

ENVIRONMENTAL POWER CORP

Form 10-Q

November 09, 2009

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, DC 20549**

**FORM 10-Q**

(Mark one)

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

For the quarterly period ended September 30, 2009

**OR**

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

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

Commission file number 001-32393

**Environmental Power Corporation**

(Exact name of registrant as specified in its charter)

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

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

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

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

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

|                                                                                              |                                                               |
|----------------------------------------------------------------------------------------------|---------------------------------------------------------------|
| Large accelerated filer <input type="checkbox"/>                                             | Accelerated filer <input checked="" type="checkbox"/>         |
| Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company) | Smaller reporting company <input checked="" type="checkbox"/> |
| Number of shares of Common Stock outstanding at September 30, 2009: 15,708,591 shares        |                                                               |

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

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**PART I. FINANCIAL INFORMATION**

**Cautionary Statement Regarding Forward-Looking Statements**

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

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

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

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

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

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

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

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

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

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

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

financing and cash flow requirements and uncertainties,

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

difficulties involved in developing and executing a business plan,

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

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, 2009 and December 31, 2008**

|                                                                         | September 30,<br>2009 | December 31,<br>2008  |
|-------------------------------------------------------------------------|-----------------------|-----------------------|
| <b>ASSETS</b>                                                           |                       |                       |
| Current Assets                                                          |                       |                       |
| Cash and cash equivalents                                               | \$ 1,080,863          | \$ 3,157,938          |
| Restricted cash                                                         | 98,463,131            | 104,577,246           |
| Receivables                                                             | 559,189               | 373,039               |
| Other current assets                                                    | 110,321               | 60,210                |
| <b>Total Current Assets</b>                                             | <b>100,213,504</b>    | <b>108,168,433</b>    |
| Restricted cash, non current                                            | 503,612               | 553,014               |
| Property, plant and equipment, net                                      | 25,408,443            | 23,932,073            |
| Construction in progress                                                | 23,510,184            | 20,101,314            |
| Licensed technology rights, net                                         | 2,190,171             | 2,329,296             |
| Notes receivable, net                                                   | 1,540,498             | 1,608,500             |
| Deferred financing costs, net                                           | 5,442,486             | 5,122,995             |
| Other assets                                                            | 446,641               | 197,569               |
| <b>TOTAL ASSETS</b>                                                     | <b>\$ 159,255,539</b> | <b>\$ 162,013,194</b> |
| <b>LIABILITIES, PREFERRED STOCK AND SHAREHOLDERS EQUITY</b>             |                       |                       |
| Current Liabilities                                                     |                       |                       |
| Accounts payable and accrued expenses                                   | \$ 7,586,502          | \$ 4,322,896          |
| Current portion of long-term debt                                       | 62,425,000            |                       |
| <b>Total Current Liabilities</b>                                        | <b>70,011,502</b>     | <b>4,322,896</b>      |
| Other Liabilities                                                       | 331,370               | 340,706               |
| Long-term debt                                                          | 75,027,489            | 129,475,023           |
| <b>Total Liabilities</b>                                                | <b>145,370,361</b>    | <b>134,138,625</b>    |
| Minority Interests                                                      | 100                   | 100                   |
| Preferred Stock (1)                                                     | 10,156,021            | 10,156,021            |
| Shareholders' Equity                                                    |                       |                       |
| Preferred stock (2)                                                     | 100                   | 100                   |
| Common stock (3)                                                        | 158,030               | 157,030               |
| Additional paid-in capital                                              | 86,420,560            | 89,986,923            |
| Accumulated deficit                                                     | (81,823,006)          | (71,401,984)          |
| Treasury stock (4)                                                      | (388,408)             | (385,402)             |
| Notes receivable from current directors and former officer and director | (638,219)             | (638,219)             |
| <b>Total Common Shareholders' Equity</b>                                | <b>3,728,957</b>      | <b>17,718,348</b>     |

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|                                                                   |                       |                       |
|-------------------------------------------------------------------|-----------------------|-----------------------|
| Total Shareholders Equity                                         | 3,729,057             | 17,718,448            |
| <b>TOTAL LIABILITIES, PREFERRED STOCK AND SHAREHOLDERS EQUITY</b> | <b>\$ 159,255,539</b> | <b>\$ 162,013,194</b> |

- (1) Preferred stock, \$.01 par value, 2,000,000 shares authorized; 281,241 shares issued as of September 30, 2009 and December 31, 2008. Stated value at September 30, 2009 and December 31, 2008 of \$52.71 per share or \$14,824,213.
- (2) Preferred stock of subsidiary, no par value, 10 shares authorized; 10 shares issued as of September 30, 2009 and December 31, 2008, respectively.
- (3) \$.01 par value; 50,000,000 shares authorized; 15,803,034 issued and 15,708,591 outstanding as of September 30, 2009 and 15,703,034 issued and 15,614,604 outstanding as of December 31, 2008.
- (4) 94,443 shares at cost as of September 30, 2009 and 88,430 shares at cost as of December 31, 2008.

See Notes to Consolidated Financial Statements.

**Table of Contents****ENVIRONMENTAL POWER CORPORATION AND SUBSIDIARIES****Condensed Consolidated Statements of Operations (unaudited) for the Three and Nine Months****Ended September 30, 2009 and September 30, 2008**

|                                                                           | <b>Three Months Ended</b> |                           | <b>Nine Months Ended</b>  |                           |
|---------------------------------------------------------------------------|---------------------------|---------------------------|---------------------------|---------------------------|
|                                                                           | <b>September 30, 2009</b> | <b>September 30, 2008</b> | <b>September 30, 2009</b> | <b>September 30, 2008</b> |
| <b>REVENUES</b>                                                           | <b>\$ 1,358,687</b>       | <b>\$ 456,250</b>         | <b>\$ 3,272,329</b>       | <b>\$ 2,538,941</b>       |
| <b>COSTS AND EXPENSES:</b>                                                |                           |                           |                           |                           |
| Operations and maintenance                                                | 708,159                   | 1,784,707                 | 2,580,366                 | 5,037,907                 |
| General and administrative                                                | 1,606,795                 | 2,865,233                 | 5,184,580                 | 9,737,772                 |
| Depreciation and amortization                                             | 433,109                   | 378,747                   | 1,265,642                 | 993,100                   |
| Impairment of assets                                                      | 5,885,614                 |                           | 5,885,614                 |                           |
| <b>TOTAL COSTS AND EXPENSES</b>                                           | <b>8,633,677</b>          | <b>5,028,687</b>          | <b>14,916,202</b>         | <b>15,768,779</b>         |
| <b>OPERATING LOSS</b>                                                     | <b>(7,274,990)</b>        | <b>(4,572,437)</b>        | <b>(11,643,873)</b>       | <b>(13,229,838)</b>       |
| <b>OTHER INCOME (EXPENSE):</b>                                            |                           |                           |                           |                           |
| Interest income                                                           | 2,493                     | 87,700                    | 31,082                    | 434,454                   |
| Interest expense                                                          | (693,034)                 | (262,690)                 | (1,599,550)               | (704,716)                 |
| Other income (expense)                                                    | 21,090                    | (14,620)                  | 94,173                    | (36,862)                  |
| <b>TOTAL OTHER INCOME (EXPENSE)</b>                                       | <b>(669,451)</b>          | <b>(189,610)</b>          | <b>(1,474,295)</b>        | <b>(307,124)</b>          |
| <b>LOSS BEFORE INCOME TAXES</b>                                           | <b>(7,944,441)</b>        | <b>(4,762,047)</b>        | <b>(13,118,168)</b>       | <b>(13,536,962)</b>       |
| <b>INCOME TAX EXPENSE</b>                                                 | <b>5,812</b>              |                           | <b>28,812</b>             |                           |
| <b>NET LOSS FROM CONTINUING OPERATIONS</b>                                | <b>(7,950,253)</b>        | <b>(4,762,047)</b>        | <b>(13,146,980)</b>       | <b>(13,536,962)</b>       |
| <b>LOSS FROM DISCONTINUED OPERATIONS, NET OF TAXES OF \$0</b>             |                           |                           |                           | <b>(1,010,534)</b>        |
| <b>GAIN ON DISPOSAL OF DISCONTINUED OPERATIONS, NET OF TAXES OF \$0</b>   |                           |                           |                           | <b>7,999,858</b>          |
| <b>NET LOSS</b>                                                           | <b>(7,950,253)</b>        | <b>(4,762,047)</b>        | <b>(13,146,980)</b>       | <b>(6,547,638)</b>        |
| <b>Preferred Securities Dividend Requirements</b>                         | <b>(333,545)</b>          | <b>(325,634)</b>          | <b>(1,000,633)</b>        | <b>(992,726)</b>          |
| <b>LOSS APPLICABLE TO COMMON SHAREHOLDERS</b>                             | <b>\$ (8,283,798)</b>     | <b>\$ (5,087,681)</b>     | <b>\$ (14,147,613)</b>    | <b>\$ (7,540,364)</b>     |
| <b>BASIC AND DILUTED INCOME (LOSS) PER SHARE:</b>                         |                           |                           |                           |                           |
| CONTINUING OPERATIONS                                                     | <b>\$ (0.53)</b>          | <b>\$ (0.33)</b>          | <b>\$ (0.91)</b>          | <b>\$ (0.93)</b>          |
| DISCONTINUED OPERATIONS                                                   |                           |                           |                           | <b>0.45</b>               |
| <b>NET LOSS PER SHARE</b>                                                 | <b>\$ (0.53)</b>          | <b>\$ (0.33)</b>          | <b>\$ (0.91)</b>          | <b>\$ (0.48)</b>          |
| <b>SHARES USED TO CALCULATE INCOME (LOSS) PER SHARE BASIC and DILUTED</b> | <b>15,588,998</b>         | <b>15,579,354</b>         | <b>15,585,819</b>         | <b>15,579,354</b>         |

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, 2009 and September 30, 2008**

|                                                           | Nine Months Ended   |                     |
|-----------------------------------------------------------|---------------------|---------------------|
|                                                           | September 30, 2009  | September 30, 2008  |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>              |                     |                     |
| Net loss                                                  | \$ (13,146,980)     | \$ (6,547,638)      |
| <i>Non-cash adjustments</i>                               |                     |                     |
| Results of discontinued operations                        |                     | (6,989,324)         |
| Impairment of assets                                      | 5,885,614           |                     |
| Depreciation and amortization                             | 1,265,642           | 993,100             |
| Stock based compensation expense                          | 328,605             | 1,682,244           |
| Non-cash income from adjustment to fair value of warrants | (121,320)           |                     |
| <i>Changes in operating assets and liabilities:</i>       |                     |                     |
| (Increase) decrease in receivables                        | (186,150)           | 315,351             |
| Decrease in other current assets                          | (50,111)            | (22,080)            |
| Decrease in notes receivable                              | 68,002              | 197,613             |
| Increase in accounts payable and accrued expenses         | 738,000             | 1,949,316           |
| Net cash used in operating activities                     | (5,218,698)         | (8,421,418)         |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>              |                     |                     |
| Disposal of discontinued operations                       |                     | 375,000             |
| Decrease (increase) in restricted cash                    | 6,163,517           | (65,320,423)        |
| Construction of projects                                  | (6,270,732)         | (11,505,420)        |
| Purchase of property, plant and equipment                 | (210,760)           | (375,493)           |
| Purchase of treasury stock                                | (3,006)             |                     |
| (Increase) decrease in other assets                       | (249,072)           | 26,976              |
| Net cash used in investing activities                     | (570,053)           | (76,799,360)        |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>              |                     |                     |
| Increase in deferred financing costs                      | (543,309)           | (2,511,429)         |
| Payment of preferred dividends                            | (667,088)           | (1,334,179)         |
| Increase (decrease) in other liabilities                  | (55,393)            | 119,224             |
| Payments on long-term debt                                | (22,534)            |                     |
| Proceeds from issuance of long term debt                  | 5,000,000           | 69,378,924          |
| Payments of dividend on behalf of subsidiary              |                     | (15,000)            |
| Net cash provided by financing activities                 | 3,711,676           | 65,637,540          |
| <b>DECREASE IN CASH AND CASH EQUIVALENTS</b>              | <b>(2,077,075)</b>  | <b>(19,583,238)</b> |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>     | <b>3,157,938</b>    | <b>26,069,198</b>   |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>           | <b>\$ 1,080,863</b> | <b>\$ 6,485,960</b> |
| <br>Supplemental disclosure of cash flow information      |                     |                     |
| Cash paid for interest (net of amount capitalized)        | \$ 905,753          | \$ 529,716          |
| Income Taxes                                              | 28,812              |                     |

