

ENVIRONMENTAL POWER CORP

Form 10-Q

July 31, 2008

Table of Contents

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

WASHINGTON, DC 20549

**FORM 10-Q**

(Mark one)

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

For the quarterly period ended June 30, 2008

OR

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

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

Commission file number 001-32393

**Environmental Power Corporation**

(Exact name of registrant as specified in its charter)

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-Q

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

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

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

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

(do not check if a smaller reporting company)

Number of shares of Common Stock outstanding at June 30, 2008: 15,624,104 shares

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

**Table of Contents**

**TABLE OF CONTENTS**

<u>Cautionary Statement Regarding Forward-Looking Statements</u>	3
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<b><u>Item 1. Financial Statements</u></b>	
<u>Condensed Consolidated Balance Sheets as of June 30, 2008 (unaudited) and December 31, 2007</u>	4
<u>Condensed Consolidated Statements of Operations (unaudited) for the Three and Six Months Ended June 30, 2008 and June 30, 2007</u>	5
<u>Condensed Consolidated Statements of Cash Flows (unaudited) for the Six Months Ended June 30, 2008 and June 30, 2007</u>	6
<u>Condensed Consolidated Statement of Equity (unaudited) for Six Months Ended June 30, 2008</u>	7
<u>Notes to Condensed Consolidated Financial Statements</u>	8
<b><u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u></b>	15
<b><u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u></b>	22
<b><u>Item 4. Controls and Procedures</u></b>	23
<b><u>PART II. OTHER INFORMATION</u></b>	
<b><u>Item 1. Legal Proceedings</u></b>	24
<u>Item 1A. Risk Factors</u>	24
<b><u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u></b>	33
<b><u>Item 3. Defaults Upon Senior Securities</u></b>	33
<b><u>Item 4. Submission of Matters to a Vote of Security Holders</u></b>	33
<b><u>Item 5. Other Information</u></b>	34
<b><u>Item 6. Exhibits</u></b>	34
<b><u>SIGNATURES</u></b>	35

**Table of Contents**

**PART I. FINANCIAL INFORMATION**

**Cautionary Statement Regarding Forward-Looking Statements**

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

uncertainties involving early-stage companies,

uncertainties regarding financing,

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

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

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

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

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

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

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

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

financing and cash flow requirements and uncertainties,

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

difficulties involved in developing and executing a business plan,

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

unpredictable developments, including plant outages and repair requirements,

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

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

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

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

uncertainties relating to general economic and industry conditions,

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

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

Condensed Consolidated Balance Sheets (unaudited) as of June 30, 2008 and December 31, 2007

	June 30, 2008 (unaudited)	December 31, 2007
<b>ASSETS</b>		
Current Assets		
Cash and cash equivalents	\$ 13,395,448	\$ 26,069,198
Restricted cash	46,489,203	45,784,702
Receivables	643,103	741,730
Other current assets	81,730	130,194
Current assets of discontinued operations	0	18,588,080
<b>Total Current Assets</b>	<b>60,609,484</b>	<b>91,313,904</b>
Restricted cash, non current	547,271	489,477
Property, plant, and equipment, net	24,518,567	261,171
Construction in progress	8,889,629	27,640,619
Goodwill	4,912,866	4,912,866
Licensed technology rights, net	2,422,046	2,514,796
Notes receivable, net	1,644,127	1,841,740
Deferred financing costs, net	2,922,350	2,564,882
Other assets	98,090	97,603
Long term assets of discontinued operations	0	68,334,073
<b>TOTAL ASSETS</b>	<b>\$ 106,564,430</b>	<b>\$ 199,971,131</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current Liabilities		
Accounts payable and accrued expenses	\$ 3,991,845	\$ 2,517,468
Current liabilities of discontinued operations	0	21,391,138
<b>Total Current Liabilities</b>	<b>3,991,845</b>	<b>23,908,606</b>
Other Liabilities	292,098	204,484
Long Term debt	60,071,496	60,453,983
Long Term liabilities of discontinued operations	0	72,132,497
<b>Total Liabilities</b>	<b>64,355,439</b>	<b>156,699,570</b>
Minority Interests	100	100
Preferred Stock (1)	10,156,021	10,156,021
Shareholders Equity		
Preferred stock (2)	100	100
Common stock (3)	157,125	156,677
Additional paid-in capital	89,440,954	88,036,289
Accumulated deficit	(56,521,688)	(54,054,005)
Treasury stock (4)	(385,402)	(385,402)
Notes receivable from officers and board members	(638,219)	(638,219)
<b>Total Common Shareholders Equity</b>	<b>32,052,770</b>	<b>33,115,340</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	<b>\$ 106,564,430</b>	<b>\$ 199,971,131</b>

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-Q

- (1) Preferred stock, \$.01 par value, 2,000,000 shares authorized; 281,241 shares issued as of June 30, 2008 and December 31, 2007.
- (2) Preferred stock of subsidiary, no par value, 10 shares authorized; 10 shares issued as of June 30, 2008 and December 31, 2007.
- (3) \$.01 par value; 50,000,000 shares authorized; 15,712,534 issued and 15,624,104 outstanding as of June 30, 2008 and 15,667,784 issued and 15,579,354 outstanding as of December 31, 2007.
- (4) 88,430 shares at cost, as of June 30, 2008 and December 31, 2007.

