period in 2006. A \$914,000 increase in non-cash compensation expense and a \$1.1 million increase in payroll related expenses including severance were the primary components of the increase. In the nine months ended September 30, 2007, we recognized \$2.1 million of non-cash compensation expenses due primarily to the FAS 123R treatment of options and stock appreciation rights issued to employees. In the nine months ended September 30, 2006, we recognized non-cash compensation expense of \$1.2 million.

In the nine months ended September 30, 2007, our construction in progress balance increased by \$10.7 million to a total of \$24.7 million. As of September 30, 2007, we had a total cost of \$21.1 million associated with the Huckabay Ridge facility, of which \$898,000 was made up of capitalized interest and finance costs and approximately \$4.8 million of capitalized commissioning costs due to the extended, ongoing commissioning period. By comparison, in the nine months ended September 30, 2006, our construction in progress balance increased by \$6.0 million to \$6.9 million.

As the result of the issuance of our series A 9% cumulative convertible preferred stock in November 2006, we experienced an increase in preferred security dividend requirements from \$3,750 for the nine months ended September 30, 2006 to \$1.0 million for the nine months ended September 30, 2007, representing dividends either accrued or paid in the nine months ended September 30, 2007. Dividends on our series A 9% cumulative convertible preferred stock accrue at the rate of 9% per annum and are payable on January 1 and July 1 of each year, to the extent declared and out of funds legally available therefor.

The foregoing expenses were offset in part by total other income of \$974,000 for the nine months ended September 30, 2007, compared to income of \$355,000 for the same period in 2006. The increase in other income is primarily due to the expiration of the statute of limitations regarding potential liability related to the Sunnyside project, which provided \$583,000 in other income during the nine months ended September 30, 2007.

**Discontinued Operations**

We experienced a pre-tax loss from discontinued operations of \$4.9 million for the nine months ended September 30, 2007, compared to a \$970,000 pre-tax loss for the same period in 2006. This increase in pre-tax loss is primarily due to an increase in operating expenses of \$3.3 million, and a decrease in power revenues of \$1.8 million as a result of an extended outage. These changes were partially offset by a \$1.3 million dollar decrease in lease expense.

Billed power generation revenues at Buzzard, which consist of power generation revenues, increased by \$325,000 to \$43.3 million for the nine months ended September 30, 2007 as a result of increased power rates, as compared to \$43.0 million for the nine months ended September 30, 2006. Buzzard operated at 91.5% of capacity for this period, compared to 96.9% of capacity for the same period in 2006. The decrease was a result of a twelve day maintenance outage in May 2007. The decrease in capacity was offset by a 7% increase in billed power rates in 2007. This increase in billed power generation revenues was completely offset by a decrease in accrued power generation revenues of \$2.2 million. The accrued power generation revenues result from the FASB 13 accounting treatment of the Scrubgrass lease. In accordance with generally accepted accounting principles in the United States, we are required to treat our power sales agreement with Penelec as a lease, aggregate the minimum lease payments expected to be received over its life, and recognize it on a straight-line basis over the 22-year lease term. However, we have limited the recognition of accrued power revenues to the recognition of the deemed minimum payments of the facility lease so that we do not recognize any profits early related to executory costs or payment for goods and services other than solely for the right to use the facility. This minimum lease payment component will continue to decrease in subsequent years, lowering our reported power generation revenues. This adjustment has no effect on pre-tax income because it is completely offset by accrued lease expense.

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

Total operating expenses at Buzzard for the nine months ended September 30, 2007 increased by \$3.3 million to \$25.2 million, as compared to \$21.9 million for the same period in 2006. This increase was primarily a result of increases in maintenance costs of \$2.8 million and labor costs of \$653,000. Lease expenses at Buzzard decreased by \$1.3 million to \$15.4 million in the nine months ended September 30, 2007, compared to \$16.7 million in the nine months ended September 30, 2006. General and administrative expenses remained constant at \$1.8 million in the nine months ended September 30, 2007 and the nine months ended September 30, 2006.

### **Continuing and Discontinued Operations**

#### **Three months ended September 30, 2007 compared to three months ended September 30, 2006.**

For the three months ended September 30, 2007, we had a net loss available to common stockholders of \$6.2 million, or \$0.61 per common share, compared to a loss of \$3.4 million, or \$0.35 per common share, for the three months ended September 30, 2006. The increase in net loss was due to a \$1.3 million increase in loss from discontinued operations, a \$1.0 increase in general and administrative expenses, primarily due to increased payroll expenses, and a \$335,024 increase in preferred dividend requirements, as described in more detail below.

