Aircastle LTD
Form 4
January 05, 2016

FORM 4

Check this box if no longer subject to Section 16. Form 4 or Form 5 obligations may continue. *See* Instruction 1(b).

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

STATEMENT OF CHANGES IN BENEFICIAL OWNERSHIP OF SECURITIES

Filed pursuant to Section 16(a) of the Securities Exchange Act of 1934, Section 17(a) of the Public Utility Holding Company Act of 1935 or Section 30(h) of the Investment Company Act of 1940

OMB APPROVAL

OMB Number:	3235-0287
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(Print or Type Responses)

1. Name and Address of Reporting Person *
Schreiner Joseph

(Last) (First) (Middle)

C/O AIRCASTLE ADVISOR LLC, 300 FIRST STAMFORD PLACE

(Street)

STAMFORD, CT 06902

(City) (State) (Zip)

2. Issuer Name **and** Ticker or Trading Symbol
Aircastle LTD [AYR]

3. Date of Earliest Transaction (Month/Day/Year)
01/01/2016

4. If Amendment, Date Original Filed(Month/Day/Year)

5. Relationship of Reporting Person(s) to Issuer

(Check all applicable)

_____ Director _____ 10% Owner
__X__ Officer (give title below) _____ Other (specify below)
Executive Vice President, Tech

6. Individual or Joint/Group Filing(Check Applicable Line)
_X_ Form filed by One Reporting Person
___ Form filed by More than One Reporting Person

Table I - Non-Derivative Securities Acquired, Disposed of, or Beneficially Owned

1.Title of Security (Instr. 3)	2. Transaction Date (Month/Day/Year)	2A. Deemed Execution Date, if any (Month/Day/Year)	3. Transaction Code (Instr. 8)		4. Securities Acquired (A) or Disposed of (D) (Instr. 3, 4 and 5)			5. Amount of Securities Beneficially Owned Following Reported Transaction(s) (Instr. 3 and 4)	6. Ownership Form: Direct (D) or Indirect (I) (Instr. 4)	7. Nature of Indirect Beneficial Ownership (Instr. 4)
			Code	V	Amount	(A) or (D)	Price			
Common Stock	01/01/2016		F		1,509 (1)	D	$ 20.89 (2)	35,297	D	

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

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SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned
(*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8. Price of Derivative Security (Instr. 5)	9. Nu Deriv Secur Bene Owne Follo Repo Trans (Instr
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares		

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
Schreiner Joseph C/O AIRCASTLE ADVISOR LLC 300 FIRST STAMFORD PLACE STAMFORD, CT 06902			Executive Vice President, Tech	

Signatures

/s/ Joseph Schreiner	01/05/2016
**Signature of Reporting Person	Date

Explanation of Responses:

* If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).

** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).

(1) Common shares repurchased by the Company pursuant to an irrevocable election made by the reporting person under the Amended and Restated Aircastle Limited 2005 Equity and Incentive Plan and the Aircastle Limited 2014 Omnibus Incentive Plan (collectively, the "Plans"), with proceeds of such repurchase being applied to the reporting person's federal and state tax obligations arising from the vesting, on January 1, 2016, of 4,146 common shares granted under the Plans.

(2) The repurchase price of $20.89 paid by the Company was the closing price on December 31, 2015, the last trading day preceding the date the sale was reported, as provided in the Plans.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number. 4,266 $ 94 2.2% **Six Months Ended 2007 over 2006 $ Change 2007 over 2006 % Change *(Dollars in thousands)***

June 30,

2007

June 30, 2006

EBV Revenues	$9,008	$6,710	$2,298	34.2%

Sales to EBV, our largest distributor and the sole independent distributor of our products in Europe, accounted for 16.3% of our total revenues for the quarter ended June 30, 2007 and 22.0% of our total revenues for the same period in 2006; and 13.7% of our total revenues for the six months ended June 30, 2007 and 22.3% for the same period in 2006. While EBV revenues increased by only 2.2% during the quarter ended June 30, 2007 as compared to the same period in 2006, they increased substantially during the six months ended June 30, 2007 as compared to the same period in 2006. The primary factor contributing to the $2.3 million increase between the six month periods was the fact that, during the first quarter of 2006, we revised our revenue recognition methodology for sales made to EBV. Under the revised methodology, revenues, as well as cost of goods sold, are deferred on items shipped to EBV

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that remain in EBV s inventories at quarter-end. Revenue is then recognized on these products, along with the corresponding gross margin, when EBV sells them to its customers in future periods. This revision resulted in a one-time revenue decrease of approximately $2.9 million for the quarter ended March 31, 2006. The revision did not have an impact on cash flows from operations or require any changes to historical financial statements.