**Non-cash investing and financing activity**

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|                                                               |                  |         |
|---------------------------------------------------------------|------------------|---------|
| Payment of license fees with issuance of 14% convertible note | <b>3,000,000</b> |         |
| Accrued dividend requirement of series A preferred stock      | <b>1,000,633</b> | 326,634 |
| Capitalized amortization of deferred financing costs          | <b>114,304</b>   | 60,066  |
| See Notes to Consolidated Financial Statements.               |                  |         |

**Table of Contents****ENVIRONMENTAL POWER CORPORATION AND SUBSIDIARIES****Condensed Consolidated Statement of Equity (unaudited) for Nine Months Ended September 30, 2009**

|                                                                                                                                                         | Common<br>Stock -<br>Shares | Common<br>Stock -<br>Amount | Additional<br>Paid-in<br>Capital | Accum.<br>Deficit      | Treasury<br>Stock -<br>Shares | Treasury<br>Stock -<br>Amount | Receivable -<br>Officers &<br>Directors | Total                |
|---------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------|-----------------------------|----------------------------------|------------------------|-------------------------------|-------------------------------|-----------------------------------------|----------------------|
| <b>Balance at December 31, 2008</b>                                                                                                                     | <b>15,703,034</b>           | <b>\$ 157,030</b>           | <b>\$ 89,986,923</b>             | <b>\$ (71,401,984)</b> | <b>88,430</b>                 | <b>\$ (385,402)</b>           | <b>\$ (638,219)</b>                     | <b>\$ 17,718,348</b> |
| Cumulative effect of change in accounting principle - January 1, 2009 reclassification of equity-linked financial instruments to derivative liabilities |                             |                             | (3,893,968)                      | 3,726,591              |                               |                               |                                         | (167,377)            |
| Dividends on preferred stock                                                                                                                            |                             |                             |                                  | (1,000,633)            |                               |                               |                                         | (1,000,633)          |
| Stock based compensation expense                                                                                                                        |                             |                             | 328,605                          |                        |                               |                               |                                         | 328,605              |
| Issuance of restricted stock                                                                                                                            | 100,000                     | 1,000                       | (1,000)                          |                        |                               |                               |                                         |                      |
| Treasury Stock                                                                                                                                          |                             |                             |                                  |                        | 6,013                         | (3,006)                       |                                         | (3,006)              |
| Net loss                                                                                                                                                |                             |                             |                                  | (13,146,980)           |                               |                               |                                         | (13,146,980)         |
| <b>Balance at September 30, 2009</b>                                                                                                                    | <b>15,803,034</b>           | <b>\$ 158,030</b>           | <b>\$ 86,420,560</b>             | <b>\$ (81,823,006)</b> | <b>94,443</b>                 | <b>\$ (388,408)</b>           | <b>\$ (638,219)</b>                     | <b>\$ 3,728,957</b>  |

See Notes to Consolidated Financial Statements.

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### **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 Environmental Power , 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, 2009 are not necessarily indicative of results to be expected for the year ending December 31, 2009. The information in this quarterly report should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and footnotes included in our Annual Report on Form 10-K for the year ended December 31, 2008 ( Annual Report ).

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

#### ***Impairment of Assets***

Due to the expected redemption or repurchase of a portion of our Texas and California tax-exempt bonds, as discussed in Note H Long Term Obligations and Contractual Commitments , we are required to record non-cash impairments on our Mission Dairy, Texas project and one of our three California projects. These non-cash impairments are described more fully in Note M Impairment of Assets . It should be noted that the recording of these impairments is required by the applicable accounting rules and does not mean we will not complete these projects at a future date. We still retain valid permits at these sites and other items of value to us, such as relationships with local farms and preliminary designs and plans, which we may utilize when we are able to obtain financings for these projects and proceed with their development.

#### ***Codification of Accounting Standards***

The Company follows accounting policies and standards set by the Financial Accounting Standards Board, commonly referred to as the ( FASB ). The FASB sets generally accepted accounting principles ( GAAP ) that we adhere to so that we can ensure we consistently report our financial condition (balance sheet), results of operations and cash flows. Over the years the FASB and other designated GAAP setting bodies have issued standards in the form of FASB Statements, Interpretations, FASB Staff Positions, EITF consensus, AICPA Statements of Position and other standards.

The FASB recognized the complexity of its standard setting process and embarked on a revised process in 2004 that culminated in the release on July 1, 2009 of the *FASB Accounting Standards Codification*, sometimes referred to as the Codification or ASC. The ASC rearranges how GAAP pronouncements are organized and consolidated all GAAP pronouncements into one document. The impact of this change is that instead of referring to a FASB Statement or Interpretation, we will reference the ASC Topic as appropriate. It is important to note the Codification did not change in any way how the Company accounts for transactions or the nature of related disclosures made. References to GAAP issued by the FASB are to the *FASB Accounting Standards Codification*, referred to as the Codification or ASC.

The change was effective for periods ending on or after September 15, 2009, and so we have updated our references in this current report on Form 10-Q to reflect the appropriate Topic in the ASC. Prior FASB standards such as FASB Statement No. 128 *Earnings Per Share* are no longer referred to using this nomenclature and are no longer being issued by the FASB.

#### ***Reclassification***

Amounts on the consolidated statements of cash flows for the nine months ended September 30, 2008 have been reclassified to reflect the January 2008 and July 2008 payment of preferred dividends.

#### **NOTE B GOING CONCERN**

The Company's consolidated financial statements have been prepared on a going concern basis, which contemplates continuity of operations, realization of assets and satisfaction of liabilities in the ordinary course of business. As a predominately development oriented company, we have experienced substantial losses since the year ended December 31, 2002. For the nine months ended September 30, 2009, we incurred a net loss applicable to common shareholders of \$14,148,000, and used cash from operating activities of \$5,219,000. For the year ended

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December 31, 2008, we incurred a net loss applicable to common shareholders of \$17,333,000 and used cash of \$13,100,000 in operating activities. We anticipate incurring losses at least through 2010 as we continue the construction of our portfolio of announced projects. As of September 30, 2009, we had an accumulated deficit of \$81,823,000 and our unrestricted cash and cash equivalents amounted to \$1,081,000. Currently, our facility at Huckabay Ridge, Texas, which is

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### **Notes to Condensed Consolidated Financial Statements (Continued)**

operating reliably, is anticipated to generate cash flow over the balance of the year. However, the cash we project to be generated from Huckabay Ridge, by itself, will be insufficient to meet our short-term and long-term corporate and project-related capital requirements.

In the past, we have been able to obtain outside financing to fund our losses and meet our capital requirements with the anticipation that once our projects are complete and operational, they would contribute to future liquidity needs. While we have substantially reduced our general and administrative expense, and Huckabay Ridge is generating positive cash flow, we will need additional funds to meet all of the required interest payments on debt and preferred dividend payment due December 1, 2009 and January 1, 2010. In addition, our cash forecasts indicate we will only be able to maintain corporate headquarters operations for a limited period. We are currently actively seeking additional funds from a variety of sources but there can be no guarantee we will raise sufficient funds to meet these obligations.

We have been working with Marathon Capital, LLC to obtain final financing proposals from prospective investors in support of its announced project pipeline. As a result of these activities, Environmental Power and our subsidiary, Microgy Holdings, LLC ( "Microgy Holdings" ), have entered into a non-binding letter of intent with a potential investor relating to, among other things, the purchase of newly issued equity interests in Microgy Holdings, the proceeds of which would be used for the completion of certain projects currently under development and construction by Microgy Holdings and its subsidiaries, as well as reimbursement of certain intercompany receivables owed by Microgy Holdings to Environmental Power. The letter of intent also addresses the development and funding of future projects based on the technology of Microgy, Inc. ( "Microgy" ). The letter of intent is not binding, and the transactions contemplated thereby remain subject to investor due-diligence and the negotiation, execution and delivery of definitive agreements.

We cannot assure you that any such definitive agreements will be entered into or that the transactions contemplated by the letter of intent will be executed. The potential investor has the right to terminate the non-binding letter of intent at any time for any reason. In addition, Environmental Power will need to continue to seek interim financing to fund operations while it seeks to finalize and close the transactions contemplated by the letter of intent. The level of funds we are able to raise, if any, will determine the level of development and construction activity that we can pursue and whether we will be able to continue as a going concern.

The accompanying consolidated financial statements have been prepared assuming that we will continue as a going concern. The uncertainties described above raise substantial doubt at September 30, 2009 about our ability to continue as a going concern without additional financing. The accompanying consolidated financial statements do not include any adjustments relating to the recoverability and classification of the carrying amount of recorded assets or to the amount and classification of liabilities that might result should we be unable to continue as a going concern.

### **NOTE C THE COMPANY**

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

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

Microgy Holdings, LLC was formed in 2006 as a subsidiary of Environmental Power Corporation in connection with the \$60 million tax-exempt debt financing we completed in November 2006 relating to the construction and operation of four RNG® facilities in Texas. The assets financed by the debt financing are pledged as collateral to the Gulf Coast Industrial Development Authority of Texas, the lender. The obligations of Microgy Holdings, LLC related to this financing are non recourse to Environmental Power, although Environmental Power is required to provide at least 20% of the construction costs of these facilities, as well as to cover any cost overruns in construction and start up and commissioning expenses prior to commercial operation. Microgy Holdings, LLC is also the obligor on what was initially \$62.425 million in

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tax-exempt debt financing from the California Statewide Communities Development Authority which we completed in September 2008 on terms similar to those of the Texas financing. Redemption and

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### **Notes to Condensed Consolidated Financial Statements (Continued)**

repayment of a portion of these bonds and terms on the remaining Texas and California bonds are discussed in Note H to the condensed consolidated financial statements. We expect as a result of the proposed redemption and purchase of Texas and California bonds described in Note H below, the outstanding principal amounts of the Texas and California bonds will be reduced to \$45,000,000 and \$32,212,500, respectively, on or about November 15, 2009.

Microgy Grand Island, LLC is the obligor on \$7.0 million in tax-exempt debt financing from the City of Grand Island, Nebraska, relating to the construction of our facility at the flagship beef processing plant of JBS Swift & Company, located in Grand Island, Nebraska. The obligations of Microgy Grand Island, LLC related to this financing are non-recourse to Environmental Power, although Environmental Power is required to provide at least 20% of the construction costs of these facilities, as well as to cover any cost overruns in construction and start up and commissioning expenses prior to commercial operation. In certain cases of redemption of the Nebraska bonds, Environmental Power may also be liable for financing costs paid from bond proceeds. .

#### ***Discontinued Operations***

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

The assets and liabilities of Buzzard have been accounted for as discontinued operations for all periods presented. We do not have a continuing involvement with the Buzzard business since the closing of the disposition of the leasehold interest in the Scrubgrass facility and do not continue any revenue or cost-generating activities related to Buzzard. The accompanying consolidated balance sheets report the assets and liabilities of Buzzard as discontinued and the consolidated statements of operations report the operations of Buzzard as discontinued operations.

#### **NOTE D PROPERTY, PLANT AND EQUIPMENT**

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

#### **NOTE E GOODWILL AND INTANGIBLE ASSETS**

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



**Table of Contents****Notes to Condensed Consolidated Financial Statements (Continued)**

Accumulated amortization of licensed technology rights was \$1,519,829 as of September 30, 2009 and \$1,380,704 as of December 31, 2008. Amortization expense for licensed technology rights was \$139,125 for the nine months ended September 30, 2009 and September 30, 2008. The future estimated amortization expense for licensed technology rights is as follows:

***Estimated Amortization Expense for Licensed Technology Rights***

| <b>Remaining<br/>2009</b> | <b>2010</b> | <b>2011</b> | <b>2012</b> | <b>2013</b> | <b>Thereafter</b> | <b>Total</b> |
|---------------------------|-------------|-------------|-------------|-------------|-------------------|--------------|
| \$ 46,375                 | 185,500     | 185,500     | 185,500     | 185,500     | 1,401,796         | \$ 2,190,171 |

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

**NOTE F DEFERRED FINANCING COSTS**

Deferred financing costs include costs directly attributable to our issuance of debt securities. In accordance with ASC 340-10 Other Assets and Deferred Costs, these costs are deferred and capitalized as part of deferred financing costs. These costs are amortized over the remaining life of the related debt.