### **Continuing Operations**

Microgy recognized revenues of \$344,000 for the three months ended September 30, 2007, down from \$595,000 for the same period in 2006. This decrease in revenue is due mainly to the change in business model from a model where we sell facilities to third parties, to the current ownership model, where we build and operate facilities for our own account. Revenues from the operation and maintenance of facilities decreased to \$276,000 for the three months ended September 30, 2007, compared to \$283,000 for the same period in the prior year. During the third quarter of 2007, we recognized carbon credit sales of \$68,000 which were verified and sold during the third quarter of 2007. The credits themselves were associated with operations of the Wisconsin facilities from January-May of 2007. Pursuant to our agreements with the owners of these facilities, a portion of this sale was recognized as revenue and a portion was applied to the balance of the notes we hold in respect of the purchase price of these facilities. We did not sell any carbon credits in the three months ended September 30, 2006.

Costs and expenses from continuing operations increased by \$827,000 to \$4.2 million for the three months ending September 30, 2007, as compared to \$3.3 million for the same period in 2006. The increase was primarily attributable to a \$1.0 million increase in general and administrative expenses, due primarily to a \$596,000 increase in salary expense and a \$155,000

---

## **Table of Contents**

increase in non cash compensation. These increases were partially offset by a \$203,000 decrease in costs of revenue at Microgy. Our cost of revenue decreased to \$313,000 for the three months ended September 30, 2007, as compared to \$516,000 for the same period in 2006. This decrease is due primarily to the shift in emphasis from a sales model to an ownership model, as discussed above.

In the three months ended September 30 2006, \$231,000 of the \$516,000 in costs of revenue was related to the construction of facilities constructed for sale. Operations and maintenance costs decreased from \$365,000 in the three months ended September 30, 2006 to \$313,000 in the three months ended September 30, 2007, due primarily to lower repair and maintenance costs at the Wisconsin facilities.

As the result of the issuance of our series A 9% cumulative convertible preferred stock in November 2006, we experienced an increase in preferred security dividend requirements from \$1,250 for the three months ended September 30, 2006, as compared to \$336,274 for the three months ended September 30, 2007. Dividends on our series A 9% cumulative convertible preferred stock accrue at the rate of 9% per annum and are payable on January 1 and July 1 of each year, to the extent declared and out of funds legally available therefor.

The foregoing expenses were offset in part by total other income of \$106,000 for the three months ended September 30, 2007, compared to income of \$78,000 for the same period in 2006.

### **Discontinued Operations**

We experienced a pre-tax loss from discontinued operations of \$2.0 million for the three months ended September 30, 2007, compared to a pre-tax loss of \$738,000 for the three months ended September 30, 2006.

Billed power revenues at Buzzard, which consist of power generation revenues remained steady at \$14.5 million for the three months ended September 30, 2007, compared to \$14.5 million for the same period in 2006. Buzzard operated at 90.99% of capacity for this period, compared to 96.7% of capacity for the same period in 2006. Billed power rates also increased by 7% as compared to the prior year period. Accrued power generation revenues were a \$1.8 million offset to Buzzard revenue, compared to a \$1.1 million offset in the previous year. The accrued power generation revenues result from the FASB 13 accounting treatment of the Scrubgrass lease. In accordance with generally accepted accounting principles in the United States, we are required to treat our power sales agreement with Penelec as a lease, aggregate the minimum lease payments expected to be received over its life, and recognize it on a straight-line basis over the 22-year lease term. However, we have limited the recognition of accrued power revenues to the recognition of the deemed minimum payments of the facility lease so that we do not recognize any profits early related to executory costs or payment for goods and services other than solely for the right to use the facility. This minimum lease payment component is higher in the early years, decreases in the subsequent years, and reverses itself in the later years of the power purchase agreement. This adjustment has no effect on pre-tax income because it is completely offset by an accrued lease expense.

Total operating expenses at Buzzard for the three months ended September 30, 2007 increased by \$0.1 million to \$7.9 million, as compared to \$7.8 million for the same period in 2006 due. A \$161,000 increase in maintenance costs and an \$86,000 increase in operations and maintenance costs were partially offset by a \$149,000 decrease in ash disposal costs.

Lease expenses at Buzzard for the three months ended September 30, 2007 increased to \$6.1 million, compared to \$5.6 million for the same period in 2006. General and administrative expenses increased to \$691,000 in the three months ended September 30, 2007, compared to \$575,000 in the same period in the prior year, due primarily to a \$266,000 increase in professional service fees.