Excluding the impact of the accounting method revision, EBV s shipments to its customers decreased by approximately $600,000 during the first half of 2007 as compared to the same period in 2006. We believe this decrease is the result of the Restriction of Hazardous Substances, or RoHS, regulations, which became effective in the European Union July 1, 2006. Under these new rules, manufacturers such as Echelon were required to eliminate certain hazardous substances (e.g., lead, cadmium, mercury, etc.) from the products they sell into the region. We believe that many of EBV s customers increased their purchases of our non-RoHS compliant products during the first half of 2006, prior to effective date of the new regulations. This resulted in a high level of EBV revenue during the first half of 2006.

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

Our contract with EBV, which has been in effect since 1997 and to date has been renewed annually thereafter, expires in December 2007. If our agreement with EBV is not renewed, or is renewed on terms that are less favorable to us, our revenues could decrease and our future financial position could be harmed.

Product revenues

	Three Months Ended June 30,			
(Dollars in thousands)	**2007**	**June 30, 2006**	**2007 over 2006 $ Change**	**2007 over 2006 % Change**
Product Revenues	$ 26,437	$ 19,209	$ 7,228	37.6%

	Six Months Ended June 30,			
(Dollars in thousands)	**2007**	**June 30, 2006**	**2007 over 2006 $ Change**	**2007 over 2006 % Change**
Product Revenues	$ 65,514	$ 29,783	$ 35,731	120.0%

The $7.2 million increase in product revenues for the quarter ended June 30, 2007 as compared to the same period in 2006 was primarily the result of a $9.0 million increase in NES product revenues and a $1.2 million increase in LonWorks Infrastructure product revenues, partially offset by a $3.0 million decrease in Enel Project revenues. The $35.7 million increase in product revenues for the six months ended June 30, 2007 as compared to the same period in 2006 was primarily the result of a $33.6 million increase in NES product revenues and a $4.2 million increase in LonWorks Infrastructure product revenues, partially offset by a $2.1 million decrease in Enel Project revenues.

Service revenues

	Three Months Ended June 30,			
(Dollars in thousands)	**2007**	**June 30, 2006**	**2007 over 2006 $ Change**	**2007 over 2006 % Change**
Service Revenues	$ 259	$ 165	$ 94	57.0%

	Six Months Ended June 30,			
(Dollars in thousands)	**2007**	**June 30, 2006**	**2007 over 2006 $ Change**	**2007 over 2006 % Change**
Service Revenues	$ 451	$ 336	$ 115	34.2%

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The $94,000 increase in service revenues during the quarter ended June 30, 2007 as compared to the same period in 2006, and the $115,000 increase during the six months ended June 30, 2007 as compared to the same period in 2006, were primarily due to an increase in NES support revenues, partially offset by a reduction in our LonWorks Infrastructure customer support and training revenues. Primarily due to the increase in NES service revenues associated with our large scale deployment projects, we currently expect that our full year 2007 service revenues will increase modestly from the $761,000 recorded in 2006.

Gross Profit and Gross Margin

	Three Months Ended June 30,			
(Dollars in thousands)	2007	June 30, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
Gross Profit	$ 10,867	$ 11,619	$ (752)	(6.5%)
Gross Margin	40.7%	60.0%		(19.3)

	Six Months Ended June 30,			
(Dollars in thousands)	2007	June 30, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
Gross Profit	$ 21,017	$ 17,356	$ 3,661	21.1%
Gross Margin	31.9%	57.6%		(25.7)

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

Both the 19.3 percentage point decrease in gross margin during the second quarter of 2007, as well as the 25.7 percentage point decrease during the first six months of 2007, were due primarily to the mix of revenues reported. In each case, the proportion of our revenues attributable to sales of our NES system products increased significantly as compared to the same periods in 2006. In general, gross margins generated from sales of our NES system products are much lower than those generated from both sales of our LonWorks Infrastructure products and services as well as sales made under the Enel Project. As a result, when NES revenues are higher as a percentage of overall revenues, as they were during the quarter and six months ended June 30, 2007, overall gross margins will be lower. Conversely, when NES revenues comprise a lower percentage of overall revenues, as they were during the quarter and six months ended June 30, 2006, overall gross margins will be higher.

Partially offsetting the decrease in gross margins during the three and six months ended June 30, 2007 as compared to the same periods in 2006 were the impacts of higher revenues. As discussed above, a portion of our cost of goods sold relates to indirect costs. Some of these costs do not increase or decrease in conjunction with revenue levels, but rather remain relatively constant from quarter to quarter. As a result, when revenues increase, as they did in the quarter and six months ended June 30, 2007 as compared to the same periods in 2006, gross margins are favorably impacted.

We expect that, for full year 2007, overall gross margin will decrease significantly from the 58.2% experienced in 2006 due to the significant increase we expect in NES revenues.