**NOTE G NOTES RECEIVABLE INCLUDING CURRENT DIRECTORS AND FORMER OFFICER AND DIRECTOR**

**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, 2009 and December 31, 2008:

|                                               | <b>September 30,<br/>2009</b> | <b>December 31,<br/>2008</b> |
|-----------------------------------------------|-------------------------------|------------------------------|
| <b>Notes Receivable</b>                       |                               |                              |
| Notes receivable                              | \$ 2,290,498                  | \$ 2,358,500                 |
| Reserve for any future cash flow deficiencies | (750,000)                     | (750,000)                    |
| <b>Notes receivable, net</b>                  | <b>\$ 1,540,498</b>           | <b>\$ 1,608,500</b>          |

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Beginning in the third quarter of 2007, we sold the greenhouse gas sequestration credits generated from the Wisconsin facilities. Pursuant to our agreements with the owners of these facilities, 50% of these sales were recognized by us as revenue and 50% was applied to the balance of the notes. During the first nine months of 2009 and 2008, the balance of the notes receivable was reduced by \$18,000 and \$198,000, respectively due to the sale of greenhouse gas sequestration credits. The sales for the nine months ended September 30, 2008 included revenues for credits generated by vintage years 2005 to 2007 but the sales for the nine months ended September 30, 2009 includes credits generated only during the first six months of 2008. Under the terms of the notes the balance of the notes is also reduced by cumulative profits of the Wisconsin facilities from gas sales. In the first nine months of 2009, note receivable balance and revenues were reduced by \$50,000 from the cumulative profits at these facilities.

*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, 2009 and December 31, 2008. These notes, partially secured by the underlying shares of stock purchased thereby, are payable upon demand and bear interest at a floating rate which is payable monthly. In accordance with company policy and applicable law, we no longer make loans to our officers or directors.

**Table of Contents****Notes to Condensed Consolidated Financial Statements (Continued)****NOTE H LONG-TERM OBLIGATIONS AND CONTRACTUAL OBLIGATIONS*****Issuance of Long-Term Debt***

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

On May 22, 2009 we issued an additional \$3,000,000 of these notes as payment for upfront license fees related to certain of our projects under a Cooperation Agreement entered into in April 2009 with the licensor of Microgy's technology as described in more detail below.

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

***Contractual Obligations***

The following table shows our known significant future contractual obligations as of September 30, 2009 of the types specified in Item 303(a) (5) of Regulation S-K. The table includes both the principal and interest payments on the tax-exempt bonds and convertible notes over the projected minimum life of the related debt.

| <b>Commitments</b>       | <b>2009</b>          | <b>2010</b>         | <b>2011</b>         | <b>2012</b>         | <b>2013</b>         | <b>Thereafter</b>     | <b>Total</b>          |
|--------------------------|----------------------|---------------------|---------------------|---------------------|---------------------|-----------------------|-----------------------|
| Operating Leases(1)      | \$ 84,168            | \$ 336,672          | \$ 298,500          | \$ 111,078          |                     |                       | \$ 830,418            |
| Microgy Commitments(2)   | 3,000,000            |                     |                     |                     |                     |                       | 3,000,000             |
| 14% convertible notes(3) |                      | 1,120,000           | 1,120,000           | 1,120,000           | 1,120,000           | \$ 8,000,000          | 12,480,000            |
| Tax-Exempt Bonds(4)      | 67,345,031           | 4,690,000           | 5,040,000           | 5,955,500           | 6,054,600           | 126,784,800           | 215,869,931           |
| Security Deposit(5)      |                      | 100,000             | 100,000             | 100,000             | 100,000             |                       | 400,000               |
| Vehicle Loans (6)        | 6,770                | 19,814              | 1,476               |                     |                     |                       | 28,060                |
| <b>TOTAL</b>             | <b>\$ 70,435,969</b> | <b>\$ 6,266,486</b> | <b>\$ 6,559,976</b> | <b>\$ 7,286,578</b> | <b>\$ 7,274,600</b> | <b>\$ 134,784,800</b> | <b>\$ 232,608,409</b> |

- (1) We are obligated under various non-cancelable operating leases for office space. These obligations have not been reduced by estimated total proceeds from the sublease of our Golden Colorado facility of \$167,500. Rent expense for these operating leases was \$371,637, \$424,765, and \$286,501 in 2008, 2007 and 2006, respectively. For the three and nine months ended September 30, 2009, our rent expense for operating leases was \$54,335 and \$211,335, respectively.
- (2) These commitments relate to various purchase agreements, and include amounts expected to be claimed by SouthTex Treaters for gas treatment and conditioning equipment, in connection with our Microgy facilities.
- (3) The entire balance of the 14% convertible notes is due January 1, 2014.
- (4) In 2007, Microgy Holdings began scheduled interest payments on the tax-exempt bonds. In 2008 Microgy Grand Island began scheduled interest payments on the tax-exempt bonds. Mandatory redemption of principal amounts begins in 2011 for the Nebraska tax-exempt bonds and 2012 for the Texas tax-exempt bonds. See below California and Texas Bonds for a discussion of the anticipated repurchase or redemption of a portion of the California and Texas bonds. This schedule has been completed based on status of the bonds at

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September 30, 2009 and does not reflect the impact of expected redemption or repurchase of a portion of the bonds.

- (5) In December 2008, Microgy signed a contract with a customer that required security deposits to protect against failure to deliver product in certain instances.
- (6) We are obligated under various loans for automobiles.

**Table of Contents****Notes to Condensed Consolidated Financial Statements (Continued)**

The following table describes our long-term debt obligations as of September 30, 2009 and December 31, 2008:

| <b>Secured Promissory Notes Payable and Other Obligations</b> | <b>September 30,<br/>2009</b> | <b>December 31,<br/>2008</b> |
|---------------------------------------------------------------|-------------------------------|------------------------------|
| Automobile loans & capital leases                             | \$ 27,489                     | \$ 50,023                    |
| 14% convertible notes                                         | 8,000,000                     |                              |
| California loan related to tax-exempt bonds                   |                               | 62,425,000                   |
| Nebraska loan related to tax-exempt bonds                     | 7,000,000                     | 7,000,000                    |
| Texas loan related to tax-exempt bonds                        | 60,000,000                    | 60,000,000                   |
| <b>TOTAL</b>                                                  | <b>\$ 75,027,489</b>          | <b>\$ 129,475,023</b>        |

**Cooperation Agreement**

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

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

The Agreement became effective on May 22, 2009 when DBT received an up-front payment of certain license fees for certain Microgy projects of Microgy's choosing, which were paid for by the Company's issuance of its 14% Convertible Notes due January 1, 2014 (the "Notes") in the original principal amount of \$3,000,000 (the "Consideration").

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

**California and Texas Bonds**

In connection with the financing of \$62.425 million in tax-exempt bonds (the "Bonds") in California completed in September 2008, Microgy Holdings and Environmental Power entered into a Demand Purchase Agreement, dated as of September 3, 2008, with Wells Fargo Bank, National Association, as Trustee (the "Trustee") and the Bondholders named therein (the "Demand Purchase Agreement"). Pursuant to the Demand Purchase Agreement, if certain conditions set forth in the Loan Agreement, dated as of August 1, 2008 (the "Loan Agreement") with the California Statewide Community Development Authority (the "Funding Conditions") were not met by June 30, 2009, the holders of a majority of the Bonds would have the right, exercisable by written notice to require Holdings to purchase the Bonds at par plus accrued interest.

The Funding Conditions described above were not met. Following a series of amendments to the Demand Purchase Agreement that extended the notification date of July 31, 2009, the parties have been negotiating an amendment to and restatement of the Demand Purchase Agreement and we currently believe that there is a high probability that we will sign this amended agreement on or about November 15, 2009. The agreement, if

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executed, is expected to have the following significant terms:

Immediate redemption of 50% of the California bonds (representing bonds allocable to one of the two projects originally financed) or \$31,212,500 plus interest through the redemption date. If the redemption date occurs on November 15, 2009 the accrued interest on the redeemed bonds would be \$1,288,000.

Immediate repurchase of 25% of the Texas bonds (representing bonds allocable to the Mission project) or \$15,000,000 plus interest through the repurchase date. If the repurchase date occurs on November 15, 2009 the accrued interest on the redeemed bonds would be \$481,000.

Microgy Holdings is to raise at least \$32,500,000 by March 31, 2010 (the Funding Condition ), with specified amounts dedicated to capitalized interest and equity contributions in respect of the remaining Texas and California facilities. If Microgy Holdings fails to do so, Bondholders would have the right to demand on or before April 15, 2010:

Redemption of all of the remaining California bonds at par plus accrued interest.

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**Notes to Condensed Consolidated Financial Statements (Continued)**

Repayment of remaining Texas bonds except for those bonds allocable to Huckabay Ridge at par plus accrued interest.

Environmental Power and Microgy Holdings would be jointly and severally liable for the payment, by April 30, 2010, of any shortfall in the amounts held by the Trustee for the foregoing redemption and repurchase.

The redemption and repurchase upon execution of the amended and restated Demand Purchase Agreement, including accrued interest, would be funded solely out of restricted cash. Our unrestricted cash balances will be unaffected except for the payment of certain fees and expenses associated with the transactions.

We expect that the amended and restated Demand Purchase Agreement will also limit the amount that Microgy Holdings may draw from the Texas bond construction fund between October 1, 2009 and December 31, 2009 to \$500,000. Any monies drawn must be used solely for engineering and design work and shall not be used for equipment purchases and site construction work. Microgy Holdings would be prohibited from withdrawing any amounts subsequent to December 31, 2009 until the Funding Condition is met.

We currently believe that if we are able to close the transactions contemplated by the letter of intent referenced above, we will meet the Funding Condition.

Because we believe that there is a high probability that the amendment and restatement of the Demand Purchase Agreement described above will be completed on or about November 15, 2009, we have accounted for this change in facts and circumstances as described in Note M Impairment of Assets .

If we are unable to complete the transaction with the bond holders discussed above, the bond holders can demand redemption of the entire amount of the outstanding California bonds or \$62,425,000.

**NOTE I ASSET RETIREMENT OBLIGATIONS**

Asset retirement costs must be capitalized along with the cost of the related long-lived asset because it is required by the Asset Retirement and Environmental Obligations Topic of the ASC. The topic also requires that asset retirement costs then be allocated to expense using a systematic and rational method. We have determined that we have an asset retirement obligation of \$174,000 associated with substrate removal at the Huckabay Ridge facility. This amount is included in property, plant and equipment and other liabilities on our balance sheet and is amortized over the life of the related asset.

**NOTE J PREFERRED STOCK AND SHAREHOLDERS EQUITY**

On November 9, 2006, we issued 281,241 units, consisting of (i) one share of series A 9% cumulative convertible preferred stock, referred to as the series A preferred stock, with each share initially convertible into 10 shares of common stock, and (ii) detachable warrants to purchase five shares of common stock exercisable at a price of \$5.522 per share, for a purchase price of \$53,335 per unit. We received approximately \$14,100,000 in proceeds from this offering after paying fees and expenses. As a result of the issuance of common shares in the public offering completed in October 2007, the applicable conversion price of the preferred stock was reduced and is now convertible into 2,823,660 shares of common stock.

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

On July 1, 2009, we did not make the required dividend payment on the series A preferred stock of \$667,088 as part of our program to conserve cash. We are in discussions with the holders of the series A preferred stock for a formal acceptance of the deferral of this payment.