**See Notes to Consolidated Financial Statements.**

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

Condensed Consolidated Statements of Operations (unaudited) for the Three and Six Months Ended June 30, 2008 and June 30, 2007

	Three Months Ended		Six Months Ended	
	June 30, 2008 (unaudited)	June 30, 2007 (unaudited)	June 30, 2008 (unaudited)	June 30, 2007 (unaudited)
REVENUES	\$ 1,112,149	\$ 326,949	\$ 2,082,691	\$ 542,222
COSTS AND EXPENSES:				
Operations and maintenance	1,936,557	243,739	3,253,200	461,060
General and administrative	3,611,393	3,655,597	6,872,539	6,001,054
Depreciation and amortization	353,579	77,303	614,353	148,165
TOTAL COSTS AND EXPENSES	5,901,529	3,976,639	10,740,092	6,610,279
OPERATING LOSS	(4,789,380)	(3,649,690)	(8,657,401)	(6,068,057)
OTHER INCOME (EXPENSE):				
Interest income	99,847	132,240	346,754	290,777
Interest expense	(265,271)	(2,283)	(442,026)	(6,202)
Other income (expense)	(8,765)		(22,242)	583,117
TOTAL OTHER INCOME (EXPENSE)	(174,189)	129,957	(117,514)	867,692
LOSS BEFORE TAXES	(4,963,569)	(3,519,733)	(8,774,915)	(5,200,365)
INCOME TAX EXPENSE		400		800
NET LOSS, FROM CONTINUING OPERATIONS	(4,963,569)	(3,520,133)	(8,774,915)	(5,201,165)
INCOME (LOSS) FROM DISCONTINUED OPERATIONS, NET OF TAXES OF \$0		(3,235,321)	(1,010,534)	(2,900,473)
GAIN ON DISPOSAL, NET OF TAXES OF \$0			7,999,858	
NET LOSS	(4,963,569)	(6,755,454)	(1,785,591)	(8,101,638)
Preferred Securities Dividend Requirements	(329,592)	(333,922)	(667,092)	(669,790)
Loss Applicable to Common Shareholders	\$ (5,293,161)	\$ (7,089,376)	\$ (2,452,683)	\$ (8,771,428)
BASIC INCOME (LOSS) PER SHARE				
CONTINUING OPERATIONS	\$ (0.34)	\$ (0.39)	\$ (0.61)	\$ (0.60)
DISCONTINUED OPERATIONS		(0.32)	0.45	(0.29)
NET LOSS	\$ (0.34)	\$ (0.71)	\$ (0.16)	\$ (0.89)
DILUTED INCOME (LOSS) PER SHARE				
CONTINUING OPERATIONS	\$ (0.34)	\$ (0.39)	\$ (0.61)	\$ (0.60)
DISCONTINUED OPERATIONS		(0.32)	0.45	(0.29)
NET LOSS	\$ (0.34)	(0.71)	\$ (0.16)	\$ (0.89)
SHARES USED TO CALCULATE INCOME (LOSS) PER SHARE				
BASIC	15,579,354	10,026,848	15,579,354	9,867,253
DILUTED	15,579,354	10,026,848	15,579,354	9,867,253

See Notes to Consolidated Financial Statements.





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

Condensed Consolidated Statements of Cash Flows (unaudited) for the Six Months Ended June 30, 2008 and June 30, 2007

	Six Months Ended	
	June 30, 2008	June 30, 2007
	(unaudited)	(unaudited)
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net (loss)	\$ (1,785,591)	\$ (8,101,638)
<i>Non-cash adjustments</i>		
Results of discontinued operations	(6,989,324)	
Depreciation and amortization	614,353	230,461
Amortization of deferred gain		(154,206)
Non-cash interest expense		285,752
Stock based compensation expense	1,405,113	1,436,592
Write-off of Sunnyside liability		(583,030)
Accrued power generation revenues		3,566,957
Accrued lease expenses		(3,566,957)
<i>Changes in operating assets and liabilities:</i>		
(Increase) decrease in receivables	98,628	(344,226)
Increase in fuel inventory		(6,198)
Decrease in other current assets	48,464	104,344
Decrease in notes receivable	197,613	8,475
Decrease in other assets		204,464
Increase in accounts payable	939,336	195,863
Increase in accrued expenses	185,040	
Other, net	12,355	
Net cash used in operating activities	(5,274,013)	(6,723,347)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Disposal of discontinued operations	375,000	
(Increase) decrease in restricted cash	(762,295)	4,513,989
Construction of projects	(5,694,744)	(5,666,497)
Property, plant and equipment, and capital lease expenditures	(322,147)	(68,973)
Net cash used for investing activities	(6,404,186)	(1,221,481)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Capitalized financing costs	(368,586)	(1,741,465)
Dividend payments on preferred stock	(667,092)	(197,671)
Payment of dividend on behalf of subsidiary	(15,000)	
Changes to long-term debt	(32,487)	
Exercise of stock options		2,875,826
Increase in other liabilities	87,614	
Net borrowings under working capital loan		1,253,000
Net cash (used in) provided by financing activities	(995,551)	2,189,690
DECREASE IN CASH AND CASH EQUIVALENTS	(12,673,750)	(5,755,138)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	26,069,198	13,794,091

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-Q

CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 13,395,448	\$ 8,038,953
Supplemental disclosure of cash flow information		
Cash paid for interest (Net of amount capitalized)	\$ 442,026	
Supplemental disclosure of non-cash investing and financing activity		
Semi-annual accrued dividend requirement to Series A Preferred Stock Holders	\$ (667,092)	\$ (669,790)

**See Notes to Consolidated Financial Statements.**

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

Condensed Consolidated Statement of Common Shareholders' Equity (unaudited) for Six Months Ended June 30, 2008