## **LIQUIDITY AND CAPITAL RESOURCES**

### ***Operating Activities***

Our net cash used in operating activities was \$7.9 million for the nine months ended September 30, 2007, compared to cash used in operating activities of \$7.8 million for the same period in 2006. We reported a net loss from continuing operations of \$8.9 million and a net loss from discontinued operations of \$4.9 million for 2007. The following adjustments need to be considered in order to reconcile our net loss in the nine months ended September 30, 2007 to our net cash used in operating activities:

*Depreciation and amortization* During the nine months ended September 30, 2007, we recognized depreciation and amortization expense for lease rights of \$111,753, licensed technology rights of \$139,125, and property plant and equipment of \$98,900.

*Interest expense, accrued and added to the balance of borrowing* During the nine months ended September 30, 2007, we had \$441,441 of interest expense that was added to the outstanding principal balance of the ArcLight loan which is associated with our discontinued operations.

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

*Stock-based compensation* The accounting for options and stock appreciated rights issued to employees resulted in non-cash compensation expenses of \$2,112,180 for the nine months ended September 30, 2007.

We also offer the following information regarding changes in operating assets and liabilities that most notably impacted our cash position during the first three quarters of 2007:

*Receivables* Microgy receivables increased to \$330,000 on September 30, 2007 from \$110,000 on December 31, 2006 primarily due to increased gas production at the Wisconsin facilities in the second quarter of 2007. Revenues from gas production at these facilities are used by the owners to pay down the notes receivable held by Microgy on these facilities. Receivables at Buzzard increased to \$14.5 million on September 30, 2007 from \$12.9 million on December 31, 2006 due to increased power generation revenues in the third quarter of 2007 compared to power generation revenues in the fourth quarter of 2006.

*Fuel Inventory* Fuel inventory at Buzzard decreased to \$918,000 on September 30, 2007, compared to \$1.2 million on December 31, 2006.

*Accounts payable and accrued expenses* Our accounts payable and accrued expenses not related to accrued preferred dividends was at \$18.8 million on September 30, 2007 compared to \$13.3 million on December 31, 2006.

### ***Investing Activities***

Our cash used for investing activities was \$3.9 million for the nine months ended September 30, 2007, as compared to \$7.1 million in the same period in 2006. Our investing activities were concentrated primarily in the following areas:

*Restricted cash* We are required to hold cash associated with our tax-exempt bond financing with a third party disbursement agent. On September 30, 2007, the disbursement agent was holding a balance of \$46.7 million in bond proceeds, compared to \$52.2 million on December 31, 2006. We also hold \$484,000 in a restricted cash fund to fund our asset retirement obligation at Huckabay. Additionally, we are contractually required to make scheduled deposits to a restricted maintenance fund for Scrubgrass to ensure that funds are available in the future for scheduled major equipment overhauls. We are allowed to use cash from this restricted maintenance fund for major equipment overhauls at Scrubgrass, subject to certain restrictions. Our restricted cash balance associated with Buzzard was \$2.3 million on September 30, 2007, compared to \$3.2 million on December 31, 2006. These funds will be used to pay for future major maintenance expenses at the Scrubgrass facility.

## **Table of Contents**

*Construction on projects* Construction continued on the Huckabay Ridge facility. Expenditures on our facilities were \$7.8 million for the nine months ended September 30, 2007. As of September 30, 2007, we had incurred expenditures of \$20.3 million related to the construction of the Huckabay Ridge facility, including \$4.8 million of capitalized commissioning costs due to the extended and continuing commissioning period. Expenditures for projects other than Huckabay Ridge were approximately \$1.2 million in the nine months ended September 30, 2007.

*Property, plant and equipment* Property, plant and equipment expenditures were \$72,000 for the nine months ended September 30, 2007, compared to expenditures of \$137,000 for the same period in 2006. This decrease is primarily a result of the fact that several vehicles required for the operation of the Dairyland facilities were purchased in the first nine months of 2006.

### ***Financing Activities***

Our cash provided by financing activities was \$1.9 million in the nine months ended September 30, 2007, compared to cash provided by financing activities of \$4.2 million in the nine months ended September 30, 2006. We offer the following information concerning the financing activities for our business:

*Dividend payments to preferred stock of subsidiary* Buzzard paid dividends of \$3,750 to its preferred stockholder during the nine months ended September 30, 2007. Environmental Power paid dividends of \$866,000 to its Series A preferred stock holders during the nine months ended September 30, 2007.