**NOTE K FAIR VALUE OF FINANCIAL INSTRUMENTS**

A contract that would otherwise meet the definition of a derivative but is both (a) indexed to the Company's own stock and (b) classified in stockholders' equity in the statement of financial position would not be considered a derivative financial instrument. Instead a two-step model is

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applied in determining whether a financial instrument or an embedded feature is indexed to an issuer's own stock and thus able to qualify for the scope exception under this topic. When we adopted new guidance with respect to the definition of (a) above on January 1, 2009, we identified outstanding warrants that required liability classification because of certain provisions that may result in an adjustment to their exercise price. Accordingly, these warrants were reclassified as liabilities as of January 1, 2009. The result was a decrease in additional paid in capital as of January 1, 2009 of \$ 3,893,968, an increase in retained earnings of \$3,726,591, and a liability of \$167,377. The liability is required to be marked to fair value as of each reporting date until the expiration or exercise of the instruments. The amount recorded in other income on the accompanying statements of operations related to these outstanding warrants for the three and nine months ended September 30, 2009 was \$20,940 and \$121,320, respectively

**Table of Contents****Notes to Condensed Consolidated Financial Statements (Continued)**

We use the Black-Scholes pricing model to calculate fair value of our warrant liabilities. Key assumptions used to apply this model are as follows:

|                                           | January 1,<br>2009 | September 30,<br>2009 |
|-------------------------------------------|--------------------|-----------------------|
| Risk free interest rate                   | 1%                 | 1%                    |
| Expected life                             | 2.8 years          | 2.1 years             |
| Expected volatility of common share price | 66%                | 99%                   |
| Common share price                        | \$ 0.63            | \$ 0.43               |

**NOTE L STOCK-BASED COMPENSATION**

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

Total stock based compensation for the three and nine months ended September 30, 2009 was \$86,041 and \$328,605, respectively. For the three and nine months ended September 30, 2008, we recognized expense of \$277,131 and \$1,682,244, respectively. The total future compensation cost related to unvested stock-based awards not yet recognized is \$382,005 at September 30, 2009. This amount will be charged against income as the awards vest over the next three years.

Valuation Assumptions. The fair value stock appreciation rights granted during the three and nine months ended September 30, 2009 and 2008 was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

|                                | Three Months Ended    |                       | Nine Months Ended     |                       |
|--------------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                                | September 30,<br>2009 | September 30,<br>2008 | September 30,<br>2009 | September 30,<br>2008 |
| Fair Market Value Per Share    | \$ 0.55               | \$ 3.20               | \$ 0.55               | \$ 3.20               |
| <i>Assumptions</i>             |                       |                       |                       |                       |
| Risk-free rate of return       | 3%                    | 3%                    | 3%                    | 3%                    |
| Volatility                     | 77%                   | 70%                   | 77%                   | 70%                   |
| Expected annual dividend yield | 0.00%                 | 0.00%                 | 0.00%                 | 0.00%                 |
| Option Life (years)            | 6                     | 5                     | 6                     | 5                     |

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### **Notes to Condensed Consolidated Financial Statements (Continued)**

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 M IMPAIRMENT OF ASSETS**

In accordance with ASC Topic 360-10-35 Accounting for the Impairment or Disposal of Long Lived Assets, on a regular basis and not less than annually, we review our long lived assets to determine whether impairment exists and a write-down is required. This review includes all of our long lived assets including property, plant and equipment, construction in progress, licensed technology rights, notes receivable, deferred financing costs and other assets. We also review notes receivable from current directors and former officer and director. In addition to this regular review, we examine all substantive changes in circumstances and events for possible impact on these assets. If the sum of the expected undiscounted cash flows is less than the carrying value of the related asset or group of assets, a loss is recognized for the difference between the fair value and carrying value of the asset or group of assets. Such analyses necessarily involve judgment. As a result of the anticipated redemption and repurchase of a portion of the Texas and California tax-exempt bonds, as discussed in Note H, we evaluated the ongoing value of our long-lived assets as of September 30, 2009. We determined that due to the anticipated redemption or repurchase of debt required for these projects, the accounting rules require us to record an impairment on our Mission Dairy, Texas project and one of our two California projects. We also determined that the current net fair value of the money invested including capitalized interest in these projects was indeterminate or \$0 and hence wrote down these assets to \$0. We may pursue these projects in the future by refinancing them if market conditions permit.

Accordingly we have recorded the following non-cash impairments in the quarter ending September 30, 2009:

Write off of construction in progress related to our Mission Dairy, Texas project of \$2,261,475 with an estimated remaining fair value of \$0.

Write off of construction in progress of \$3,283,253 on one of our California projects to an estimated remaining fair value of \$0.

Write off of certain forfeited tank deposits related to our ongoing Texas projects of \$340,886.

We may pursue these projects when we obtain the necessary equity and debt financings. We retain certain items that will be valuable to the future development of Mission dairy and the California project mentioned above, such as valid permits and preliminary plans and designs.

#### **NOTE N INCOME TAXES**

Under the method we use to account for income taxes, deferred tax assets and liabilities are determined based on differences between the financial reporting and tax reporting bases of assets and liabilities and are measured by applying the enacted tax rates and laws to taxable years in which the differences are expected to reverse. We recognize a deferred tax asset for the tax benefit of net operating loss carry forwards when it is more likely than not that the tax benefits will be realized. We reduce the deferred tax asset with a valuation reserve when it is more likely than not that some portion of the tax benefits will not be realized.

It is our policy to recognize interest and penalties related to uncertain tax positions in income tax expense. As of September 30, 2009 and 2008, we did not have any accrued interest or penalties related to uncertain tax positions.

In accounting for income taxes including the determination of whether we have any uncertain tax positions we follow the requirements established by the Income Taxes Topic of the ASC.

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

future examinations by relevant tax authorities.

**Table of Contents****Notes to Condensed Consolidated Financial Statements (Continued)****NOTE O NET INCOME OR LOSS PER COMMON SHARE**

Basic income or loss per common share for continuing and discontinued operations is computed by dividing net income or loss applicable to common stockholders by the weighted average number of common shares outstanding for the period. Diluted income or loss per common share excludes common stock equivalent shares and unexercised stock options if their effect would be antidilutive. Employee stock options and stock warrants outstanding at September 30, 2009 were not included in the computation of diluted earnings per share because their assumed exercise and conversion would have an antidilutive effect on the computation of diluted loss per share. We follow these principles so that we will be in compliance with the Earnings Per Share Topic of the ASC.

**NOTE P RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS**

The Company adopted new guidance that defines fair value, establishes a framework for measuring fair value and expands required disclosures about fair value measurements as of January 1, 2008.

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

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

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

*Level 3:* Unobservable inputs reflecting management's own assumptions about the inputs used in pricing the asset or liability. The following table presents the financial instruments carried at fair value on September 30, 2009.

|                     | Value at<br>September 30,<br>2009 | Quoted<br>prices in<br>active<br>markets<br>(Level 1) | Significant<br>other<br>observable<br>inputs<br>(Level 2) | Significant<br>unobservable<br>inputs<br>(Level 3) |
|---------------------|-----------------------------------|-------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
| Warrant liabilities | \$ 46,057                         | \$                                                    | \$ 46,057                                                 | \$                                                 |

We have concluded, based on the recent nature of the transaction, that the fair value of the 14% convertible notes issued in March and May of 2009 approximates the recorded value on the balance sheet of \$8,000,000 as of September 30, 2009.

We have concluded it is impractical to estimate the fair value of (1) 9% California tax-exempt bonds (2) 7% Texas tax-exempt bonds and (3) 7% Nebraska tax-exempt bonds. Current markets for these securities are illiquid and there are few or any comparable transactions being completed. In addition, the current credit profiles of Environmental Power, Microgy Holdings and Microgy Grand Island, the existence of certain restricted funds that may be used as collateral for these bonds, and the current state of projects that these bonds are financing makes it impractical to calculate a fair value of these instruments using management assumptions. Management is unable to observe comparable transactions.

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

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

#### ***Overview***

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

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

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

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

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

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



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

Microgy's efforts have resulted in the start of commercial operations at the Huckabay Ridge facility in Stephenville, Texas, in the first quarter of 2008. Huckabay Ridge consists of eight 916,000-gallon digesters which operate together to process the manure from approximately 10,000 cows in combination with various substrate feedstocks in our co-digestion process. The gas is treated and compressed to produce pipeline-grade methane that is sold and delivered directly into nearby natural gas pipelines. Huckabay Ridge is expected to produce an annual sales volume of 782,000 MMBtus per year reflecting the addition of a combined heat and power (CHP) process provided by a third party under a services agreement. This arrangement will allow us to reduce our internal parasitic loads, which had increased due to modifications required by the gas conditioning process, freeing up more gas for sale in the market. The net effect will be an increase in revenue offset by increased thermal costs but at a lower value than our RNG<sup>®</sup> product pricing and reduced electric costs for the facility. The CHP process is expected to be in operation within 4 months after appropriate escrow accounts have been funded.

We have two other multi-digester facilities in development in Texas with an expected output. We will also consider the addition of a CHP process at each of these facilities and other projects in development to maximize RNG<sup>®</sup> sales, while utilizing waste heat sources for more efficient energy utilization. We have also announced three proposed multi-digester RNG<sup>®</sup> facilities in California that are in advanced stages of development. We currently expect to have outstanding \$45 million in tax-exempt bond financing relating to the construction and operation of the Huckabay Ridge facility and the two additional planned facilities in Texas. Furthermore, we currently expect to have outstanding \$31.2 million in tax-exempt bond financing relating to the construction and operation of one of the proposed California facilities. For a discussion of the expected redemption and repurchase of a portion of the Texas and California tax-exempt bonds see Note H Long-term Obligations and Contractual Obligations - California and Texas Bonds

Construction at Microgy's Swift Grand Island biogas facility has progressed with major equipment procurement nearly complete. Operations are expected to commence in 2010, subject to obtaining sufficient financing to complete construction. Microgy's Grand Island biogas facility will consist of two 1.3 million gallon digesters that will process wastes generated by the Swift Grand Island processing facility. The plant is expected to produce 235,000 MMBtus per year of biogas that will be purchased by Swift under a fifteen year gas purchase agreement to offset natural gas consumption at Swift Grand Island. Swift will provide all the necessary feedstock material, both manure and substrate required by our process. We completed \$7.0 million in tax-exempt bond financing in Nebraska in July 2008 to finance a portion of the construction costs of the Swift Grand Island facility.

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

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

### ***Discontinued Operations***

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

### ***Going Concern***

The Company's consolidated financial statements have been prepared on a going concern basis, which contemplates continuity of operations, realization of assets and satisfaction of liabilities in the ordinary course of business. As a predominately development oriented company, we have experienced substantial losses since the year ended December 31, 2002. For the nine months ended September 30, 2009, we incurred a net

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loss applicable to common shareholders of \$14,148,000, and used cash from operating activities of \$5,219,000. For the year ended December 31, 2008, we incurred a net loss applicable to common shareholders of \$17,333,000 and used cash of \$13,100,000 in operating activities. We anticipate incurring losses at least through 2010 as we continue

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the construction of our portfolio of announced projects. As of September 30, 2009, we had an accumulated deficit of \$81,823,000 and our unrestricted cash and cash equivalents amounted to \$1,081,000. Currently, our facility at Huckabay Ridge, Texas, which is operating reliably, is anticipated to generate cash flow over the balance of the year. However, the cash we project to be generated from Huckabay Ridge, by itself, will be insufficient to meet our short-term and long-term corporate and project-related capital requirements.

In the past, we have been able to obtain outside financing to fund our losses and meet our capital requirements with the anticipation that once our projects are complete and operational, they would contribute to future liquidity needs. While we have substantially reduced our general and administrative expense, and Huckabay Ridge is generating positive cash flow, we will need additional funds to meet all of the required interest payments on debt and preferred dividend payment due December 1, 2009 and January 1, 2010. In addition, our cash forecasts indicate we will only be able to maintain corporate headquarters operations for a limited period. We are currently actively seeking additional funds from a variety of sources but there can be no guarantee we will raise sufficient funds to meet these obligations.

We are currently actively seeking additional sources of capital to meet our financing needs and provide sufficient equity for our existing projects. To that end, on March 13, 2009 we closed on a sale of \$5.0 million original principal amount of our 14% convertible notes due January 1, 2014 for net proceeds of approximately \$4.5 million, and, on May 22, 2009, we issued an additional \$3.0 million principal amount of such notes to Xergi in consideration for payment of project licensing fees. We continue to work with our financial advisors to identify and explore various opportunities to raise the capital we require. The level of funds we are able to raise, if any, will determine the level of development and construction activity that we can pursue and whether we will be able to continue as a going concern.

We have been working with Marathon Capital, LLC to obtain final financing proposals from prospective investors in support of its announced project pipeline. As a result of these activities, Environmental Power and our subsidiary, Microgy Holdings, LLC ( "Microgy Holdings" ), have entered into a non-binding letter of intent with a potential investor relating to, among other things, the purchase of newly issued equity interests in Microgy Holdings, the proceeds of which would be used for the completion of certain projects currently under development and construction by Microgy Holdings and its subsidiaries, as well as reimbursement of certain intercompany receivables owed by Microgy Holdings to Environmental Power. The letter of intent also addresses the development and funding of future projects based on the technology of Microgy, Inc. ( "Microgy" ). The letter of intent is not binding, and the transactions contemplated thereby remain subject to investor due-diligence and the negotiation, execution and delivery of definitive agreements.