	Common Stock - Shares	Common Stock - Amount	Additional Paid-in Capital	Accum. Deficit	Treasury Stock - Shares	Treasury Stock - Amount	Receivable - Officers & Directors	Total
<b>Balance at December 31, 2007</b>	<b>15,667,784</b>	<b>\$ 156,677</b>	<b>\$ 88,036,289</b>	<b>\$ (54,054,005)</b>	<b>88,430</b>	<b>\$ (385,402)</b>	<b>\$ (638,219)</b>	<b>\$ 33,115,340</b>
Dividends on preferred stock				(667,092)				(667,092)
Stock based compensation expense			1,405,113					1,405,113
Dividend paid on behalf of subsidiary				(15,000)				(15,000)
Issuance of restricted stock	44,750	448	(448)					
Net loss				(1,785,591)				(1,785,591)
<b>Balance at June 30, 2008</b>	<b>15,712,534</b>	<b>\$ 157,125</b>	<b>\$ 89,440,954</b>	<b>\$ (56,521,688)</b>	<b>88,430</b>	<b>\$ (385,402)</b>	<b>\$ (638,219)</b>	<b>\$ 32,052,770</b>

See Notes to Consolidated Financial Statements.

---

**Table of Contents**

**Notes to Condensed Consolidated Financial Statements**

**NOTE A BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements of Environmental Power Corporation ( we , us , EPC , or the Company and our subsidiaries have been prepared in accordance with the instructions to Form 10-Q and with Article 10 of Regulation S-X and include all of the information and footnotes required by generally accepted accounting principles for interim financial information. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The results of operations for the three and six months ended June 30, 2008 are not necessarily indicative of results to be expected for the year ending December 31, 2008. 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, 2007 ( 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 B Significant Accounting Policies to the consolidated financial statements included in the Annual Report.

**NOTE B THE COMPANY**

Environmental Power Corporation (the Company ) is a developer, owner, and operator of renewable energy production facilities. The Company's goal is to produce Energy that is . . . Beyond Renewable®, which the Company defines as energy that not only uses waste materials instead of limited resources, but that also is clean, reliable, and cost-effective.

Microgy, Inc., a wholly owned subsidiary of the Company ( Microgy ), is a developer of renewable energy facilities for the production and commercial application of methane-rich biogas produced from livestock and food industry wastes, as well as wastes from other organic sources. The biogas can be sold to an end user or used to produce pipeline-grade methane, which we refer to as renewable natural gas, or RNG®, liquefied natural gas, or LNG, compressed natural gas, or CNG, renewable electrical energy or thermal energy as well as other useful by-products. The Company's systems utilize a proven biogas production technology that we believe is superior to other such technologies.

Microgy intends to continue to focus on a 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 produced by such facilities, as well as sales of greenhouse gas sequestration credits or other marketable environmental benefits. The strategy encompasses the construction and operation of stand-alone merchant 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.

Microgy began 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. The gas is treated and compressed to produce pipeline-grade methane that is sold as a commodity and delivered directly into nearby natural gas pipelines. Huckabay Ridge is expected to produce approximately 635,000 million British Thermal Units, or MMBtus, of pipeline-grade methane per year.

Microgy also operates 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 ( Dairyland ). The biogas from these projects is used by Dairyland to generate electricity.

Environmental Power and Microgy pursue Microgy's business through several subsidiaries and special purpose entities. The principal such entity is Microgy Holdings, LLC, ( Microgy Holdings ) which was formed in 2006 as a subsidiary of Environmental Power Corporation in connection with the \$60 million tax-exempt bond financing we completed in November 2006 relating to the construction and operation of four RNG® facilities in Texas, and which is expected to be the vehicle for our proposed tax-exempt bond financing in California relating to our proposed California projects. The assets financed by the debt financing are pledged as collateral to the Gulf Coast Industrial Development Authority of Texas, the lender. The debt held by Microgy Holdings is non-recourse to

**Table of Contents**

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. Another such entity is Microgy Grand Island, LLC, which was formed to own and operate our Grand Island, Nebraska facility currently under construction, and which is the obligor under our tax-exempt bond financing for such facility described below.

In the past, the Company operated in two major segments: through Microgy, as described above, and through EPC Corporation and its subsidiary, Buzzard Power Corporation, as holder of a leasehold interest in a waste-coal fired generating facility in Pennsylvania known as the Scrubgrass facility. On February 29, 2008, we completed the disposition of the leasehold interest in the Scrubgrass facility. As a result, for financial reporting purposes, we are now consolidating all segments of continuing operations and reporting the results of Buzzard as discontinued operations . We now operate only in Microgy s segment.

**Discontinued Operations**

The disposition of Buzzard Power Corporation s ( Buzzard ) 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, located on a 600-acre site in Venango County, Pennsylvania, is an approximately 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.

The assets and liabilities of Buzzard have been accounted for as discontinued operations for all periods presented in accordance with the criteria established in Statement of Financial Accounting Standard ( SFAS ) No. 144 *Accounting for Impairment or Disposal of Long-Lived Assets* . We no longer have a continuing involvement with the Buzzard business since we disposed of the leasehold interest in the Scrubgrass facility and do not continue to generate any revenue or cost-generating activities related to Buzzard. In accordance with SFAS No. 144, the accompanying consolidated balance sheets report the assets and liabilities of Buzzard as discontinued operations and the consolidated statements of operations report the operations of Buzzard as discontinued operations during the period prior to disposition of the entity.

The Company 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 and the Company s subsidiary, EPC Corporation. We recorded net income from discontinued operations for the six months ended June 30, 2008 of \$6,989,000. The net income reflects a loss from operations of \$1,011,000 and a one time gain from disposal of approximately \$8,000,000. The gain of approximately \$8,000,000 on the transaction, 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 transaction was recorded net of tax of \$0 because it is anticipated that existing net operating loss carryforwards will offset any federal or state tax liabilities.