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Operating Expenses

Product Development

(Dollars in thousands)	Three Months Ended June 30, 2007	June 30, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
Product Development	$ 8,130	$ 7,163	$ 967	13.5%

(Dollars in thousands)	Six Months Ended June 30, 2007	June 30, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
Product Development	$ 15,931	$ 14,154	$ 1,777	12.6%

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

The $967,000 and $1.8 million increases in product development expenses for the quarter and six month periods ended June 30, 2007 as compared to the same periods in 2006 were primarily due to increases in compensation expenses for our product development personnel, fees paid to third party service providers, and equipment and supplies used in the development process.

We expect that, for full year 2007, product development expenses will increase over 2006 levels. This increase will primarily be the result of increased development efforts related to our NES system products.

Sales and Marketing

(Dollars in thousands)	Three Months Ended June 30, 2007	June 30, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
Sales and Marketing	$ 4,953	$ 5,089	$ (136)	(2.7%)

(Dollars in thousands)	Six Months Ended June 30, 2007	June 30, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
Sales and Marketing	$ 10,368	$ 10,236	$ 132	1.3%

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

The $136,000 reduction in sales and marketing expenses during the quarter ended June 30, 2007 as compared to the same period in 2006 was primarily the result of a decrease in costs associated with tradeshows. The $132,000 increase in sales and marketing expenses during the six months ended June 30, 2007 as compared to the same period in 2006 was primarily due to increases in compensation related expenses for our sales and marketing personnel.

Also contributing to the changes in sales and marketing expenses between 2006 and 2007 were the impacts of foreign currency exchange rate fluctuations between the U.S. dollar and the local currencies in several of the foreign countries in which we have operations, including the Euro, the British Pound Sterling, and the Japanese Yen. These exchange rate fluctuations caused sales and marketing expenses to increase by approximately $74,000 during the second quarter of 2007 as compared to the same period in 2006, and to increase by approximately $192,000 during the six months ended June 30, 2007 as compared to the same period in 2006.

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We expect that, during 2007, our sales and marketing expenses will increase over 2006 levels. In addition, if the United States dollar were to weaken against the foreign currencies where we do business, our sales and marketing expenses could increase further. Conversely, if the dollar were to strengthen against these currencies, it would have a favorable impact on our sales and marketing expenses.

General and Administrative

(Dollars in thousands)	Three Months Ended June 30, 2007	June 30, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
General and Administrative	$ 4,291	$ 3,798	$ 493	13.0%

(Dollars in thousands)	Six Months Ended June 30, 2007	June 30, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
General and Administrative	$ 7,999	$ 7,200	$ 799	11.1%

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

Both the $493,000 and $799,000 increases in general and administrative expenses during the quarter and six months ended June 30, 2007, respectively, as compared to the same periods in 2006, were primarily attributable to increases in compensation related expenses for our executive, accounting, and administrative personnel, and to a lesser extent, fees paid to our independent accountants and other third party service providers.

We believe that, during 2007, general and administrative costs will increase modestly above 2006 levels.

Interest and Other Income, Net

(Dollars in thousands)	Three Months Ended June 30, 2007	June 30, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
Interest and Other Income, Net	$ 1,488	$ 1,404	$ 84	6.0%

(Dollars in thousands)	Six Months Ended June 30, 2007	June 30, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
Interest and Other Income, Net	$ 2,985	$ 2,798	$ 187	6.7%

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

During the second quarter of 2007, interest and other income, net increased by approximately $84,000 as compared to the same period in 2006. This increase was primarily due to a $168,000 reduction in foreign exchange translation losses, partially offset by a $101,000 decrease in interest income. During the six months ended June 30, 2007, interest and other income, net increased by approximately $187,000 as compared to the same period in 2006. As was the case with the change between the two quarterly periods, this increase was primarily due to a $244,000 reduction in foreign exchange translation losses, partially offset by a $78,000 decrease in interest income. The reduction in interest income for both the quarter and six months ended June 30, 2007 as compared to the same periods in 2006 is primarily the result of a reduction in our average invested cash balance between the periods.

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Although interest rates have increased substantially since June 2004, we expect that our anticipated operating losses for 2007 will require us to use a portion of our existing cash and short-term investment portfolio to fund ongoing business operations. In addition, we may decide to continue repurchasing our common stock in accordance with our board of directors approved stock repurchase program, which expires in March 2008. As a result, we expect that the average amount of our invested cash will decrease during 2007, which will result in reduced interest income if interest rates remain unchanged. In addition, future fluctuations in the exchange rates between the United States dollar and the currencies in which we maintain our short-term intercompany balances (principally the European Euro and the British Pound Sterling) will also affect our interest and other income, net.

Provision for Income Taxes

(Dollars in thousands)	Three Months Ended June 30, 2007	June 30, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
Provision for Income Taxes	$ 107	$ 80	$ 27	33.8%

(Dollars in thousands)	Six Months Ended June 30, 2007	June 30, 2006	2007 over 2006 $ Change	2007 over 2006 % Change
Provision for Income Taxes	$ 215	$ 160	$ 55	34.4%

The provision for income taxes for 2007 includes a provision for federal, state and foreign taxes based on our annual estimated effective tax rate for the year. The difference between the statutory rate and our effective tax rate is primarily due to the impact of foreign taxes. Income taxes of $107,000 and $80,000 for the quarters ended June 30, 2007 and 2006, respectively, and $215,000 and $160,000 for the six months ended June 30, 2007 and 2006, respectively, consist primarily of taxes related to profitable foreign subsidiaries and various state minimum taxes.