*Exercise of stock options and warrants* We received \$3.0 million of gross proceeds from the exercise of stock options and warrants in the nine months ended September 30, 2007.

*Working capital loan and current notes payable for Scrubgrass* Buzzard may borrow up to \$6 million under a lessee working capital loan agreement with the lessor of the Scrubgrass facility for ongoing working capital requirements of this project. The outstanding borrowings under this loan were \$3.8 million as of September 30, 2007.

## **2007 Outlook**

### ***Operations***

The following forward-looking information concerning our results of operations for the full year 2007 is being compared to our historical results of operations for 2006:

We expect increased revenues in the fourth quarter, as we recognize sales of RNG<sup>®</sup> from our Huckabay Ridge facility in Texas. Our revenues related to the Wisconsin facilities are expected to increase slightly, as the owners recognize increased revenues from gas sales to Dairyland and use these revenues to pay down the notes held by Microgy. All three Wisconsin digester facilities will be fully operational for the entire year, whereas some facilities were still in construction for part of 2006.

We have experienced an extended period of commissioning costs at Huckabay Ridge, and management currently believes the Huckabay Ridge facility will reach full commercial operations in the fourth quarter of 2007. With the completion of modifications to the gas conditioning system, and front-end manure processing systems, we expect the facility to be capable of achieving its production target of 635,000 MMBTUs per year.

With the receipt of the Type V waste management permit for the Huckabay Ridge facility from the State of Texas, grease trap waste is the predominant material delivered to the site and used in the digesters with the manure. We are confident that there is a large quantity of grease trap waste available for co-digestion at the Huckabay Ridge facility from the surrounding area and that substrate supply will fully support production objectives for the foreseeable future.

With the increased RNG<sup>®</sup> production, our operating expenses are expected to increase in the fourth quarter to reflect the commercial operation of the Huckabay Ridge facility. Commissioning costs are currently being capitalized prior to the commencement of commercial operations. General and administrative expenses are expected to increase relative to last year as we prepare for the development of additional planned digester facilities. We will continue to incur substantial costs associated with the growth of our business. For 2007, we expect a significant increase in general and administrative expenses for 2007 as compared to 2006, as we make payment under various severance arrangements and incur elevated non-cash compensation expense.

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

As of September 30, 2007, we had a total cost of \$21.1 million associated with the Huckabay Ridge facility, of which \$898,000 is capitalized interest and finance costs and approximately \$4.8 million is capitalized commissioning costs due to the extended, ongoing commissioning period. In the nine months ended September 30, 2007, we received proceeds of approximately \$332,000 from sales of the RNG<sup>®</sup> produced by the Huckabay Ridge facility, which has operated intermittently at various production levels. As these sales have been incurred prior to the facility achieving full-scale commercial production, these sales have been credited against capital expenditures on the Huckabay Ridge facility.

In addition to Huckabay, the other Texas projects are in normal, varying degrees of development. Development activities include finalizing off-take agreements, firming up manure and substrate-supply on the best possible terms, identifying and establishing construction contractors, and finalizing standard designs, taking into account our experience from the Huckabay Ridge project.

Substantial progress has been made in selection of a constructor for the previously announced JBS Swift project in Grand Island, Nebraska. We have executed a letter of intent with The Benham Companies, LLC and are negotiating supporting contractual arrangements. Once final contracts are in place, construction is expected to commence promptly, with groundbreaking currently expected late in the fourth quarter of 2007.

Permit applications have been submitted for all previously announced projects in California. Once permits are obtained, we plan to apply for tax-exempt debt financing for these projects similar to the financing obtained for the Texas projects.

We further anticipate heightened capital expenditures in the first and second quarters of 2008 associated with the commencement of the construction phase of other projects.

**Table of Contents**

The following table sets forth the various facilities under development by Microgy and its affiliates, including information with respect to the type of facility, its location, and its anticipated output:

Facility	Location	Type Gas	Expected Gas Production <sup>(a)</sup>
Huckabay Ridge	TX	RNG <sup>®</sup>	635,000
Mission	TX	RNG <sup>®</sup>	635,000
Rio Leche	TX	RNG <sup>®</sup>	635,000
Cnossen	TX	RNG <sup>®</sup>	635,000
Hanford Cluster	CA	RNG <sup>®</sup>	605,000
Bar 20	CA	RNG <sup>®</sup>	570,000
Riverdale Cluster	CA	RNG <sup>®</sup>	550,000
Cargill 1	ID	RNG <sup>®</sup>	550,000
Cargill 2	CO	RNG <sup>®</sup>	365,000
Gallo-Columbard	CA	Inside-the-Fence <sup>(b)</sup>	145,000
Swift-Grand Island	NE	Inside-the-Fence <sup>(b)</sup>	235,000
<b>Total</b>			<b>5,560,000</b>

(a) Expected saleable gas production in MMBTU/year at full operation.