**NOTE C PROPERTY, PLANT AND EQUIPMENT**

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

**Table of Contents****NOTE D NET INCOME OR LOSS PER COMMON SHARE**

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

**NOTE E STOCK-BASED COMPENSATION**

We maintain equity incentive compensation plans under which restricted stock awards, stock options, stock appreciation rights and other stock-based awards may be granted to employees, directors, 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 and/or pursuant to performance-based vesting criteria. The stock options generally expire 10 years from the date of grant. We generally issue new, previously unissued shares of common stock upon exercise of stock options, though we may issue treasury shares.

During the second quarter of 2008, the Company granted 44,750 shares of restricted stock to certain employees which vests over a two year period. The restricted shares had an aggregate market value at the date of issuance of approximately \$247,000. The Company uses the intrinsic value method to measure the compensation expense related to these shares and recorded approximately \$18,000 in expense during the second quarter.

Total stock-based compensation for the three and six months ended June 30, 2008 was \$1,115,360 and \$1,405,113, respectively. In the three and six months ended June 30, 2007, we recognized \$898,000 and \$1,436,592, respectively in non-cash compensation expense under SFAS 123R. The total compensation cost related to unvested stock-based awards for not yet recognized is \$1,617,137. This amount will be charged against income over the next three years.

Valuation Assumptions: The fair value of stock options and stock appreciation rights granted during the three months and six months ended June 30, 2008 and June 30, 2007 was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Three Months Ended		Six Months Ended	
	June 30, 2008	June 30, 2007	June 30, 2008	June 30, 2007
Fair Market Value Per Share	\$ 3.20	\$ 4.65	\$ 3.20	\$ 4.80
<i>Assumptions</i>				
Risk-free rate of return	3.27%	4.63%	3.27%	4.60%
Volatility	69.73%	72.64%	69.73%	72.82%
Expected annual dividend yield	0.00%	0.00%	0.00%	0.00%
Option Life (years)	5	4	5	4

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

**NOTE F GOODWILL AND INTANGIBLE ASSETS**

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

**Table of Contents**

Accumulated amortization of licensed technology rights was \$1,287,954 as of June 30, 2008 and \$1,195,204 as of December 31, 2007. Amortization expense for licensed technology rights was \$46,375 for the three months ended June 30, 2008 and \$92,750 for the six months ended June 30, 2008. The future estimated amortization expense for licensed technology rights is as follows:

**Estimated Amortization Expense for Licensed Technology Rights**

2008	2009	2010	2011	2012	Thereafter	Total
\$ 92,750	185,500	185,500	185,500	185,500	1,587,296	\$ 2,422,046

**NOTE G CONTRACTUAL OBLIGATIONS AND LONG-TERM OBLIGATIONS**

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

Commitments	2008	2009	2010	2011	2012	Thereafter	Total
Operating Leases(1)	\$ 111,621	\$ 337,090	\$ 340,321	\$ 301,548	\$ 222,156		\$ 1,312,736
Microgy Commitments(2)	7,694,789						7,694,789
Relocation Costs(3)	100,000						100,000
Separation Agreement Payments(4)	50,092						50,092
Tax Exempt Bonds(5)	2,100,000	4,200,000	4,200,000	4,200,000	5,150,000	127,423,200	147,273,200
Vehicle Loan and Other Capital Leases(6)	19,855	31,827	19,814				71,496
<b>TOTAL</b>	<b>\$ 10,076,357</b>	<b>\$ 4,568,917</b>	<b>\$ 4,560,135</b>	<b>\$ 4,501,548</b>	<b>\$ 5,372,156</b>	<b>\$ 127,423,200</b>	<b>\$ 156,502,313</b>

- (1) We are obligated under various non-cancelable operating leases for office space and automobiles. Rent expense for these operating leases was \$424,765, \$286,501, and \$174,334, in 2007, 2006 and 2005, respectively. In the three and six months ended June 30, 2008, our rent expense for operating leases was \$126,917 and \$180,181, respectively.
- (2) These commitments relate to various purchase agreements, including minimum purchase agreements with SouthTex Treaters for gas treatment and conditioning equipment, made in connection with our Microgy facilities.
- (3) These costs are comprised mainly of costs associated with our relocation of company headquarters from Portsmouth, New Hampshire to Tarrytown, New York. These costs will be recognized as incurred.
- (4) These commitments reflect payments for severance and separation agreements made to certain former employees, and are included in our balance of accrued expenses.
- (5) In 2007, Microgy began scheduled interest payments on the tax exempt bonds. Mandatory redemption of principal amounts begins in 2012.
- (6) We are obligated under various non-cancelable capital leases for automobiles and computer equipment.

The following table describes our debt obligations as of June 30, 2008 and December 31, 2007:

Secured Promissory Notes Payable and Other Obligations	June 30, 2008	December 31, 2007
Automobile loan & capital leases	\$ 71,496	\$ 103,983
Tax exempt bond financing	60,000,000	60,350,000
<b>TOTAL</b>	<b>\$ 60,071,496</b>	<b>\$ 60,453,983</b>



**Table of Contents**

*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 June 30, 2008 and December 31, 2007. These notes, secured by the underlying shares of stock purchased thereby, are payable upon demand and bear interest at a floating rate which is payable monthly. In accordance with company policy and applicable law, we no longer make loans to our officers or directors.