Although we expect to generate a loss before provision for income taxes in 2007, we will be required to book income tax expense to cover, at a minimum, the foreign taxes owed on income generated by our profitable foreign subsidiaries as well as state minimum taxes. We currently expect our 2007 provision for income taxes will be slightly higher than the amounts provided for in 2006.

Off-Balance-Sheet Arrangements and Other Contractual Obligations

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

Operating Lease Commitments. We lease our present corporate headquarters facility in San Jose, California, under two non-cancelable operating leases. The first lease agreement expires in 2011 and the second lease agreement expires in 2013. Upon expiration, both lease agreements provide for extensions of up to ten years. As part of these lease transactions, we provided the lessor with security deposits in the form of two standby letters of credit totaling $6.2 million.

In addition to our corporate headquarters facility, we also lease facilities for our sales, marketing, distribution, and product development personnel located elsewhere within the United States and in nine foreign countries throughout Europe and Asia. These operating leases are of shorter duration, generally one to five years, and in some instances are cancelable with advance notice. Lastly, we also lease certain equipment and, for some of our sales personnel, automobiles. These operating leases are generally less than five years in duration.

Purchase Commitments. We utilize several contract manufacturers that manufacture and test our products requiring assembly. These contract manufacturers acquire components and build product based on demand information supplied by us in the form of purchase orders and demand forecasts. These purchase orders and demand forecasts

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generally cover periods that range from one to six months, and in some cases, up to one year. We also obtain individual components for our products from a wide variety of individual suppliers. We generally acquire these components through the issuance of purchase orders, and in some cases through demand forecasts, both of which cover periods ranging from one to nine months.

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

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

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

Royalties. We have certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense is generally based on a U.S. dollar amount per unit shipped or a percentage of the underlying revenue. Royalty expense, which is recorded under our cost of products revenue on our consolidated statements of operations, was approximately $150,000 during the quarter ended June 30, 2007, and $102,000 for the same period in 2006, and $299,000 for the six months ended June 30, 2007, and $211,000 for the same period in 2006.

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

Taxes. We conduct our operations in many tax jurisdictions throughout the world. In many of these jurisdictions, non-income based taxes such as property taxes, sales and use taxes, and value-added taxes are assessed on Echelon s operations in that particular location. While we strive to ensure compliance with these various non-income based tax filing requirements, there have been instances where potential non-compliance exposures have been identified. In accordance with generally accepted accounting principles, we make a provision for these exposures when it is both probable that a liability has been incurred and the amount of the exposure can be reasonably estimated. To date, such provisions have been immaterial, and we believe that, as of June 30, 2007, we have adequately provided for such contingencies. However, it is possible that our results of operations, cash flows, and financial position could be harmed if one or more non-compliance tax exposures are asserted by any of the jurisdictions where we conduct our operations.

Legal Actions. From time to time, in the ordinary course of business, we are subject to legal proceedings, claims, investigations, and other proceedings, including claims of alleged infringement of third-party patents and other intellectual property rights, and commercial, employment, and other matters. In accordance with generally accepted accounting principles, we make a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. While we believe we have adequately provided for such contingencies as of June 30, 2007, it is possible that our results of operations, cash flows, and financial position could be harmed by the resolution of any such outstanding claims.

Liquidity and Capital Resources

Since our inception, we have financed our operations and met our capital expenditure requirements primarily from the sale of preferred stock and common stock, although during the years 2002 through 2004, we were also able

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to finance our operations through operating cash flow. From inception through June 30, 2007, we raised $281.3 million from the sale of preferred stock and common stock, including the exercise of stock options and warrants from our employees and directors.

In March and August 2004, March 2006, and February 2007, our board of directors approved a stock repurchase program, which authorizes us to repurchase up to 3.0 million shares of our common stock, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. There were no repurchases under the program during the three and six months ended June 30, 2007. Since inception, we have repurchased a total of 2,204,184 shares under the program at a cost of $16.1 million. As of June 30, 2007, 795,816 shares are available for repurchase. The stock repurchase program will expire in March 2008.