We cannot assure you that any such definitive agreements will be entered into or that the transactions contemplated by the letter of intent will be executed. The potential investor has the right to terminate the non-binding letter of intent at any time for any reason. In addition, Environmental Power will need to continue to seek interim financing to fund operations while it seeks to finalize and close the transactions contemplated by the letter of intent. The level of funds we are able to raise, if any, will determine the level of development and construction activity that we can pursue and whether we will be able to continue as a going concern.

The accompanying consolidated financial statements have been prepared assuming that we will continue as a going concern. The uncertainties described in the preceding paragraph raise substantial doubt at September 30, 2009 about our ability to continue as a going concern without additional financing. The accompanying consolidated financial statements do not include any adjustments relating to the recoverability and classification of the carrying amount of recorded assets or to the amount and classification of liabilities that might result should we be unable to continue as a going concern.

## **RESULTS OF OPERATIONS**

The following Management's Discussion and Analysis of Financial Condition and Results of Operations compares the results of operations for the three and nine month periods ended September 30, 2009 with the results of operations for the three and nine month periods ended September 30, 2008. Historical results and trends that might be discussed below should not be taken as indicative of the results for the full year or for future operations generally.

### *Nine Months Ended September 30, 2009 Compared to Nine Months Ended September 30, 2008*

**Overview.** For the nine months ended September 30, 2009, we had a net loss applicable to common shareholders of \$14,148,000 or a loss of \$0.91 per share, compared to a net loss applicable to common shareholders of \$7,540,000 or \$0.48 per share in the same period of the prior year. These results should be viewed in the context of two unusual items in 2008 and 2009 as follows:

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In the nine months ended September 30, 2008, we had net income from discontinued operations of \$6,989,000 due to the disposal of our Buzzard operation.

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In the nine months ended September 30, 2009 we recorded a non-cash impairment of certain assets which totaled \$5,886,000. Without the adjustments discussed above, the net loss applicable to common shareholders would have been \$8,262,000 for the nine months ended September 30, 2009 and the net loss applicable to common shareholders for the nine months ended September 30, 2008 would have been \$14,530,000.

Results from continuing operations, except for the impairment of assets write-down improved in the first nine months of 2009. The net loss from continuing operations, excluding the impairment, was \$7,261,000 for the nine months ended September 30, 2009, as compared to a net loss from continuing operations of \$13,537,000 for the nine months ended September 30, 2008. The reduction in the net loss from continuing operations was primarily due to a decline in general and administrative expenses of \$4,553,000 and a decrease in operating losses before depreciation at our Huckabay Ridge facility during the first nine months of 2009 of \$3,405,000 due principally to increased gas sales and a reduction in operating and maintenance expenses at the facility.

**Revenues.** Revenues for the nine months ended September 30, 2009 increased to \$3,272,000 from \$2,539,000 for the nine months ended September 30, 2008. The increase in revenues of \$733,000 is primarily attributable to increased gas sales at Huckabay Ridge which more than offset a reduction in sales of greenhouse gas sequestration credits in the first nine months of 2009 derived from the Wisconsin facilities. During the first nine months of 2009, we recorded \$18,000 in revenues from sales of such credits, as opposed of \$198,000 in such revenues for the prior year. In the 2008 period, we received revenues from the sale of credits for vintage years 2005 to 2007 but for the first nine months of 2009 we only received revenues for credits for the first six months of 2008. We currently expect revenues to increase in future periods compared to 2008, as Huckabay Ridge revenues in the fourth quarter of 2009 should be substantially above 2008 amount. The facility experienced a prolonged downtime during the last six months of 2008, whereas in 2009 it is currently operating at normal production levels.

**Operations and maintenance expenses.** Operations and maintenance expense was \$2,580,000 for the nine months ended September 30, 2009 as compared to \$5,038,000 for the same period in 2008, a decrease of \$2,458,000. The decrease was primarily due to a reduction in operations and maintenance expense at Huckabay Ridge of \$2,643,000 as start up and non-recurring costs were reduced and Huckabay Ridge received certain insurance proceeds for settlement of claims related to events that occurred in 2008. In addition, in May 2009, we reversed certain reserves established in 2008 for the disposal of substrate which resulted in reduced operations and maintenance expenses for the nine months ended September 30, 2009. We currently expect non-recurring and start up costs at Huckabay Ridge to continue to decrease as operations at this facility become more reliable due to the completion of the improvements to the biogas collection and conditioning systems. In addition, we anticipate reductions in substrate costs in the fourth quarter as a result of our substrate sourcing plan, which was implemented in the third quarter of 2009 and has reduced net substrate costs.

**General and administrative expenses.** General and administrative expenses from continuing operations declined by \$4,553,000 to \$5,185,000 for the nine months ended September 30, 2009, as compared to \$9,738,000 for the same period in 2008. The decline is attributable primarily to lower salary expenses in the 2009 period, reflecting the reductions in staffing, lower non-cash compensation expense in the 2009 period due to reduced expense from stock based compensation and reductions in development expense in the 2009 period as we slowed development efforts to conserve cash pending our fundraising initiatives. Without the inclusion of non-cash compensation expense, general and administrative expenses would have been \$4,856,000 and \$8,056,000 for the nine months ended September 30, 2009 and 2008, respectively.

**Depreciation and amortization expenses.** Depreciation and amortization expense increased to \$1,266,000 for the nine months ended September 30, 2009 from \$993,000 for the nine months ended September 30, 2008. The increase in depreciation and amortization expense was principally due to the fact that the nine months of 2009 included nine months of depreciation at the Huckabay Ridge facility whereas the nine months of 2008 included only eight months depreciation for this facility. The facility began commercial operations in February 2008, so we began to recognize depreciation expense for this facility at that time. In addition, depreciation and amortization for 2009 includes amortization of deferred financing costs related to the 14% convertible notes we issued in March and May 2009.

**Impairment of assets** On a regular basis management reviews long-lived assets to determine if there is any impairment that require writing down the carrying value of the asset. In the third quarter of 2009, due to the expected repurchase and redemption of a portion of the Texas and California bonds we determined that certain assets in construction in progress required write-downs of \$5,545,000. Also we wrote off \$341,000 of forfeited tank deposits. These adjustments were non-cash in nature.

**Operating loss.** As a result of the changes described above, our operating loss from continuing operations increased to \$11,644,000 in the nine months of 2009 from \$13,230,000 in the same period in 2008. Excluding the asset impairments, the operating loss in 2009 would have been \$5,758,000.

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**Interest income.** Interest income on unrestricted cash for the nine months ended September 30, 2009 was \$31,000 as compared to \$434,000 for the nine months ended September 30, 2008. Interest income decreased due to both lower invested cash balances and lower interest rates on such balances.

**Interest expense.** Interest expense increased to \$1,600,000 for the nine months ended September 30, 2009, as compared to \$705,000 for the nine months ended September 30, 2008. This increase was due to several factors. We ceased the capitalization of interest expense related to the Huckabay Ridge facility when it began commercial operations in February 2008. The interest expense related to the portion of the bonds allocated to finance the Huckabay Ridge facility is now recorded as interest expense. Therefore we had nine full months of interest expense relating to the Huckabay Ridge facility in the nine months of 2009, whereas we had only eight months of such interest expense related to Huckabay Ridge in the first nine months of 2008. In the nine months of 2009, we also incurred \$537,000 in interest expense on \$8,000,000 original principal amount of our 14% convertible notes which were issued in March and May 2009. Finally, beginning in April 2009 we stopped capitalizing interest on our Swift facility in Grand Island, Nebraska due to the fact that we temporarily suspended construction as of April 1, 2009. As a result, we expensed \$245,000 of interest related to the Swift facility in the second and third quarters of 2009.

**Other income (expense).** We had other income of \$94,000 for the nine months ended September 30, 2009, as compared to other expense of \$37,000 for the nine months ended September 30, 2008. The other income for the nine months ended September 30, 2009 reflects principally income recognized from a reduction in the market value of certain outstanding warrants partially offset by the net loss associated with the sublease of our Golden, Colorado office facility. The other expense in the first nine months of 2008 was principally the result of the disposal of assets associated with the closing of office facilities in Portsmouth, New Hampshire and Golden, Colorado.

**Income tax expense.** The income tax expense for the first nine months of 2009 reflects estimated state income and franchise tax payments.

**Income from discontinued operations, net of taxes.** The results for the nine months ended September 30, 2009 do not include the results of discontinued operations because these operations were disposed of in February 2008. The loss from discontinued operations of \$1,011,000 in 2008 reflects the operations of Buzzard for the first two months of 2008 before we disposed of it. On February 29, 2008 we disposed of Buzzard's interest in the Scrubgrass facility and recognized a one time gain of \$8,000,000. With the exception of a cash payment of \$375,000 the gain was non-cash and consisted primarily of recognition of a previously deferred gain in the amount of \$2,570,000, forgiveness of indebtedness in the amount of \$3,456,000 and elimination of other obligations of \$1,630,000. There was no tax provision provided on the disposition because we believe that we have sufficient net operating loss carry-forwards at the federal and state levels to offset any potential tax liability with respect to the gain on disposition. Therefore the net result of income from discontinued operations for the nine months ended September 30, 2008 was income of \$6,989,000.

### *Three Months Ended September 30, 2009 Compared to Three Months Ended September 30, 2008*

**Overview.** For the three months ended September 30, 2009, we had a net loss applicable to common shareholders of \$8,284,000 or a loss of \$0.53 per common share compared to loss applicable to common shareholders of \$5,088,000 or loss of \$0.33 per common share for the three months ended September 30, 2008. In the three months ended September 30, 2009, we recorded impairment of assets, a non-cash event, in the amount of \$5,886,000. Without this write-down, net loss applicable to common shareholders would have been \$2,398,000. The improvement in results before the impairment write-down is primarily due to improved performance at our Huckabay Ridge facility and a reduction in general and administrative expenses consistent with our cost reduction plan. These results are explained in more detail below.

**Revenues.** Revenue for the three months ended September 30, 2009 increased to \$1,359,000 from \$456,000 for the three months ended September 30, 2008. The increase in revenues of \$903,000 is primarily attributable to increased revenues at our Huckabay Ridge facility in the third quarter of 2009, which increased by \$921,000 due to higher performance and fewer outages.

**Operations and maintenance expenses.** Operations and maintenance expense was \$708,000 for the three months ended September 30, 2009, as compared to \$1,785,000 for the same period in 2008, a decrease of \$1,077,000. The decrease was primarily due to a reduction in operations and maintenance expense at Huckabay Ridge of \$1,295,000 as start up and non-recurring costs were reduced for the three months ended September 30, 2009. We also received insurance proceeds during the three months ended September 30, 2009 from claims related to 2008 events, which reduced operations and maintenance expenses during the third quarter of 2009.

**General and administrative expenses.** General and administrative expenses from continuing operations declined by \$1,258,000 to \$1,607,000 for the three months ended September 30, 2009, as compared to \$2,865,000 for the same period in 2008. The decline is attributable primarily to lower salary expenses in 2009, reflecting the reductions in staffing, lower non-cash compensation expense in the 2009 period due to reduced expense from stock based compensation and reductions in development expense in the 2009 period as



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we slowed development efforts to conserve cash pending our fundraising initiatives. Without the inclusion of non-cash compensation expense, general and administrative expenses would have been \$1,521,000 and \$2,588,000 for the three months ended September 30, 2009 and 2008, respectively.

***Depreciation and amortization expenses.*** Depreciation and amortization expense increased to \$433,000 for the three months ended September 30, 2009 from \$379,000 for the three months ended September 30, 2008. The increase in depreciation and amortization expense was principally due to increased depreciation at Huckabay Ridge because of capital additions in 2008 and 2009 and amortization expense on deferred financing costs related to the 14% convertible notes issued in March and May 2009.

***Impairment of assets*** On a regular basis management reviews long-lived assets to determine if there is any impairment that require writing down the carrying value of the asset. In the third quarter of 2009, due to the expected repurchase and redemption of a portion of the Texas and California bonds we determined that certain assets in construction in progress required write-downs of \$5,545,000. Also we wrote off \$341,000 of forfeited tank deposits. These adjustments were non-cash in nature.