**NOTE H NOTES RECEIVABLE**

In 2005, we completed construction of the digester projects at Five Star Dairy, Wild Rose Dairy, and Norswiss Dairy. Each digester had a purchase price of \$1,037,000, of which Microgy agreed to provide 100% seller financing. The notes issued by the purchasers of the digester projects each bear simple interest at 5% per annum, to be paid monthly after the first month that revenues are received under the purchasers respective biogas supply agreement with Dairyland Power Cooperative. Each maker of these notes is only required to make interest and principal payments from the revenues under the applicable biogas supply agreement with Dairyland Power Cooperative, to the extent that the operation of the facility, which we manage and operate, provides sufficient funds to pay. Each note matures 11 years after the bill of sale for the facility to which it relates has been executed. Because we have limited operating history, we have set up a reserve on these notes in the amount of \$750,000 to allow for any future cash flow deficiencies that would impair the full value of the notes. We also do not expect to record interest income from these notes. As we gain operations and maintenance experience and develop a track record, we will evaluate this allowance and make adjustments accordingly. The following table shows the balance on these notes receivable on June 30, 2008 and December 31, 2007.

	June 30, 2008	December 31, 2007
<b>Notes Receivable</b>		
Notes receivable	\$ 2,394,127	\$ 2,591,740
Reserve for any future cash flow deficiencies	(750,000)	(750,000)
<b>Notes receivable, net</b>	<b>\$ 1,644,127</b>	<b>\$ 1,841,740</b>

Beginning in the third quarter of 2007, we sold the greenhouse gas offset credits generated from the Wisconsin facilities during 2005 and 2006. Pursuant to our agreements with the owners of these facilities, 50% of these sales were recognized by the Company as revenue and 50% was applied to the balance of the notes. During the first six months of 2008, the balance of the notes receivable was reduced by \$198,000 due to the sale of greenhouse gas offset credits.

**NOTE I INCOME TAXES**

It is our policy to recognize interest and penalties related to uncertain tax positions in income tax expense. As of June 30, 2008, we did not have any accrued interest or penalties related to uncertain tax positions. Uncertain tax positions are defined by Interpretation No. 48 Accounting for Uncertainty in Income Taxes ( FIN48 ). We determined that we had no tax positions that met the definition of uncertainty under the provisions of FIN48.

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

**NOTE 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.

---

## **Table of Contents**

On October 3, 2007, we closed a public offering of 5,400,000 shares of our common stock at a price to the public of \$5.25 per share. We received net proceeds from this offering of approximately \$26,199,000, after deducting underwriting discounts and commissions and costs and expenses associated with the offering.

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

### **NOTE K ASSET RETIREMENT OBLIGATIONS**

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

### **NOTE L RECENT ACCOUNTING PRONOUNCEMENTS**

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

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

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

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

*Level 3:* Unobservable inputs reflecting management's own assumptions about the inputs used in pricing the asset or liability. As of June 30, 2008, substantially all of the fair values of the Company's financial assets and liabilities were categorized as Level 1.

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

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations (revised-2007)* ( SFAS No. 141(R) ). SFAS No. 141(R) is a revision to previously existing guidance on accounting for business combinations. The statement retains the fundamental concept of the purchase method of accounting, and introduces new requirements for the recognition and measurement of assets acquired, liabilities assumed and noncontrolling



## **Table of Contents**

interests. SFAS No. 141(R) also requires acquisition related transaction and restructuring costs to be expensed rather than treated as part of the cost of the acquisition. SFAS No. 141(R) applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company is currently evaluating the impact this statement will have on its financial position and results of operations and does not expect this statement to have a material impact on its financial position and results of operations.

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

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

## **NOTE M SUBSEQUENT EVENTS**

On July 24, 2008, Microgy Grand Island, LLC, referred to as Grand Island, a wholly owned subsidiary of the Company, closed the sale of tax-exempt bonds through the City of Grand Island, Nebraska resulting in gross proceeds of \$7,000,000. The proceeds are to be used to finance part of the construction costs of the proposed biogas facility to be located at the Grand Island, Nebraska beef processing facility of JBS Swift & Co. The bonds that Grand Island issued bear interest at 7% annually and mature on June 1, 2023. Grand Island is required to pay interest only through 2010 with level debt service thereafter. Of the proceeds of the bonds, \$700,000 was deposited into a debt service reserve fund to be used to pay interest and principal in the event Grand Island does not have sufficient funds to do so.

---

## **Table of Contents**

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

*You should read the following discussion together with our financial statements and accompanying notes included in this quarterly report and our audited financial statements included in our annual report on Form 10-K for the year ended December 31, 2007 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 Corporation (the "Company") is a developer, owner, and operator of renewable energy production facilities. The Company's goal is to produce Energy that is . . . Beyond Renewable<sup>®</sup>, which the Company defines as energy that not only uses waste materials instead of limited resources, but that also is clean, reliable, and cost-effective.

Microgy, Inc., a wholly owned subsidiary of the Company ("Microgy"), is a developer of renewable energy facilities for the production and commercial application of methane-rich biogas produced from livestock and food industry wastes, as well as wastes from other organic sources. The biogas can be sold to an end user or used to produce pipeline-grade methane, which we refer to as renewable natural gas, or RNG<sup>®</sup>, liquefied natural gas, or LNG, compressed natural gas, or CNG, renewable electrical energy or thermal energy as well as other useful by-products. The Company's systems utilize a proven biogas production technology that we believe is superior to other such technologies.

Microgy intends to continue to focus on a 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 produced by such facilities, as well as sales of greenhouse gas sequestration credits or other marketable environmental benefits. The strategy encompasses the construction and operation of stand-alone merchant 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.

Microgy began 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. The gas is treated and compressed to produce pipeline-grade methane that is sold as a commodity and delivered directly into nearby natural gas pipelines. Huckabay Ridge is expected to produce approximately 635,000 million British Thermal Units, or MMBTUs, of pipeline-grade methane per year.