The following table presents selected financial information as of June 30, 2007 and for each of the last three fiscal years (dollars in thousands):

		December 31,		
	June 30, 2007	**2006**	**2005**	**2004**
Cash, cash equivalents, and short-term investments	$ 117,464	$ 124,157	$ 154,480	$ 160,364
Trade accounts receivable, net	18,161	13,918	11,006	17,261
Working capital	125,742	132,420	157,474	173,391
Stockholders equity	151,093	156,575	181,308	211,062

As of June 30, 2007, we had $117.5 million in cash, cash equivalents, and short-term investments, a decrease of $6.7 million as compared to December 31, 2006. Historically, our primary source of cash, other than stock sales, has been receipts from revenue, and to a lesser extent, proceeds from the exercise of stock options and warrants by our employees and directors. Our primary uses of cash have been cost of product revenue, payroll (salaries, commissions, bonuses, and benefits), general operating expenses (costs associated with our offices such as rent, utilities, and maintenance; fees paid to third party service providers such as consultants, accountants, and attorneys; travel and entertainment; equipment and supplies; advertising; and other miscellaneous expenses), acquisitions, capital expenditures, and purchases under our stock repurchase program.

Cash flows from operating activities. Cash flows from operating activities have historically been driven by net income (loss) levels, adjustments for non-cash charges such as depreciation, amortization, in-process research and development charges, and stock-based compensation, as well as fluctuations in operating asset and liability balances. Net cash used in operating activities was $6.3 million for the six months ended June 30, 2007, a $2.3 million decrease from the same period in 2006. During the six months ended June 30, 2007, net cash used in operating activities was primarily a result of our net loss of $10.5 million, changes in our operating assets and liabilities of $253,000, an increase in accrued investment income of $245,000, and a reduction in our bad debt reserve balance of $57,000, partially offset by stock-based compensation expenses of $2.6 million, and depreciation and amortization expense of $2.2 million. During the six months ended June 30, 2006, net cash used in operating activities was primarily a result of our net loss of $11.6 million, changes in our operating assets and liabilities of $1.5 million, an increase in accrued investment income of $286,000, and a reduction in our bad debt reserve balance of $35,000, partially offset by stock-based compensation expenses of $2.7 million, and depreciation and amortization expense of $2.2 million.

Cash flows from investing activities. Cash flows from investing activities have historically been driven by transactions involving our short-term investment portfolio, capital expenditures, changes in our long-term assets, and acquisitions. Net cash provided by investing activities was $4.0 million for the six months ended June 30, 2007, a $4.0 million increase from the same period in 2006. During the six months ended June 30, 2007, net cash provided by investing activities was primarily the result of proceeds from maturities and sales of available-for-sale short-term investments of $62.2 million, and changes in our other long-term assets of $43,000, partially offset by purchases of available-for-sale short-term investments of $55.1 million, and capital expenditures of $3.1 million. During the six months ended June 30, 2006, net cash provided by investing activities was primarily the result of proceeds from maturities and sales of available-for-sale short-term investments of $37.4 million, and changes in our other long-term assets of $22,000, partially offset by purchases of available-for-sale short-term investments of $34.5 million, and capital expenditures of $2.9 million.

Cash flows from financing activities. Cash flows from financing activities have historically been driven by the proceeds from issuance of common and preferred stock offset by transactions under our stock repurchase programs. Net cash provided by financing activities was $2.3 million for the six months ended June 30, 2007, a $4.7 million increase over the same period in 2006. During the six month period ended June 30, 2007, net cash provided by financing activities was attributable to proceeds of $3.2 million from issuance of common stock as a result of options exercised by our employees, partially offset by $842,000 of repurchases of common stock from our employees for payment of income and other payroll taxes they owed upon the vesting of performance shares and upon the exercise of stock options. During the six month period ended June 30, 2006, net cash used in financing activities was attributable to $2.5 million of open-market purchases of our common stock under our stock repurchase program, partially offset by $191,000 of proceeds from issuance of common stock as a result of options exercised by our employees.

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

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

Our existing cash, cash equivalents, and investment balances will likely decline during 2007 as a result of our anticipated operating losses. In addition, any weakening of current economic conditions, or changes in our planned cash outlay, could also negatively affect our existing cash, cash equivalents, and investment balances. However, based on our current business plan and revenue prospects, we believe that our existing cash and short-term investment balances will be sufficient to meet our projected working capital and other cash requirements for at least the next twelve months. Cash from operations could be affected by various risks and uncertainties, including, but not limited to, the risks detailed later in this discussion in the section titled *Factors That May Affect Future Results of Operations.* In the unlikely event that we would require additional financing within this period, such financing may not be available to us in the amounts or at the times that we require, or on acceptable terms. If we fail to obtain additional financing, when and if necessary, our business would be harmed.

Related Party Transactions

During the quarter and six months ended June 30, 2007, and the years ended December 31, 2006, 2005, and 2004, the law firm of Wilson Sonsini Goodrich & Rosati, P.C. acted as principal outside counsel to our company. Mr. Sonsini, a director of our company, is a member of Wilson Sonsini Goodrich & Rosati, P.C.