(b) Biogas provided primarily to host customer operations.

**Cash Flow Outlook**

During the remainder of 2007 and 2008, we expect to fund our business activities principally from available cash balances, investment earnings, raising additional funds through debt and or equity financings by Environmental Power or Microgy 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 over the next twelve months. We do not expect to receive cash from the operations of Buzzard, insofar as any available cash would be used to repay interest and principal on the ArcLight loan and, in any event, we expect to dispose of this leasehold interest. We expect to receive a cash payment at the time of the termination of the lease in the amount of \$375,000 less any transaction costs.

On September 30, 2007, our unrestricted cash balance was \$3.9 million, as compared to \$13.8 million as of December 31, 2006. In addition, our restricted cash balances were \$47.2 million and \$52.2 million from continuing operations, at September 30, 2007 and December 31, 2006, respectively. We are allowed to spend restricted cash representing the remaining proceeds of our \$60 million tax-exempt bond financing to construct up to four planned RNG<sup>®</sup> facilities in Texas, subject to certain restrictions.

On October 3, 2007, we closed a firm commitment underwritten public offering of 5,400,000 shares of our common stock at a price to the public of \$5.25 per share. We received net proceeds from this offering of approximately \$26,199,000, after deducting underwriting discounts and commissions and costs and expenses associated with the offering. This amount appears as a receivable on the balance sheet as at September 30, 2007. The underwriters held an option to purchase up to an additional 810,000 shares of common stock which expired on October 27, 2007 without exercise.

We believe that our current cash balance will be sufficient to fund our minimum lease, debt obligations, current contractual commitments, and our corporate overhead requirements through at least the end of 2008. However, we will require additional financing to complete the construction of currently planned facilities.

**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, debt and lease expenses associated with Buzzard. A change in interest rates 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 risk associated with fluctuating gas prices. These risks are described in more detail below.

**Short-term investments**



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

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*

Buzzard, our discontinued operation, has borrowings that bear interest at variable rates that are based on LIBOR.

Additionally, we expect to finance Microgy's projects going forward with debt financing, which will be subject to prevailing interest rates.

### *Lease Expense*

As a lease cost of the Scrubgrass plant, Buzzard is required to fund the lessor's debt service which consists primarily of borrowings which bear interest at variable rates based on either quoted bond rates or LIBOR. The manager of Scrubgrass monitors market conditions for interest rates and, from time to time, enters into interest rate swaps to manage the interest payments for Scrubgrass. The interest rate swaps have the effect of converting the variable rate borrowings to fixed rate borrowings for specified time periods.

As of September 30, 2007, the aggregate outstanding balance of the lessor's variable rate debt obligations, which are passed along to us as a lease expense, was \$109,069,500. Based on these balances, an immediate change of one percent for the variable interest rates would cause a change in lease expense of \$1,090,695. Our objective in maintaining these variable rate borrowings is to achieve a lower overall cost when compared to fixed-rate borrowings. We believe the lessor has the same objective for maintaining its variable rate borrowings.

**Table of Contents*****Commodity Price Risk***

As Microgy establishes multi-digester projects for the production of RNG<sup>®</sup>, we could become increasingly 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 Texas bond financing, we are required to maintain certain gas price protection arrangements for the gas output of our Texas facilities. In connection with this obligation, Microgy Holdings LLC has entered into an agreement to sell up to 2,000 MMBTUs per day of the output of our Huckabay Ridge facility to a counterparty under a collared product pricing arrangement for a term of 18 months beginning April 2007 and ending in October 2008. Beginning October 1, 2008 Microgy will begin deliveries of RNG<sup>®</sup> from the Huckabay facility to Pacific Gas and Electric. The parties signed a 10-year agreement which allows PG&E to purchase up to 8,000 MMBtu of pipeline quality renewable natural gas daily from Microgy's California and Huckabay facilities at a fixed rate reflecting the renewable character of our natural gas.

***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 an unfavorable shift in the availability of certain types of substrates as a result of increases in corn and animal-feed prices. 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**

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2007. 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. While our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only such reasonable assurance, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of September 30, 2007, our chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended September 30, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

We are not a party to any material legal proceedings.