***Operating loss.*** As a result of the changes described above, our operating loss from continuing operations increased to \$7,275,000 in the third quarter of 2009 from \$4,572,000 in the same period in 2008. Excluding the asset impairment, the loss for the third quarter of 2009 would have been \$1,389,000.

***Interest income.*** Interest income on unrestricted cash for the three months ended September 30, 2009 was \$2,000, as compared to \$88,000 for the three months ended September 30, 2008. Interest income decreased due both to lower invested cash balances and lower interest rates on such balances.

***Interest expense.*** Interest expense increased to \$693,000 for the three months ended September 30, 2009, as compared to \$263,000 for the three months ended September 30, 2008. This increase was due principally to the fact that we accrued \$280,000 in interest expense on \$8,000,000 original principal amount of our 14% convertible notes which were issued in March and May 2009. In addition we expensed \$123,000 in interest costs related to our Swift facility in Grand Island, Nebraska, because we temporarily suspended construction as of April 1, 2009. Previously we had capitalized these interest costs.

***Other income (expense).*** We had other income of \$21,000 for the three months ended September 30, 2009, as compared to other expense of \$15,000 for the three months ended September 30, 2008. The other income for the three months ended September 30, 2009 reflects a decrease in the market value of certain outstanding warrants. The other expense in the third quarter of 2008 was the result of the disposal of certain fixed assets due to our closing office facility in Golden, Colorado.

***Income tax expense.*** Because we are not assured of realizing the benefits of operating losses for tax purposes, we did not record an income tax benefit for losses incurred for the three months ended September 30, 2009 or 2008. The income tax expense represents estimated state income and franchise tax payments.

## ***Liquidity and Capital Resources***

### ***Certain Balance Sheet Items***

#### ***September 30, 2009 compared to December 31, 2008***

**Cash.** The decrease in our unrestricted cash of \$2,077,000 for the period is described below. It reflects primarily the Company's operating losses offset by the net proceeds from the Company's \$5,000,000 offering of convertible notes.

**Restricted Cash.** The decrease in the restricted cash balance is the result primarily of qualified draws to fund construction of various projects.

**Property, plant and equipment, net and construction in progress.** The property plant and equipment balances were \$25,408,000 and \$23,932,000 as of September 30, 2009 and December 31, 2008, respectively. The increase in property, plant and equipment is principally due to completion of capital additions at the Huckabay Ridge facility and the reclassification of the completed construction costs to property plant and equipment from construction in progress at December 31, 2008. The total additions to the Huckabay Ridge facility, added to property plant and equipment during the nine months of 2009, were \$2,525,000 of which \$2,283,000 was included in construction in progress at December 31, 2008. In the construction in progress account, this reclassification of costs associated with the Huckabay Ridge facility of \$2,283,000 was offset by additions \$11,577,000 resulting in net increase to the construction in progress account, before reductions for the impairment of assets, a non-cash event, of \$9,294,000. Of total capital additions to the construction in progress account in the nine months of 2009, \$6,639,000 reflects

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capitalized interest on our Texas, California and Nebraska projects and \$1,054,000 reflects construction expenditures at our Grand Island facility. Included in construction in progress at September 30, 2009 is \$3,000,000 to satisfy certain license fees to Xergi in May 2009.

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**Current portion of long-term debt.** As more fully described in Note H, we anticipate an agreement with our bondholders to repurchase 25% or \$15,000,000 of the Texas tax-exempt bonds, and to redeem 50% or \$31,212,500, of the California tax-exempt bonds. We expect these bonds to be repurchased or redeemed on or about November 15, 2009. However, at September 30, 2009, the bondholders had the right to redeem the \$62,425,000 in California bonds, so this amount is shown as current. At December 31, 2008, these obligations were classified as a long-term obligation, because the bondholders did not hold the right to demand purchase or redemption of the bonds as of such date and no principal amounts were due in 2009.

### *Operating Activities*

Our net cash used in operating activities was \$5,219,000 for the nine months ended September 30, 2009, compared to cash used in operating activities of \$8,421,000 for the same period in 2008. We reported a net loss of \$13,147,000 for the nine months ended September 30, 2009. The following adjustments need to be considered in order to reconcile our net loss in the nine months ended September 30, 2009 to our net cash used in operating activities:

**Depreciation and amortization.** During the nine months ended September 30, 2009, we recognized depreciation of property plant and equipment of \$1,017,000, amortization expense for licensed technology rights of \$139,000 and amortization of deferred financing costs of \$110,000.

**Stock-based compensation.** Accounting for options, restricted stock and stock appreciation rights issued to employees resulted in non-cash compensation expenses of \$329,000 for the nine months ended September 30, 2009, as compared to \$1,682,000 in such expenses for the same period in 2008.

**Impairment of assets.** The \$5,886,000 impairment of assets loss is a non-cash transaction and is therefore added back to net loss to arrive at cash used in operations.

### *Investing Activities*

Our cash used for investing activities was \$570,000 for the nine months ended September 30, 2009, as compared to \$76,799,000 in the same period in 2008. Our investing activities were concentrated primarily in the following areas:

**Restricted cash.** The decrease in restricted cash for the nine months ended September 30, 2009 of \$6,164,000 reflects principally payment of interest costs from restricted cash accounts as well as the draws for costs of construction for the Texas and Grand Island, Nebraska facilities.

**Construction of projects.** For the nine months ended September 30, 2009 we incurred total costs of \$11,577,000 related to the construction of our Texas, California and Nebraska projects. Of these total capital costs \$1,054,000 was for construction expenditures on our Swift project at Grand Island, Nebraska. Of total capital costs, \$3,000,000 was non-cash in nature related to issuance of 14% convertible notes. In addition, \$2,192,000 reflects unpaid capitalized interest which is non-cash in nature.

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

**Other Assets:** The use of funds for other assets in the nine months of 2009 is principally due to deposits we made in conjunction with long term contracts to sell our RNG<sup>®</sup> product.

### *Financing Activities*

Our cash provided by financing activities was \$3,712,000 for the nine months ended September 30, 2009, compared to cash used for financing activities of \$66,638,000 in the nine months ended September 30, 2008. We offer the following information concerning the financing activities for our business:

**Dividends on preferred stock.** Our Series A cumulative convertible preferred stock has a 9% dividend payable semi-annually. We paid \$667,000 in such dividends on January 1, 2009. The required July 1 2009, dividend payment was not made and deferred to a later date. In 2008 we paid dividends on January 1, 2008 and July 1, 2008.

**Payment of financing costs.** The \$543,000 used for financing costs for the first nine months of 2009 resulted primarily from the costs of issuance of our 14% convertible notes due January 1, 2014.

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**Proceeds from long-term debt.** We issued \$5,000,000 original principal amount of our 14% convertible notes due January 1, 2014 for net proceeds of approximately \$4.5 million in March 2009. We issued an additional \$3,000,000 of these notes in May 2009. Since these latter notes were issued to pay license fees on projects in development, the \$3,000,000 original principal amount is not included in proceeds from long-term debt but is shown as a supplemental non-cash disclosure on the consolidated statements of cash flow. In 2008 we issued \$7,000,000 in tax-exempt Nebraska bonds and \$62,425,000 in tax-exempt California bonds.

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### ***2009 Outlook***

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

### ***Current Operations***

We expect increased revenues during 2009 from increased sales of our RNG<sup>®</sup> product our Huckabay Ridge facility in Texas, as it achieves anticipated production and stable revenues from the Wisconsin operating contracts.

Our previously reported comprehensive upgrades to process-instrumentation and controls, the gas conditioning system, and the gas-collection system at Huckabay Ridge continue to deliver improved online reliability. Indeed, during the period from July through September, we were producing product between 90% and 96% of the time versus a targeted level of 90%. During the last half of October, the Huckabay Ridge facility produced RNG<sup>®</sup> product 98% of the time. After an outage in early October to repair and modify elements in the gas processing system, the Huckabay Ridge facility produced RNG<sup>®</sup> product 97% of the time with production averaging 87% of target for the period. RNG<sup>®</sup> production for the last 11 days of the month averaged 95% of target as the system stabilized. We achieved this level of performance while meeting or exceeding pipeline-quality standards for the removal of CO<sub>2</sub>, H<sub>2</sub>S and HO. These results confirm our confidence in our operating model and give us added confidence in our ability to manage the biogas-generation process as we look forward to our next generation of operating units.

We continue to experience biogas production at or above expected levels based on substrate characteristics. We have successfully managed through the recessionary conditions experienced earlier in 2009 resulting in our suppliers curtailing operations or experiencing lower quantities of materials which caused us to transport substrate material from greater distance impacting our cost to transport. As a result, we established our substrate sourcing plan to address our needs, have executed on the plan and have achieved the results we expected-reduced costs, increased biogas production and more consistent supply. Our budgeted net substrate costs were \$30,000 and \$25,000 for the months of September and October 2009, respectively. Our actual performance was much better as we had net substrate costs of \$4,000 in September 2009 and \$2,000 in October 2009.

A positive result of expanding our reach of suppliers based on this sourcing plan is to improve the pool of suppliers for Huckabay Ridge as well as building our pool of suppliers for our other Texas projects. In addition, when the biodiesel industry turns around we are prepared to take delivery of glycerin, an excellent form of substrate, as project economic conditions dictate.

We expect our operation and maintenance expenses at Huckabay Ridge to reflect the full year of commercial operations during 2009 at increased capacity. We expect the Dairyland sites' operations and maintenance expenses to remain approximately even with 2008 levels.

In 2008 and early 2009 we instituted a number of steps to reduce or eliminate certain general and administrative costs. General and administrative expenses should continue to decline relative to 2008 and were reduced in the nine months of 2009 from amounts for the same period in 2008.

### ***Projects in Development***

**Other Texas Projects.** The Clossen and Rio Leche projects are in the engineering phase and initial site work has been completed. We have made our required initial equity contributions for these projects and expect to proceed with foundation construction and additional site work when we complete the required equity funding, with anticipated completion of construction less than one year after we begin full construction. As a result of the expected repurchase and retirement of a portion of the Texas bonds, we wrote off our expenditures on the Mission Dairy project.

**California Projects.** As previously reported, our California projects have all requisite water and air permits. Our ability to continue development of these projects will depend on whether we can obtain the necessary equity funding and, in addition, whether we are able to maintain or refinance our existing debt financing. As described more fully in Note H, we expect the bondholders to redeem 50% of the outstanding bonds or \$31,212,500. As a result, accounting rules required us to write-off our investment in one of the California projects although development activities continue on all three California projects. We also have returned our volume cap allocation targeted to the Bar 20 project. We anticipate pursuing this allocation again at a later date.

**JBS Swift Grand Island.** Construction on the biogas facility located at the JBS Swift & Co. beef processing plant in Grand Island, Nebraska, began in 2008 and has been funded to date from the \$7 million tax-exempt bond financing described in greater detail in our Current Report on Form 8-K, dated July 22, 2008, as filed with the Securities and Exchange Commission on July 25, 2008. We have, however, suspended construction pending financing commitments for remaining equity requirements.

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The suspension of construction has resulted in a delay in meeting the scheduled date for commencement of biogas deliveries under the terms of the Biogas Purchase and Sale Agreement between Microgy Grand Island, LLC and JBS Swift. Microgy Grand Island has informed JBS Swift that Microgy Grand Island intends to resume construction once remaining financing needs are secured and has, on a reservation-of-rights basis, made certain payments to JBS Swift to cover its claim for liquidated damages. We believe that such damages constitute the sole remedy under the biogas agreement for delay, although it is not known whether JBS Swift will concur regarding its sole remedy or pursue further claims based on the delay.

**Table of Contents***Cash Flow Outlook for 2009*

On September 30, 2009 we had an unrestricted cash balance of \$1,081,000 as compared to \$3,158,000 at December 31, 2008. We expect to fund our business activities principally from available cash balances, raising additional funds through debt and/or equity financings by Environmental Power, Microgy or their affiliates and project-specific financing, to the extent available. We are also actively pursuing federal and state administered stimulus funding to augment sources of private capital. The requirement for additional financing will be in direct proportion to the number of projects on which we begin construction, as well as our construction schedule. In addition, we will need to meet significant interest and preferred dividend obligations prior to January 2, 2010 as well as fund general and operating expenses. We will require significant additional funds in the fourth quarter in order to meet these obligations. However there can be no assurance that we will obtain sufficient additional funds to meet our obligations through that date.