From time to time, M. Kenneth Oshman, our Chairman of the Board and Chief Executive Officer, uses private air travel services for business trips for himself and for any employees accompanying him. Prior to January 1, 2005, a company controlled by Armas Clifford Markkula, a director of our company, provided these private air travel services. Our net expense with respect to such private air travel services is no greater than comparable first class commercial air travel services. Such net outlays to date have not been material.

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

Under the terms of the stock purchase agreement, Enel has the right to nominate a member of our board of directors. As of July 31, 2007, a representative of Enel has not been appointed to our board.

At the time we entered into the stock purchase agreement with Enel, we also entered into a research and development agreement with an affiliate of Enel (the R&D Agreement). Under the terms of the R&D Agreement, we cooperated with Enel to integrate LonWorks technology into Enel s remote metering management project in Italy, the Contatore Elettronico. We completed the sale of our components and products for the deployment phase of the Contatore Elettronico project during 2005. During 2006, we supplied Enel and its designated manufacturers with limited spare parts for the Contatore Elettronico system. In October 2006, we entered into a new development and supply agreement and a software enhancement agreement with Enel. Under the development and supply agreement, Enel and its contract manufacturers will purchase additional electronic components and finished goods from Echelon, assuming certain initial acceptance tests are completed successfully. Under the software enhancement agreement, we will provide software enhancements to Enel for use in its Contatore Elettronico system. Both the new development and supply agreement and the software enhancement agreement expire in December 2009, although delivery of products and services can extend beyond that date and the agreements may be extended under certain circumstances.

For the quarter and six months ended June 30, 2007, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $3.8 million and $5.0 million, respectively. As of June 30, 2007, $158,000 of our total accounts receivable balance related to amounts owed by Enel and its designated manufacturers. For the quarter and six months ended June 30, 2006, we recognized revenue from products and services sold to Enel and its designated manufacturers of approximately $6.9 million and $7.1 million, respectively. As of June 30, 2006, $6.8 million of our total accounts receivable balance related to amounts owed by Enel and its designated manufacturers.

Recently Issued Accounting Standards

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159 (SFAS 159), *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective for Echelon beginning in our fiscal year ending December 31, 2008, although earlier adoption is permitted. We are currently evaluating the impact that SFAS 159 will have on our consolidated financial statements.

Factors That May Affect Future Results Of Operations

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

Our NES revenues may not be predictable.

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

- the time it takes for utilities to evaluate multiple competing bids, negotiate terms, and award contracts for large scale metering system deployments;

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- the deployment schedule for projects undertaken by our utility or systems integrator customers; and
- delays in installing, operating, and evaluating the results of NES system field trials.

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

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

We have invested and intend to continue to invest significant resources in the development and sales of our NES system. Our long-term financial goals include expectations for a reasonable return on these investments. However, to date the revenues generated from sales of our NES system products have yielded very little gross profit, while our NES related operating expenses have increased significantly. Additionally, gross margins on our NES system offerings are currently lower than gross margins on our other product offerings.

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

- Increase market acceptance of our NES system products in order to increase revenues;
- Increase gross margin from our NES revenues by reducing the cost of manufacturing our NES system products;
- Manage the manufacturing transition to reduced-cost NES products; and
- Manage our operating expenses to a reasonable percentage of revenues.

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

We depend on a limited number of key suppliers.

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

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

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We cannot be certain that these and other key suppliers will continue to supply us with critical products or components. If any of our key suppliers were to stop manufacturing our products or supplying us with our key components, it could be expensive and time-consuming to find a replacement. In addition, as our NES business grows, we will be required to expand our business with our key suppliers or find additional sources of supply. There is no guarantee that we would be able to find acceptable alternative or additional sources. Additional risks that we face if we must transition between CEMs include:

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

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

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

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

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

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

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

The markets for our products are highly competitive.

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

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

- our ability to anticipate changes in customer requirements and to develop new or improved products that meet these requirements in a timely manner;

the price and features of our products such as adaptability, scalability, functionality, ease of use, and the ability to integrate with other products;

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- our product reputation, quality, performance, and conformance with established industry standards;
- our customer service and support;
- warranties, indemnities, and other contractual terms; and
- customer relationships and market awareness.

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

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

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

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

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

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

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

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

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

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

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

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

We face financial and operational risks associated with international operations.

We have operations located in nine countries around the world. Revenues from international sales, which include both export sales and sales by international subsidiaries, accounted for about 81.2% of our total net revenues for the quarter ended June 30, 2007, and 75.9% for the same period in 2006, and 86.0% of our total net revenues for the six months ended June 30, 2007, and 68.7% for the same period in 2006. We expect that international sales will constitute an even more significant portion of our total net revenues as our NES revenues, which currently result predominantly from international sales, will increase significantly in 2007 as compared to 2006.

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

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

For our cost of goods sold, the majority of our products are assembled by CEMs in China, and to a lesser extent, in the European Union, although our transactions with these vendors have historically been denominated in U.S. dollars. These vendors may require us to pay in their local currency, or demand a U.S. dollar price adjustment or

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other payment to address a change in exchange rates, which would increase our cost to procure our products. This is particularly a risk in China, where any future revaluations of the Chinese currency against the U.S. dollar could result in significant cost increases.