**Item 1A. Risk Factors**

You should carefully consider the following risk factors, in addition to other information included in this quarterly report on Form 10-Q and the other reports that we file with the Securities and Exchange Commission, in evaluating our business. If any of the following risks occur, our business, financial condition and operating results could be materially adversely affected. The following risk factors include any material changes to and supersede the risk factors previously disclosed in our annual report on Form 10-K for the year ended December 31, 2006.

*We have experienced losses to date, and we anticipate it will continue to experience losses into at least 2008.*

We have a history of losses. For the nine months ended September 30, 2007, we incurred a net loss of \$13.9 million. For the years ended December 31, 2006, 2005 and 2004, we incurred net losses of \$14.1 million, \$11.4 million and \$4.0 million, respectively. We expect our Microgy subsidiary 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 its business. These ongoing losses will adversely affect our financial condition into at least 2008. 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 overhead requirements. 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. Our inability to obtain adequate financing would likely result in the need to curtail or cease our business operations and, consequently, a much lower stock price.

*Our principal operating business, Microgy, has very little operating history from which to evaluate its business and products.*

Our principal 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, Microgy 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 commodity. Microgy has substantially completed construction on the multi-digester Huckabay Ridge facility, which is expected to achieve commercial operations in the fourth quarter. However, Microgy has experienced difficulties with the commissioning process and we cannot assure you that such difficulties will not recur. Because of Microgy's limited experience, 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

**Table of Contents**

completion of construction and commencement of commercial operations. For instance, Microgy has encountered problems with the quality of the gas conditioning and compression equipment supplied to it for the Huckabay Ridge facility. 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:

Site agreements;

Supply contracts;

Design/build or other construction-related agreements;

Off-take agreements for gas produced;

Power sales contracts;

Various co-product sales agreements;

Waste disposal agreements;

Licenses;

Environmental and other permits;

Local government approvals; and

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 sales 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 2008, we do not have adequate funds on hand to complete construction of the facilities we currently have planned. We are seeking and will require corporate, project or cross

collateralized 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. 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. This financing will depend on prospective lenders' or investors' review of our financial capabilities as well as specific facilities and other factors, including assessment of our ability to construct and manage each facility successfully. If we are unable to obtain the required financing, your investment in our securities will be materially adversely affected.

***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 an unfavorable shift in the availability at a reasonable cost of certain types of substrates as a result of increases in corn and animal-feed prices, and is unable to determine how long this shift will continue or what its long term effects may be on the cost of substrates and the operating costs of its facilities. We cannot assure you that the waste resources Microgy's facilities require will be available in the future 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 gas as a commodity; as a result, it will be exposed to risk relating to volatility in the commodity price of natural gas, which could have a material adverse impact on its profitability.***

Microgy is expected to derive a significant portion of its revenues from the sale of renewable natural gas as a commodity. As a result, Microgy will be exposed to market risk with respect to the commodity pricing applicable to its gas production. Realized commodity prices received for such production are expected to be primarily driven by spot prices applicable to natural gas. Historically, natural gas prices have been volatile, with recent significant price declines, and Microgy expects such volatility to continue. Furthermore, future supply of and demand for natural gas is unpredictable. There are many players in the markets for natural gas and other energy commodities that natural gas tends to track, including large energy companies and foreign cartels, that are of far greater size than Microgy and which can often cause significant movement in the short- and long-term supply and prices of natural gas. Fluctuations in the commodity price of natural gas may have a materially adverse impact on the profitability of some of Microgy's facilities, particularly where the facility does not have a long-term contract for the sale of its 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, it intends to explore various strategies, including hedging transactions and long-term sale agreements, in order to mitigate the associated commodity price risk. Microgy, Inc. has entered into a long-term fixed price arrangement with PG&E to purchase the gas produced from our planned California facilities and our Huckabay facilities in an amount up to 8,000 MMBTUs per day.

Furthermore, Microgy Holdings is required by the terms of its tax-exempt bonds to maintain certain gas price protection arrangements for specified periods of time. However, we cannot assure you that any such risk management vehicles will be available or successful. As a result, any such facility, and Microgy as a whole, may become unprofitable.

***We expect Microgy to derive substantial revenues from sales of carbon sequestration credits and other environmental attributes, but the market for such attributes is nascent and may not develop in a manner that allows Microgy 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 carbon 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 protocol could substantially diminish further carbon credit eligibility. Furthermore, much of the participation in these markets is voluntary, in response to social and environmental

**Table of Contents**

concerns, as opposed to being driven by regulatory requirements. While many states are pursuing 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 carbon sequestration credits or other environmental attributes.