Microgy also operates 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 ("Dairyland"). The biogas from these projects is used by Dairyland to generate electricity.

Environmental Power and Microgy pursue Microgy's business through several subsidiaries and special purpose entities. The principal such entity is Microgy Holdings, LLC, which was formed in 2006 as a subsidiary of Environmental Power Corporation in connection with the \$60 million tax-exempt bond financing we completed in November 2006 relating to the construction and operation of four RNG<sup>®</sup> facilities in Texas, and which is expected to be the vehicle for our proposed tax-exempt bond financing in California relating to our proposed California projects. The assets financed by the debt financing are pledged as collateral to the Gulf Coast Industrial Development Authority of Texas, the lender. The debt held by Microgy Holdings is 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. Another such entity is Microgy Grand Island, LLC, which was formed to own and operate our Grand Island, Nebraska facility currently under construction, and which is the obligor under our tax-exempt bond financing for such facility described below.

In the past, the Company operated in two major segments: through Microgy, as described above, and through EPC Corporation and its subsidiary, Buzzard Power Corporation, as holder of a leasehold interest in a waste-coal fired generating facility in Pennsylvania known as the Scrubgrass facility. On February 29, 2008, we completed the

---

## **Table of Contents**

disposition of the leasehold interest in the Scrubgrass facility. As a result, for financial reporting purposes, we are now consolidating all segments of continuing operations and reporting the results of Buzzard as discontinued operations. We now operate only in Microgy's segment.

### **Discontinued Operations**

The Company's total assets declined from \$200,000,000 at December 31, 2007 to \$107,000,000 at June 30, 2008 due to the disposition of assets associated with discontinued operations as discussed below.

We formerly operated in an additional segment through our subsidiary, EPC Corporation, and its subsidiary, Buzzard Power Corporation, the holder of a leasehold interest in a waste-coal fired generating facility in Pennsylvania known as the Scrubgrass facility. 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.

The assets and liabilities of Buzzard have been accounted for as discontinued operations for sale for all periods presented in accordance with the criterion established in Statement of Financial Accounting Standard (SFAS) No. 144 *Accounting for Impairment or Disposal of Long-Lived Assets*. We no longer have a continuing involvement with the Buzzard business since we disposed of the leasehold interest in the Scrubgrass facility and do not continue any revenue or cost-generating activities related to Buzzard. In accordance with SFAS No. 144, the accompanying consolidated balance sheets and statements of operations report the assets, liabilities and operations of Buzzard as discontinued.

### **RESULTS OF OPERATIONS**

The following Management's Discussion and Analysis of Financial Condition and Results of Operations compares the results of operations for the three and six month periods ended June 30, 2008 with the results of operations for the three and six month periods ended June 30, 2007. Historical results and trends that might be discussed below should not be taken as indicative of the results for the full year or from future operations generally.

#### **SIX MONTHS ENDED JUNE 30, 2008 COMPARED TO SIX MONTHS ENDED JUNE 30, 2007.**

**Overview** For the six months ended June 30, 2008, we had a net loss applicable to common shareholders of \$2,453,000 or loss per share of \$0.16, compared to a net loss applicable to common shareholders of \$8,771,000 or loss per share of \$0.89, for the six months ended June 30, 2007. The reduction in net loss applicable to common shareholders is entirely attributable to the gain on disposal of discontinued operations. For the six months ended June 30, 2008 the combined results of operations of discontinued operations and gain on disposal of discontinued operations were income of \$6,989,000 or \$0.45 per share. For the six months ended June 30, 2007 the results from discontinued operations were a loss of \$2,900,000 or \$0.29 a share. The income from discontinued operations for the six months ended June 30, 2008 more than offset the increase in the loss from continuing operations. The loss from continuing operations for the six months ended June 30, 2008 was \$8,775,000 as compared to a loss from continuing operations of \$5,201,000 for the six months ended June 30, 2007.

**Revenues** Revenue for the six months ended June 30, 2008 increased to \$2,083,000 from \$542,000 for the six months ended June 30, 2007 an increase of 284%. The increase is attributable to revenues from the Huckabay Ridge facility which began operations in February 2008 and had revenues of \$1,346,000 for the six months ended June 30, 2008. The remainder of the increase in revenues was due to sales of greenhouse gas offset credits. During the first six months of 2008 we recorded approximately \$198,000 in revenue from sales of these credits. We currently expect revenues to increase in future periods as operations at the Huckabay Ridge facility become more reliable and additional facilities are completed.

---

**Table of Contents**

**Operations and maintenance** For the six month period ended June 30, 2008 operations and maintenance expense was \$3,253,000 or \$2,792,000 more than for the same period in 2007. The increase was due to operations and maintenance expense of \$2,994,000 at Huckabay Ridge during the first six months of 2008. Huckabay Ridge began commercial operation in February 2008 so it did not have any operations and maintenance expense in 2007. We currently expect operations and maintenance expense at the Huckabay Ridge facility to decrease as operations at such facility become more reliable, though we expect an overall increase in operations and maintenance expenses in future periods as additional facilities are completed.

**General and administrative.** General and administrative expenses from continuing operations increased by \$872,000 to \$6,873,000 for the six months ended June 30, 2008, as compared to \$6,001,000 for the same period in 2007. Non-cash compensation expense for stock options, restricted stock and stock appreciation rights was \$1,405,000 and \$1,437,000 for the six months ended June 30, 2008 and 2007, respectively. The principal reasons for the increase in general and administrative expenses were increases in payroll costs, due to higher employee headcount, travel and entertainment and development costs associated with our efforts to develop new facilities. We have been increasing our staff and our development efforts as we seek to execute on our development plans. These increases in general and administrative expenses also included an increase in professional fees.