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

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

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

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

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

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

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

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

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

If we sell our NES system products to a utility directly, we may be required to assume responsibility for installing the NES system in the utility s territory, integrating the NES system into the utility s operating and billing system, overseeing management of the combined system, and undertaking other activities. To date, we do not have

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any significant experience with providing these types of services. As a result, if we sold directly to a utility, it may be necessary for us to contract with third parties to satisfy these obligations. We cannot assure you that we would find appropriate third parties to provide these services on reasonable terms, or at all. Assuming responsibility for these or other services would add to the costs and risks associated with NES system installations, and could also negatively affect the timing of our revenues and cash flows related to these transactions.

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

Our quarterly and annual results have varied significantly from period to period, and we have sometimes failed to meet securities analysts expectations. Moreover, we have a history of losses and we expect to incur substantial losses again in 2007. Our future operating results will depend on many factors, many of which are outside of our control, including the following:

- the mix of products and services that we sell may change to a less profitable mix;
- the complex revenue recognition rules relating to products such as our NES system could require us to defer some or all of the revenue associated with NES product shipments until certain conditions, such as delivery and acceptance criteria, are met in a future period;
- our contract electronic manufacturers may not be able to provide quality products on a timely basis, especially during periods where capacity in the CEM market is limited;
- shipment and payment schedules may be delayed;
- our products may not be manufactured in accordance with specifications or our established quality standards, or may not perform as designed;
- our products may not be accepted by utilities, OEMs, systems integrators, service providers and end-users at the levels we project;
- downturns in any customer s or potential customer s business, or declines in general economic conditions, could cause significant reductions in capital spending, thereby reducing the levels of orders from our customers;
- recording of expense relating to equity compensation as required under Statement of Financial Accounting Standard (SFAS) No. 123(revised 2004), *Share-Based Payment*, will decrease our earnings;
- we may incur costs associated with any future business acquisitions; and
- results of impairment tests for goodwill and other intangible assets in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, with respect to goodwill and other identified intangible assets that we acquired in the past or that we may acquire in the future may negatively affect our earnings and financial condition.

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

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

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

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instance, we have published all of the network management commands required to develop software that competes with our LNS software.

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

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

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

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

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

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

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

We have limited ability to protect our intellectual property rights.

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

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

Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or services or use information that we regard as proprietary. Any of our patents, trademarks, copyrights or intellectual property rights could be challenged, invalidated or circumvented. In addition, we cannot assure you that we have taken or will take all necessary steps to protect our intellectual property rights. Third parties may also independently develop similar technology without breach of our trade secrets or other proprietary rights. In addition, the laws of some foreign countries, including several in which we operate or sell our products, do not protect proprietary rights to as great an extent as do the laws of the United States and it may take longer to receive a remedy

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from a court outside of the United States. Also, some of our products are licensed under shrink-wrap license agreements that are not signed by licensees and therefore may not be binding under the laws of certain jurisdictions.

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

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

Our company s success depends substantially on the performance of our executive officers and key employees. Due to the specialized technical nature of our business, we are particularly dependent on our Chief Executive Officer, our President and Chief Operating Officer, and our technical personnel. Our future success will depend on our ability to attract, integrate, motivate and retain qualified technical, sales, operations, and managerial personnel, as well as our ability to successfully implement a plan for management succession.

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

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

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

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

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

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

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

In addition, many of our products and the industries in which they are used are subject to U.S. and foreign regulation. For example, the power line medium, which is the communications medium used by some of our

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products, is subject to special regulations in North America, Europe and Japan. In general, these regulations limit the ability of companies to use power lines as a communication medium. In addition, some of our competitors have attempted to use regulatory actions to reduce the market opportunity for our products or to increase the market opportunity for their own products.

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

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

As of July 31, 2007, our directors and executive officers, together with certain entities affiliated with them (including, for this purpose, Enel, which has the right to nominate a director to our board of directors), beneficially owned 35.4% of our outstanding stock.

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

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

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

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

We have not experienced any material change in our exposure to interest rate and foreign currency risks since the date of our Annual Report on Form 10-K for the year ended December 31, 2006.

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

Interest Rate Sensitivity. We maintain a short-term investment portfolio consisting mainly of fixed income securities with a weighted average maturity of less than one year. These available-for-sale securities are subject to interest rate risk and will fall in value if market interest rates increase. If market rates were to increase immediately and uniformly by 10% from levels at June 30, 2007 and June 30, 2006, the fair value of the portfolio would decline

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by an immaterial amount. We currently intend to hold our fixed income investments until maturity, and therefore we would not expect our operating results or cash flows to be affected to any significant degree by a sudden change in market interest rates. If necessary, we may sell short-term investments prior to maturity to meet the liquidity needs of the company.