*Capacity Update*

As a result of our experienced gained at Huckabay Ridge and the plan to utilize other gas conditioning technologies in our future projects, RNG related parasitic loads will decrease and we will therefore have increased RNG sales volumes as described below.

| Project                   | Cnossen | Cnossen 2 | Rio Leche | Hanford | Riverdale | Bar 20  |
|---------------------------|---------|-----------|-----------|---------|-----------|---------|
| Previous MMBtu Production | 635,000 | 635,000   | 635,000   | 732,000 | 621,000   | 601,000 |
| MMBtu Production with PSA | 670,000 | 670,000   | 670,000   | 780,000 | 639,000   | 629,000 |
| Percent Increase          | 6%      | 6%        | 6%        | 7%      | 3%        | 5%      |

The increased revenue will be partially offset by increased parasitic electricity costs. In addition, we are actively assessing the benefits of producing or purchasing lower cost energy either utilizing a similar CHP process as at Huckabay Ridge or other means which would result in an additional increase in RNG sales volume offset by the net cost of energy procured

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

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

*Short-term investments*

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

*Debt*

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

*Exposure to Renewable Energy Pricing and Commodity Price Risk*

Although we produce a natural gas commodity, we believe the pricing and value to our customers is different than traditional natural gas, insofar as our product has the important attribute of being renewable. Therefore we believe the price of our product is based primarily on the value associated with its renewable nature. As a renewable energy product, our RNG® product competes primarily with other renewable energy products, such as wind, solar and geothermal energy. As a result, changes in the prices for other forms of renewable energy, for instance, due to changes in the efficiency, availability, reliability and regulatory and tax treatment of other forms of renewable energy, in each case as compared

to our RNG® product, have affected and will continue to affect the pricing of our RNG® product.

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To the extent that, due to regulatory changes or other factors, customers begin to place less value on the renewable attributes of our RNG® product and begin to view it as on a par with natural gas, we could become exposed to market risk with respect to natural gas prices, to the extent that this risk is not mitigated by long term off-take agreements. Historically, natural gas prices have been volatile, and we expect such volatility to continue. Fluctuations in the commodity price of natural gas may have a materially adverse impact on the profitability of some of our facilities; particularly where we do not have a long-term contract for the sale of the facility's output at a fixed or predictable price. In such cases, we would explore various strategies, including hedging transactions and the like, in order to mitigate the associated commodity price risk.

In connection with our tax-exempt bond financings in Texas and California, we are required to maintain certain gas price protection arrangements for the gas output of our facilities.

### ***Substrate Costs***

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

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

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

Under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by the Exchange Act Rule 13a-15(b) as of September 30, 2009. Based on that evaluation the Chief Executive Officer and the Chief Financial Officer have concluded that these disclosure controls and procedures were effective at the reasonable assurance level as of September 30, 2009. There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2009 that have materially affected, or are 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**

Investing in our securities, involves a high degree of risk. You should carefully consider the risks and uncertainties described below before purchasing our securities. The risks and uncertainties described below are not the only ones facing our company. Additional risks and

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uncertainties may also impair our business operations and adversely affect our prospects. The order in which such risks are presented does not necessarily reflect the relative importance of such risks or the likelihood that any of the events or circumstances described below will occur or exist.

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

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

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

We are a company in the process of pursuing an aggressive and novel business approach to the construction and operation of renewable energy facilities and the production of renewable natural gas. As noted below, our sole operating business, Microgy, is in the early stages of its development. As a result, we have a history of losses. For the nine months ended September 30, 2009, we incurred a net loss from continuing operations of \$13,147,000. For the year ended December 31, 2008, we incurred a net loss from continuing operations of \$22,996,000 which includes a non-cash, non-recurring expense for the impairment of goodwill of \$4,913,000. For the years ended December 31, 2007 and 2006, we incurred net losses from continuing operations of \$11,161,000, and \$11,399,000, respectively. We expect to continue to incur losses, reduce our earnings or, as the case may be, add to our earnings deficit as we seek to further develop our business. We currently expect that these ongoing losses will adversely affect our financial condition through at least 2010. As a result of these losses, we anticipate that we will, in all likelihood, have to rely on external financing for most of our capital and operational requirements. We will need to raise substantial financing in order to fund ongoing general and administrative expenses associated with our corporate overhead as well as interest and dividend requirements and to continue as a going concern. We currently have no commitments for any such financing. We cannot assure you such financing will be available on reasonable terms or in a timely fashion, or at all, particularly in the current economic environment, in which capital raising activities are especially challenging. Future losses are likely to continue unless we successfully implement our business plan. If we are not successful in reaching and maintaining profitable operations, we may not be able to attract sufficient capital to continue our operations and avoid defaulting on our corporate and subsidiary debt and other obligations. Our inability to obtain adequate financing would likely result in the need to reduce the number of projects we construct and even to curtail or cease our business operations and would materially impair the value of your investment in our securities.

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

Our sole operating business, Microgy, was formed in 1999 and remains in the early stages of its development. Microgy is developing facilities that use environmentally friendly anaerobic digestion and other technologies to produce biogas from animal and organic wastes. Although Microgy has developed and is operating three single digester facilities in Wisconsin and the multi-digester Huckabay Ridge facility, Microgy still has limited experience in the construction and operation of multiple digester facilities such as those Microgy is currently constructing or intends to construct, and limited experience in gas conditioning or the sale of gas as a commodity. In addition, Microgy has experienced challenges during the startup and initial operation of the Huckabay Ridge facility that have resulted in outages for corrective measures. We took advantage of such an outage to complete comprehensive upgrades to process-instrumentation and controls, the gas conditioning system, and the gas-collection system in order to achieve anticipated performance levels. While we gained valuable knowledge as to our processes and incorporated the lessons learned into future projects, we cannot assure you that similar challenges will not be encountered with respect to future facilities. Because of Microgy's limited experience, there is a risk that Microgy may never be profitable.

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

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

Off-take interconnection agreements;

Site agreements;

Supply contracts;

Design/build or other construction-related agreements;

Off-take agreements for gas produced;

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

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

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Various co-product sales agreements;

Waste disposal agreements;

Environmental and other permits and licenses;

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 revenue projections. We expect that, in some cases, it may take a year or more to obtain decisions on permits and approvals and to negotiate and close these complex agreements. Such delays could harm our operating results and financial condition.

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

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

Because we have not yet generated sufficient positive cash flow, and do not expect to do so until at least 2011, we do not have adequate funds on hand to complete construction of the facilities we currently have planned. We are seeking and will require corporate, project or group financing to fund the cost of any development we may decide to pursue for Microgy's facilities. This financing may be difficult or impossible for us to obtain particularly in the current economic environment, in which capital raising activities are especially challenging. If we are unable to obtain such financing, the value of our Microgy investment may be reduced significantly, and we may be required to substantially curtail our business or completely cease construction or operation of any facilities. The availability of additional financing will depend on prospective lenders' or investors' review of our financial capabilities as well as specific facilities and other factors, including their assessment of our ability to construct and manage each facility successfully and the current state of the economy. Such financing may not be available to us on acceptable terms, or at all. If we are unable to obtain the required financing, we will have to reduce the number of projects we construct and may even have to curtail or cease our business operations, which would have a material adverse effect on your investment in our securities.

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

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

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

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

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

The multiple digester facilities that we plan to implement through Microgy Holdings and our other subsidiaries are expected to produce greenhouse gas sequestration credits and other marketable environmental attributes. While there exist trading markets for these attributes, and additional trading markets or other commercial avenues may develop, the existing trading markets are new and experience thin trading and price volatility, which can hinder sales of credits and make their value unpredictable. The quantity of credits that may be generated are a function of the carbon credit offset characteristics as determined by protocols used to document and verify the carbon offset value. These protocols continue to evolve, and changes in these protocols could substantially diminish further carbon credit eligibility. Furthermore, much of the participation in these markets is voluntary, in response to social and environmental concerns, as opposed to being driven by regulatory requirements. While many states and the federal government are pursuing or are considering carbon emissions limits and related initiatives that may spur greater development of and participation in these markets, we are unable to determine the effect of these initiatives on these markets. We cannot assure you that these trading markets will develop further, or even that they will continue to exist. In addition, many of our agreements with our business partners and investors require us to share such credits or any revenues we derive from sales of such credits, and agreements we negotiate in the future may also include such requirements. As a result of the foregoing, we may recognize significantly smaller revenues than we anticipate from the sale of greenhouse gas sequestration credits or other environmental attributes.

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

We have invested, and expect to invest, substantial funds and resources in the Huckabay Ridge facility and the other multi-digester, renewable natural gas facilities in Texas, California and Nebraska. We have pledged all of our interest in the Huckabay Ridge facility, as well as the Rio Leche, Cnossen and Mission facilities in Texas as collateral security for the loan to our subsidiary, Microgy Holdings, from the Gulf Coast Industrial Development Authority of Texas relating to the \$60 million tax-exempt bond financing we completed in November 2006. The outstanding principal amount of these bonds has been reduced to \$45,000,000. We have pledged all of our interest in the Riverdale and Hanford facilities in California as collateral security for the loan to our subsidiary, Microgy Holdings, from the California Statewide Communities Development Authority relating to the \$62.425 million tax-exempt bond financing we completed in September 2008. The outstanding amount of these bonds has been reduced to \$31,212,500. While these loans are non-recourse to Environmental Power, Environmental Power is required to provide at least 20% of the construction costs of these facilities, as well as to cover any cost overruns in construction and certain other significant costs, which represents a substantial investment of corporate resources. If Microgy Holdings were to default on these loans, we would lose some or all of our investment in the Texas and California facilities, which would have a material adverse effect on our business, financial condition and results of operations. In addition, our subsidiary, Microgy Grand Island, LLC, has entered into a \$7.0 million sale and leaseback transaction with the City of Grand Island, Nebraska in connection with its tax-exempt bond financing in Nebraska to finance the construction of the Grand Island facility, and has guaranteed the City's obligations under the tax-exempt bonds. Environmental Power has equity contribution and support obligations with respect to the Grand Island facility that are substantially similar to those under the Texas and California financings. If Microgy Grand Island defaults on its lease and guarantee obligations to the City of Grand Island, we would lose some or all of our investment in the Grand Island facility, which would have a material adverse effect on our business, financial condition and results of operations.

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

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

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

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

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

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

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

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

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

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

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

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

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We expect that Microgy's facilities are likely to be subject to various local, state and federal government regulations, including regulations covering air and water quality, solid waste disposal and related pollution issues. These regulations are mandated by the United States Environmental Protection Agency, or EPA, and state and local governments and are usually implemented through a permitting process, with ongoing compliance requirements thereafter. For example, grease-trap waste from restaurants and other food

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service providers is a desirable and highly available form of substrate for our facilities in Texas. However, the Texas environmental authorities required that we obtain a solid-waste permit for each of our planned facilities in Texas to the extent we desire to use grease-trap waste as substrate in the operation of such facilities. Furthermore, we have had to obtain water discharge permits for our planned California facilities, which typically involve a lengthy process. We expect that all of our facilities will be required to obtain various environmental and other permits and approvals, which will vary from location to location. In addition, our activities will fall under a number of health and safety regulations and laws and regulations relating to farming and zoning. Compliance with these regulations and permitting requirements could delay the development of facilities and could be costly and harm our financial condition.

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

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

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

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

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

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

the success or failure of the facilities currently underway;

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

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

other unforeseen activities or issues.

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

*If current negotiations with bondholders result in the anticipated agreement with the bondholders and if Microgy Holdings is unable to raise \$32,500,000 in additional financing by March 31, 2010, bondholders can require Microgy Holdings to redeem the remaining California bonds and \$30,000,000 of outstanding Texas bonds.*

If Environmental Power and Microgy Holdings complete an agreement with the bond holders, as anticipated, the terms of Microgy Holdings remaining tax-exempt bond financings in California and Texas would require that Microgy Holdings raise \$32,500,000 by March 31, 2010 or the bondholders can demand redemption of the anticipated remaining California bonds and repayment of \$30,000,000 of the Texas bonds, by written notice to Microgy Holdings on or before April 15, 2010. If the holders of the California bonds require purchase or redemption of their

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bonds, then, assuming there are no defenses available to such actions and obligations, the proceeds of the California and Texas bonds would not be available for Microgy Holdings for one of planned California projects and two Texas projects. If the holders of the California bonds require purchase or redemption of their bonds, then, assuming there are no defenses available to such actions and obligations, the proceeds of the California bonds would not be available for Microgy Holdings planned California projects. As of the date of this report, in the event of the expected immediate repurchase and redemption and the further redemption of the California bonds or repurchase of the Texas bonds, there would be a shortfall of approximately \$5.0 million for Texas and \$5.1 million for California plus accrued interest from June 1, 2009 through the date of purchase and redemption. Currently, neither Environmental Power nor Microgy Holdings has sufficient funds to cover this shortfall.