**Depreciation and amortization.** Depreciation and amortization expense increased to \$614,000 for the six months ended June 30, 2008, as compared to \$148,000 for the six months ended June 30, 2007. The increase in depreciation and amortization expense was principally due to the fact that the first six months of 2008 included five months of depreciation of the Huckabay Ridge facility, which began commercial operations in February 2008, whereas no such depreciation and amortization expense was recorded in the same period in 2007.

**Operating Loss.** As a result of the changes described above, our operating loss from continuing operations increased to \$8,657,000 for the first six months of 2008 from \$6,068,000 in the same period in 2007.

**Interest income.** Interest income for the six months ended June 30, 2008 was \$347,000 as compared to \$291,000 for the six months ended June 30, 2007. Interest income increased principally because of higher invested cash balances in the six months ended June 30, 2008 as compared to the same period in 2007 due to the funds received from our public offering in October 2007.

**Interest expense, net.** Interest expense, net, increased to \$442,000 for the six months ended June 30, 2008, as compared to \$6,000 for the six months ended June 30, 2007. This increase was due to the fact that we ceased the capitalization of interest expense related to the Huckabay Ridge facility when it began commercial operations in February 2008. The interest expense related to the portion of the bonds allocated to finance the Huckabay Ridge facility is now recorded as interest expense.

**Other income (expense).** We had other expense of \$22,000 for the six months ended June 30, 2008, as compared to other income of \$583,000 for the six months ended June 30, 2007. The other income in 2007 was the one-time recognition of the reversal of a reserve resulting from the expiration of the statute of limitations on a contingent obligations related to the sale of a project in 2001. Other expense in the six months ended June 30, 2008 was comprised of loss on disposal of fixed assets.

**Income tax expense (benefit).** Because we are not assured of realizing the benefits of operating losses for tax purposes, we did not record an income tax benefit for losses incurred for the six months ended June 30 of 2008 or 2007.

**Income (loss) from discontinued operations, net of taxes.** The results for the six months ended June 30, 2008 include the results of discontinued operations for the two months ended February 29, 2008. We disposed of Buzzard's interest in the Scrubgrass facility on February 29, 2008 and recognized a one time gain of \$8,000,000 in the six months ended June 30, 2008 as a result of this disposition. With the exception of a cash payment of \$375,000, the gain was non-cash and consisted principally 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 in the amount 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. The net result of loss from discontinued operations and gain on disposal of discontinued operations for the six months ended June 30, 2008 was income of \$6,989,000.

**Table of Contents**

**THREE MONTHS ENDED JUNE 30, 2008 COMPARED TO THREE MONTHS ENDED JUNE 30, 2007.**

**Overview.** For the three months ended June 30, 2008, we had a net loss applicable to common shareholders of \$5,293,000 or loss per share of \$0.34, compared to a net loss applicable to common shareholders of \$7,089,000 or loss per share of \$0.71 for the three months ended June 30, 2007. The net loss applicable to common shareholders declined in 2008 because for the three months ended June 30, 2007, we had a loss from discontinued operations of \$3,235,000 which offset an increase in the net loss from continuing operations.

**Revenues.** Revenue for the three months ended June 30, 2008 increased to \$1,112,000 from \$327,000 for the three months ended June 30, 2007 an increase of 240%. The increase is attributable to revenues from the Huckabay Ridge facility which began operations in February 2008 and had revenues of \$790,000 for the quarter ended June 30, 2008 whereas such facility was still under construction and had no such revenues in the quarter ended June 30, 2007. We currently expect revenues to increase in future periods as operations at the Huckabay Ridge facility become more reliable and additional facilities are completed.

**Operations and maintenance.** For the three month period ended June 30, 2008 operations and maintenance expense was \$1,937,000 as compared to \$244,000 for the same period in 2007, an increase of \$1,693,000. The increase was due to operations and maintenance of \$1,924,000 at Huckabay Ridge during the second quarter of 2008. Huckabay Ridge began commercial operation in February 2008 so it did not have any operations and maintenance expense in 2007. We currently expect operations and maintenance expense at the Huckabay Ridge facility to decrease as operations at such facility become more reliable, though we expect an overall increase in operations and maintenance expenses in future periods as additional facilities are completed.

**General and administrative.** General and administrative expenses from continuing operations were essentially the same, decreasing by \$44,000 to \$3,611,000 for the three months ended June 30, 2008, as compared to \$3,656,000 for the same period in 2007.

**Depreciation and amortization.** Depreciation and amortization expense increased to \$354,000 for the three months ended June 30, 2008, as compared to \$77,000 for the three months ended June 30, 2007. The increase in depreciation and amortization expense was principally due to the fact that the second quarter of 2008 included three months depreciation of the Huckabay Ridge facility, which began commercial operations in February 2008, whereas no such depreciation and amortization expense was recorded for the same period of 2007.

**Operating Loss.** As a result of the changes described above, our operating loss from continuing operations increased to \$4,789,000 in the second quarter of 2008 from \$3,650,000 in the same period in 2007.

**Interest income.** Interest income for the three months ended June 30, 2008 was \$100,000 as compared to \$132,000 for the three months ended June 30, 2007. Interest income decreased primarily due to lower interest rates on invested cash balances.

**Interest expense, net.** Interest expense, net, increased to \$265,000 for the three months ended June 30, 2008, as compared to \$2,000 for the three months ended June 30, 2007. This increase was due principally to the fact that we ceased the capitalization of interest expense related to the Huckabay Ridge facility when it began commercial operations in February 2008. The interest expense related to the portion of the bonds allocated to finance the Huckabay Ridge facility is now recorded as interest expense.