Foreign Currency Exchange Risk. We have international subsidiaries and operations and are, therefore, subject to foreign currency rate exposure. To date, our exposure to exchange rate volatility has not been significant. If foreign exchange rates were to fluctuate by 10% from rates at June 30, 2007, and June 30, 2006, our financial position and results of operations would not be materially affected. However, we could experience a material impact in the future.

ITEM 4. CONTROLS AND PROCEDURES

Our review of our internal controls over financial reporting was made within the context of the relevant professional auditing standards defining internal controls over financial reporting, reportable conditions, and material weaknesses. As part of our evaluation of internal controls over financial reporting, we also address other, less significant control matters that we or our auditors identify, and we determine what revision or improvement to make, if any, in accordance with our on-going procedures.

Limitations on the Effectiveness of Controls

Since we began reviewing our internal controls over financial reporting, we have identified a number of procedures where an opportunity to improve our internal controls existed. As part of our ongoing effort to maximize our internal controls over financial reporting, each of these control improvement opportunities has been, or is in the process of being, remediated by management.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures (as defined in the Securities Exchange Act of 1934, or the Exchange Act, Rules 13a-15(e) and 15d-15(e)) or our internal controls over financial reporting will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected.

Conclusions Regarding Disclosure Controls and Procedures and Internal Controls Over Financial Reporting

Our CEO and our CFO have reviewed our disclosure controls and procedures and our internal controls over financial reporting in order to both evaluate their effectiveness and to ensure they have been designed to provide reasonable assurance of achieving their objectives, which is to make sure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms. Based on this evaluation, they have concluded that as of June 30, 2007, our disclosure controls and procedures and our internal controls over financial reporting are effective at this reasonable assurance level.

Changes in Internal Controls Over Financial Reporting

There were no changes in our internal controls over financial reporting (as defined in Rule 13a-15(e) of the Exchange Act) that occurred during the quarter ended June 30, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

For a discussion regarding our legal proceedings and matters, please refer to the Legal Actions section of Note 6, Commitments and Contingencies, to our condensed consolidated financial statements included under Item 1 of Part I, Financial Information, which information is incorporated herein by reference.

ITEM 1A. RISK FACTORS

A restated description of the risk factors associated with our business is included under Factors That May Affect Future Results Of Operations in Management s Discussion and Analysis of Financial Condition and Results of Operations, contained in Item 2 of Part I of this report. This restated description includes any material changes to and supersedes the description of the risk factors associated with our business previously disclosed in Part I Item 1A of our 2006 Annual Report on Form 10-K and in Part II Item 1A of our Quarterly Report on Form 10-Q for the quarter ended March 31, 2007, and is incorporated herein by reference.

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

In March and August 2004, our board of directors approved a stock repurchase program, which authorizes us to repurchase up to 3.0 million shares of our common stock in the open market, in accordance with Rule 10b-18 and other applicable laws, rules and regulations. The board of directors extended the term of the stock repurchase program in March 2006 and again in February 2007. Since inception, we have repurchased a total of 2,204,184 shares under the program at a cost of $16.1 million. As of June 30, 2007, 795,816 shares are available for repurchase. The stock repurchase program will expire in March 2008. The following table provides information about the repurchase of our common stock during the quarter ended June 30, 2007:

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (1)
April 1- April 30	41,822	$ 11.96		795,816
May 1- May 31	62,708	$ 15.00		795,816
June 1- June 30 31	38,613	$ 18.26		795,816
Total	143,143	$ 14.99		795,816

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

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ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Company held its annual meeting of stockholders on May 15, 2007. At such meeting, the following directors were elected: Richard M. Moley and Betsy Rafael. Our incumbent directors, M. Kenneth Oshman, Robert J. Finocchio, Jr., Armas Clifford Markkula, Jr., Robert R. Maxfield, and Larry W. Sonsini will continue to serve on the Board. Voting results for the election of the directors were as follows:

	Votes For	Votes Withheld
Richard M. Moley	33,545,860	102,320
Betsy Rafael	33,522,012	126,168

The only other matter submitted to stockholder vote at the Annual Meeting was the ratification of the appointment of KPMG LLP as independent auditors of the Company for the fiscal year ending December 31, 2007. Voting results for the KPMG LLP appointment were as follows:

Votes For:	Votes Against:	Abstain:
33,402,415	194,883	50,882

ITEM 6. EXHIBITS

Exhibit No.	Description of Document
31.1	Certificate of Echelon Corporation Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certificate of Echelon Corporation Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certification by the Chief Executive Officer and the Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, furnished herewith.

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SIGNATURE

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

ECHELON CORPORATION

Date: August 9, 2007

By: /s/ Oliver R. Stanfield
Oliver R. Stanfield,
Executive Vice President and Chief Financial Officer
(Duly Authorized Officer and Principal Financial and Accounting Officer)

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