***We have pledged all of our interest in our facilities in Texas as security for the loan relating to Microgy Holdings tax-exempt bond financing in Texas.***

We have invested, and expect to invest, substantial funds and resources in the development of four multi-digester, renewable natural gas facilities in Texas modeled on the facility located in Stephenville, Texas, which we refer to as the Huckabay Ridge facility. We have pledged all of our interest in these facilities 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. While the loan is 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, which represents a substantial investment of corporate resources. If Microgy Holdings were to default on this loan, we would lose some or all of our investment in the Texas facilities, 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.

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 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 the anaerobic digestion process on which they are based, are complex and, therefore, 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. For instance, Texas experienced record cold temperatures in early 2007 which negatively impacted the startup of the Huckabay Ridge facility. In addition, unusually heavy rains can upset the proper mix of inputs necessary for the anaerobic digestion process, and facilities can also be sensitive to lightning strikes. While Microgy considers typical local weather conditions in the design of its facilities, Microgy cannot anticipate unusual weather events, and such events have had and are likely to continue to have a material adverse effect on the operation of its facilities.

***Because the market for renewable energy is unproven, it is possible that we may expend large sums of money to bring Microgy's offerings to market and that the revenue that Microgy derives from these offerings 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 demand for 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.***

Neither Microgy nor, we believe, Microgy's licensor has filed any patent applications on the intellectual property which forms the basis of Microgy's technology. Should Microgy or its licensor 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.

Microgy relies heavily 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.

***If Microgy's relationship with the licensor of its technology was terminated for any reason or such licensor ceased doing business, our Microgy business would be negatively impacted.***

Microgy licenses its anaerobic digester technology from Danish Biogas Technology, A.S., referred to as DBT, a Danish company. DBT is a single purpose entity formed to hold the license agreement by Dansk Biogas, A.S. Dansk Biogas, A.S. was merged with DDH Contractors in 2004 and the combined entity is now known as Xergi, A.S. DBT is now a wholly owned entity of Xergi, A.S. The license agreement grants to Microgy a perpetual, exclusive license to develop facilities based on this technology in North America. Pursuant to the license agreement, Microgy is required to pay a one-time licensing fee per facility and engineering and design fees to DBT in connection with the development of facilities. Over the course of development of the Microgy facilities to date, Microgy has become less and less dependent on the technical and operating experience of DBT and Xergi and the exclusivity provisions of the license agreement have become a valuable component of Microgy's business as it limits entrance of other competitors or Xergi itself into the market space. Therefore, if DBT or Xergi were to cease doing business or the license agreement itself was abandoned, our Microgy business may be negatively impacted due to the loss of our ability to control dissemination of the technology through the loss of the exclusivity provisions.

## **Table of Contents**

*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. 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.

*As producers of carbon dioxide, Microgy s facilities may become subject to regulations or taxes based on carbon emissions.*

Microgy s facilities produce and emit into the atmosphere carbon dioxide as a result of the anaerobic digestion process that they employ. While such facilities capture a significantly greater amount of carbon, in the form of methane, than they produce in the form of carbon dioxide, 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 carbon emissions. If any such legislation, regulations or treaties were implemented, Microgy s may be required to expend resources to capture the carbon dioxide it produces, pay a tax on its carbon emissions, purchase carbon emissions credits or take similar actions. 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

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.

### **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.



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

A significant portion of our outstanding shares of common stock had been restricted from immediate resale, but are now available for sale in the market pursuant to Rule 144 under the Securities Act of 1933. As of September 30, 2007, we had approximately 1,109,924 shares of restricted common stock outstanding, all of which shares are eligible for resale without volume and manner of sale restrictions in accordance with Rule 144(k). We are currently authorized to issue 50,000,000 shares of common stock.

Furthermore, we currently have on file with the Securities and Exchange Commission an effective registration statement that permits the resale by certain of our stockholders of up to 1,677,688 shares of our restricted common stock, of which 1,066,928 shares are currently issued and outstanding and 610,760 shares were subject to outstanding warrants, of which warrants for 446,108 shares have been exercised and warrants for 164,652 shares have now expired. 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 4,398,610 shares of common stock issuable upon conversion of such shares of series A preferred stock and exercise of such warrants. 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.

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 175,912 warrants, representing 1% our fully diluted common stock at the time to Cargill as required by the business development agreement.