We believe the loss of the proceeds of the California or Texas bonds, or the inability of Microgy Holdings to pay the full amount owed upon redemption of the California bonds could have a material adverse effect on our financial condition, our results of operations and our ability to continue as a going concern if ongoing alternative financing efforts are not successful.

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### ***Risks Relating to Our Capital Stock***

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

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

A significant portion of our outstanding shares of common stock had been restricted from immediate resale, but is now available for sale in the market pursuant to Rule 144 under the Securities Act of 1933. As of September 30, 2009, we had approximately:

15,803,034 shares of our common stock are issued and 15,708,591 shares are outstanding, of which 1,212,726 shares of common stock outstanding are restricted securities within the meaning of Rule 144 and 117,625 shares are subject to vesting pursuant to restricted stock awards granted to certain employees; and

2,823,659 shares of common stock issuable upon conversion of our series A preferred stock; all of which shares, other than employee restricted stock awards subject to vesting, are eligible for resale without volume and manner of sale restrictions in accordance with Rule 144, except to the extent held by our affiliates. We are currently authorized to issue 50,000,000 shares of common stock.

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

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

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

On May 22, 2009 we issued an additional \$3 million original principal amount of the notes as payment for certain license fees to the licensor of Microgy's technology in a private placement transaction. These notes are convertible into up to approximately 555,556 shares of common stock, based upon the minimum conversion price. These shares are restricted securities within the meaning of Rule 144.

We currently have pending with the Securities and Exchange Commission a registration statement covering an offering of an additional \$5 million of the notes, which would be converted into an aggregate of up to approximately 925,926 shares of our common stock, based upon the minimum conversion price of the notes. If this offering is consummated, all of such shares may be sold by the holders thereof without restriction, except to the extent held by our affiliates.

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As of September 30, 2009, we had outstanding options and warrants to acquire up to approximately 4,610,827 shares of our common stock at prices ranging from \$1.75 to \$8.89 per share, with a weighted average exercise price of \$5.13 per share and an average remaining contractual term of 4 years. The shares of common stock issuable upon exercise of these options will be freely transferable without restriction, except to the extent that they are held by our affiliates. Any shares held by our affiliates may only be sold in compliance with the volume limitations of Rule 144. These volume limitations restrict the number of shares that may be sold by an affiliate in any three-month period to the greater of 1% of the number of shares then outstanding, which equals approximately 156,000 shares as of September 30, 2009, or the average weekly trading volume of our common stock during the four calendar weeks preceding the filing of a notice on Form 144 with respect to the sale.

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

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

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

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

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

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

While our common stock is currently listed for trading on the NASDAQ Capital Market, trading activity in our common stock has fluctuated and has at times been limited. For example, for the one-month period from September 1, 2009 to September 30, 2009, our daily trading volume ranged from a low of 13,400 shares to a high of 117,800 shares, and averaged 36,948 shares. We cannot guarantee that a consistently active trading market will develop in the future. As a result, a holder of our common stock may find it difficult to dispose of our common stock.

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

Our common stock is currently listed on The Nasdaq Capital Market. In order to maintain that listing, we must satisfy minimum financial and other listing requirements. Among these requirements is that our common stock maintain a minimum closing bid price of at least \$1.00 per share. On September 22, 2009, we received a notice dated September 15, 2009 from Nasdaq that our common stock had failed to maintain a minimum closing bid price of at least \$1.00 per share for thirty consecutive business days. In accordance with Nasdaq Listing Rule 5810(c)(3)(A), we have 180 calendar days, or until March 15, 2010, to regain compliance with the minimum bid price requirement. The Nasdaq Listings Qualifications Department informed us that if, at any time before March 15, 2010, the bid price of our common stock closes at \$1.00 per share or more for a minimum of 10 consecutive business days, Nasdaq will provide written notification that we have achieved compliance with the minimum bid price requirement, although Nasdaq may, in its discretion, require that an issuer maintain a bid price of at least \$1.00 per share for a period in excess of 10 consecutive business days, but generally no more than 20 consecutive business days, before determining that the issuer has demonstrated an ability to maintain long-term compliance. In the event we do not regain compliance with the minimum bid price requirement by March 15, 2010, Nasdaq will provide written notification that our common stock will be subject to delisting from The Nasdaq Capital Market. At that time, we may appeal Nasdaq's determination to delist our common stock to a Nasdaq Hearings Panel. Alternatively, we may be eligible for an additional grace period if we meets the initial listing standards for The Nasdaq Capital Market, with the exception of the minimum bid price requirement, in which case Nasdaq will notify us that we have been granted an additional 180 calendar day grace period to regain compliance with the minimum bid price rule. We have not yet determined what action, if any, we will take in response to this notice, although we intend to monitor the closing bid price of our common stock between now and March 15, 2010. We will consider available options if our common stock does not trade at a level likely to result in regaining compliance with the minimum bid price requirement. We disclaim any intention or obligation to update the statements in this report for purposes of disclosing any action or response that we decide to

take after the date hereof.

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If we fail to regain compliance within the foregoing periods, our common stock may be subject to delisting from the NASDAQ Capital Market. If we fail to continue to meet all applicable listing requirements of The NASDAQ Capital Market and NASDAQ determines to delist our common stock, an active trading market for our common stock may not be sustained and the market price of our common stock could decline. In addition, the delisting of our common stock would also trigger a right on the part of the holders of our outstanding shares of series A preferred stock to increase the cumulative dividend rate on such shares from 9% per year to 16% per year. We cannot assure you that we will not ultimately fail to comply with NASDAQ listing standards.

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

The market price for our common stock has been volatile, and it is likely to continue to be so. For instance the closing price of our common stock reached a high of \$6.25 in the first quarter of 2008 and a low of \$0.28 in the fourth quarter of 2008 and has varied from a low of \$0.41 to a high of \$0.69 in the nine months of 2009. While we cannot state with any certainty the specific reasons for the recent volatility of our stock price, we believe that such volatility could be due to the current financial recession and related economic uncertainties and their impact on the stock market generally as well as on the stock prices of early stage companies such as ours, in addition to the risks and uncertainties regarding our business described elsewhere in this report. In addition, the market price for our common stock could be subject to significant fluctuations in response to variations in quarterly operating results, announcements of technological innovations or new facilities and products by us or our competitors, or our failure to achieve operating results consistent with any securities analysts' projections of our performance. Furthermore, the stock market has 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 continue to work with our financial advisors to identify and explore various opportunities to raise the capital we require. However, we cannot assure you that we will be able to raise sufficient capital on acceptable terms, or at all. The level of funds we are able to raise, if any, will determine the level of development and construction activity that we can pursue and whether we will be able to continue as a going concern. We will require and will continue to seek corporate and project financing to fund our ongoing overhead and growth plans as well as the cost of any development we may decide to pursue for our facilities. Without limiting the foregoing, as described elsewhere in this annual report, we will have to raise significant additional capital in the fourth quarter of 2009 in order to fund ongoing general and administrative expenses associated with our corporate overhead as well as interest and dividend requirements and to continue as a going concern. We cannot assure you that such capital will be available in sufficient amounts or on terms acceptable to us, if at all. Any such financing could be in the form of debt or equity instruments or a combination of debt and equity instruments. To the extent any such financing involves equity or convertible debt, we may issue a significant number of shares of our common stock or preferred stock, which will dilute an existing investment in our common stock, and we may issue such shares at prices that may be lower than the price paid for our common stock by our stockholders. In addition, if we issue shares of preferred stock, such preferred stock may have rights and preferences that are superior to those of our common stock. Indeed, the shares of our series A preferred stock issued in our November 2006 private placement have rights and preferences that are superior to those of our common stock. Because we are authorized to issue shares of additional series of preferred stock, as designated by our board of directors, subject to certain limitations included in the terms of our series A preferred stock, we may issue more shares of preferred stock in the future.

Issuances of common stock or securities convertible into common stock in the future could dilute existing stockholders and adversely affect the market price of our common stock. Of the 50,000,000 shares of authorized common stock, 15,803,034 are issued, 15,708,591 are outstanding and 4,668,978 have been reserved for issuance upon the exercise of options and warrants outstanding as of September 30, 2009. An additional 2,823,660 shares have been reserved for issuance in connection with the conversion of shares of our series A preferred stock issued in our November 2006 private placement. We may also issue warrants to purchase up to 4.99% of our common stock, on a fully diluted basis, to Cargill, Incorporated pursuant to the terms of our business development agreement. In May 2007, we issued warrants to purchase 175,912 shares of our common stock at an exercise price \$5.37 per share, representing 1% of our fully diluted common stock at the time to Cargill as required by the business development agreement. Additionally, in October 2007, we issued 5,400,000 shares of common stock in an underwritten public offering. We also have the authority to issue preferred stock as previously described, debt securities convertible into common stock, and options and warrants to purchase shares of our common stock. We may issue shares of common stock or securities convertible into common stock at values below our market price up to a maximum of 19.9% of our outstanding common stock without stockholder approval, which values may be substantially below the price paid for our common stock by our stockholders. We also do not need stockholder approval to issue an unlimited number of



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shares of common stock or securities convertible into common stock (provided sufficient shares of common stock are authorized and unreserved) at or above the market price for our common stock pursuant to certain NASDAQ Capital Market requirements. Any such issuances could be at values below the price paid for our common stock by our stockholders.

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

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

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

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

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

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

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

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

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

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

Not applicable.

**Item 3. Defaults Upon Senior Securities**

Our Series A 9% Cumulative Convertible Preferred Stock accrues dividends at the rate of 9% per annum payable semi-annually on January 1 and July 1 of each year. As of the date of this report, the semi-annual dividend payment of \$667,088 due on July 1, 2009 had not been paid and remains in arrears.

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

Not applicable

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### **Item 5. Other Information**

On November 6, 2009, Environmental Power, Microgy Holdings, the purchasers of the \$62.425 million in tax-exempt bonds (the Bonds ) issued in connection with Microgy Holdings tax-exempt bond financing in California in September 2008 (the Bondholders ) and Wells Fargo Bank, National Association, as Trustee (the Trustee ) entered into a Seventh Amendment (the Amendment ) to the Demand Purchase Agreement, dated as of September 3, 2008, among the Company, Holdings, the Bondholders and the Trustee (the Demand Purchase Agreement ) to extend to November 13, 2009 the date until which the Bondholders may exercise the Option (as defined below), and to extend to November 27, 2009, the date on which the Environmental Power would be required to pay costs of issuance if the Option is exercised.

Environmental Power, Microgy Holdings and the Bondholders deem it in their mutual best interests to extend again the period of time during which the Option may be exercised, in light of current capital raising activities by Environmental Power and Microgy Holdings. The purpose of the Amendment is to provide adequate time for continued discussions between Environmental Power and Microgy Holdings, on the one hand, and the Bondholders, on the other hand.

Pursuant to the Demand Purchase Agreement, if certain conditions set forth in the Loan Agreement, dated as of August 1, 2008, with the California Statewide Community Development Authority were not met by June 30, 2009, the holders of a majority of the Bonds would have the option, exercisable by written notice to Holdings on or before July 31, 2009, to require Microgy Holdings to purchase the Bonds at par plus accrued interest on or before August 31, 2009 (the Option ).

### **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.

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**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 9, 2009

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**Exhibit Index**

**Exhibit**

| <b>No.</b> | <b>Description</b>                                                                |
|------------|-----------------------------------------------------------------------------------|
| 31.1       | Rule 13a-14(a)/15(d)-14(a) Certifications of Registrant's Chief Executive Officer |
| 31.2       | Rule 13a-14(a)/15(d)-14(a) Certifications of Registrant's Chief Financial Officer |
| 32.1       | Section 1350 Certifications of the Registrant's Chief Executive Officer           |
| 32.2       | Section 1350 Certifications of the Registrant's Chief Financial Officer           |