As of September 30, 2007, we had outstanding options and warrants to acquire up to approximately 4,994,040 shares of our common stock at prices ranging from \$1.75 to \$10.50 per share. 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 103,000 shares as of September 30, 2007, 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 price of our common stock.***

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.

---

**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 September 30, 2007, management 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 10.8% 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 21.6% 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 American Stock Exchange, trading activity in our common stock has fluctuated and has at times been limited. For example, for the one-month period from September 1, 2007 to September 30, 2007, our daily trading volume ranged from a low of 14,300 shares to a high of 1,091,600 shares, and averaged 187,000 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.

***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. 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 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 operation losses into at least 2008. 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 \$26,199,000. 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. 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 convertible debt, we may issue a significant number of shares of our common stock or preferred stock, which will dilute your investment in our common stock, and we may issue such shares at prices that may be lower than the price you paid for our common stock. 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 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. We have the authority to issue up to 50,000,000 shares of common stock, of which 10,179,354 are issued and outstanding and 4,994,040 have been reserved for issuance upon the exercise of options and warrants outstanding as of September 30, 2007. 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 175,912 warrants, 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

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

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 our market price pursuant to certain American Stock Exchange requirements. Any such issuances could be at values below the price paid for our common stock by our stockholders.

***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 two times 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. We have agreed not to issue securities senior to or on a par with the series A preferred stock and to limit our ability to incur additional indebtedness while such preferred stock is outstanding, which 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 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. 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 the company or reducing the proceeds available to common stockholders as a result of any such acquisitions.

**Table of Contents**

*We do not intend to pay cash dividends on our common stock for the foreseeable future.*

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 your investment on our common stock will depend solely on a change, if any, in the market value of our common stock.

**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**

We held our Annual Meeting of Stockholders on September 10, 2007. At the Annual Meeting, our stockholders elected a Board of Directors to serve for the ensuing year until their respective successors have been duly elected and qualified. The results of the voting were as follows:

Elected as a Director	Number of Shares Voted in Favor	Number of Shares Withheld
Joseph E. Cresci	8,844,948	86,484
Kamlesh R. Tejwani	8,785,287	146,145
John R. Cooper	8,832,202	99,230
August Schumacher Jr.	8,652,925	278,507
Robert I. Weisberg	8,637,507	293,925
Lon Hatamiya	8,783,867	147,565
Steven Kessner	8,776,175	155,259
Richard E. Kessel	8,840,903	90,529
Roger S. Ballentine	8,843,123	88,309

In addition, our stockholders acted upon and approved the following items by the following votes:

Item	Votes For	Votes Against	Abstained	Broker Non-Votes
1. The approval of an amendment to our certificate of incorporation, increasing the number of shares of common stock authorized for issuance thereunder from 21,400,000 to 50,000,000.				
a. Common stock, voting separately as a single class	8,632,042	276,790	22,600	0
b. Common stock and series A convertible preferred stock, voting together as a single class	8,632,042	276,790	22,600	0
2. The approval of an amendment to our 2006 Equity Incentive Plan to increase the number of shares of our common stock reserved for issuance thereunder from 300,000 to 800,000.	4,037,160	1,488,541	34,417	3,371,314
3. The ratification of our board of directors' selection of Vitale, Caturano & Company, Ltd. as our independent auditors for the fiscal year ending December 31, 2007.	8,831,421	87,705	12,306	0

As a result of the approval of the amendment to our 2006 Equity Incentive Plan, our 2006 Director Option Plan, which had 210,000 shares of common stock remaining for issuance, was terminated.

**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.

**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)

November 14, 2007

**Table of Contents**

**Table of Contents**

**Exhibit Index**

- 3.1 Restated Certificate of Incorporation of the Registrant, as amended.
- 3.2 Restated Bylaws of the Registrant (Incorporated by reference to Exhibit 3.02 to the Registrant's Current Report on Form 8-K/A dated June 2, 2003, as filed on June 10, 2003 (SEC File No. 000-15472)).
- 3.3 Certificate of Designations, Preferences and Rights of the Registrant's Series A 9% Cumulative Convertible Preferred Stock (Incorporated by reference to exhibit 3.1 to the Registrant's Current Report on Form 8-K dated November 9, 2006, as filed with the SEC on November 14, 2006 (SEC File No. 001-32393)).
- 10.1 2006 Equity Incentive Plan, as amended.
- 10.2 Summary of Non-Employee Director Compensation
- 31.1 Rule 13a-14(a)/15d-14(a) Certifications of the Registrant's Chief Executive Officer.
- 31.2 Rule 13a-14(a)/15d-14(a) Certifications of the 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.