**Other income (expense).** We had other expense of \$9,000 for the three months ended June 30, 2008, as compared to other income of \$0 for the three months ended June 30, 2007.



## **Table of Contents**

**Income tax expense (benefit).** Because we are not assured of realizing the benefits of operating losses for tax purposes, we did not record an income tax benefit for losses incurred for the three months ended June 30 of 2008 or 2007.

**Income (loss) from discontinued operations, net of taxes.** The results for the three months ended June 30, 2008 do not include the results of discontinued operations because these operations were disposed of in February 2008.

## **LIQUIDITY AND CAPITAL RESOURCES**

### ***Introduction***

The following discussion and analysis of our liquidity and capital resources is based on a comparison of balance sheet amounts at June 30, 2008, with balance sheet amounts at December 31, 2007 after the disposal of assets and liabilities related to discontinued operations. In addition, certain significant balance sheet changes resulted from the reclassification of certain items due to the achievement of commercial operations at our Huckabay Ridge facility, as described in greater detail below.

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

**Cash.** The decline in our cash position is explained on the statement of cash flows.

**Restricted Cash.** The increase in the restricted cash balance reflects interest income earned on the balance. There were no drawdowns from restricted cash in the second quarter of 2008 due to the early stages of engineering and construction activities at our other projects in Texas. In addition, we deposited additional cash into an escrow account as part of an agreement with one of our contractors

**Property, plant and equipment, net and construction in progress.** The increase in the balance of property plant and equipment at June 30, 2008 of \$24,258,000 from \$261,000 at December 31 2007 to \$24,519,000 at June 30, 2008 is due principally to the completion of the Huckabay Ridge facility and the reclassification of the completed construction costs to property plant and equipment from construction in progress. The total cost of the Huckabay Ridge facility, including capitalized interest and financing costs, was \$24,446,000, of which \$22,768,000 was included in construction in progress at December 31, 2007. This reclassification in costs associated with the Huckabay Ridge facility is the reason for the decline in the balance in construction in progress, which was partially offset by capital expenditures on other projects.

### ***Operating Activities***

Our net cash used in operating activities was \$5,274,000 for the six months ended June 30, 2008, compared to cash used in operating activities of \$6,723,000 for the same period in 2007. We reported a net loss from continuing operations of \$8,775,000 and net income from discontinued operations of \$6,989,000 for the six months ended June 30, 2008. The following adjustments need to be considered in order to reconcile our net income in the six months ended June 30, 2008 to our net cash used in operating activities:

**Results of discontinued operations.** The results of discontinued operations include non-cash items including a gain of \$2,570,000 which had previously been deferred as a credit on our balance sheet, as well as the forgiveness of an outstanding loan with a balance of \$3,456,000 and elimination of other obligations in the amount of \$1,630,000.

**Depreciation and amortization.** During the six months ended June 30, 2008, we recognized depreciation and amortization expense for licensed technology rights of \$92,000, property plant and equipment of \$511,000 and other amortization of approximately \$11,000.

**Stock-based compensation.** Accounting for options, restricted stock and stock appreciation rights issued to employees resulted in non-cash compensation expenses of \$1,405,000 for the six months ended June 30, 2008, as compared to \$1,437,000 in such expenses for the same period in 2007.

## **Table of Contents**

### ***Investing Activities***

Our cash used for investing activities was \$6,404,000 for the six months ended June 30, 2008, as compared to \$1,221,000 in the same period in 2007. Our investing activities were concentrated primarily in the following areas:

**Restricted cash.** We are required to hold cash associated with our Texas tax-exempt bond financing with a third party disbursement agent. On June 30, 2008, the disbursement agent was holding balances of \$45,624,000 in bond proceeds, compared to \$45,785,000 on December 31, 2007. We also hold \$547,000 in a restricted cash fund to fund our asset retirement obligation at the Huckabay Ridge facility. The increase in restricted cash reflects interest income earned on invested restricted cash balances. In addition at June 30, 2008 we had an additional escrow account of \$865,000 as part of a contractual arrangement.

**Construction of projects.** For the six months ended June 30, 2008 we incurred expenditures of \$5,695,000 related to the construction of projects, including the completion of the Huckabay Ridge facility.

**Property, plant and equipment.** Property, plant and equipment expenditures were approximately \$322,000.

### ***Financing Activities***

Our cash used for financing activities was \$996,000 for the six months ended June 30, 2008, compared to cash provided by financing activities of \$2,190,000 in the six months ended June 30, 2007. We offer the following information concerning the financing activities for our business:

**Dividend payments on preferred stock.** In January 2008, we made semi-annual dividend payments of approximately \$667,000 on our Series A 9% cumulative convertible preferred stock.

**Exercise of stock options and warrants.** There were no exercise of stock options or warrants during the first six months of 2008. Stock option and warrant exercises in the six months ended June 30, 2007 provided proceeds of \$2,876,000.

## **2008 Outlook**

### ***Operations***

The following forward-looking information concerning our anticipated results of operations for the full year 2008 is being compared to our historical results of operations for 2007.

We expect increased revenues during 2008, as we recognize sales of RNG<sup>®</sup> from our Huckabay Ridge facility in Texas, which began commercial operations in February 2008. Our revenues related to the Wisconsin facilities are expected to be consistent with revenues from such facilities in 2007.

We completed sales of greenhouse gas offset credits related to our Wisconsin facilities that were related to the years 2005 and 2006 during the first six months of 2008 and recorded income of \$198,000 from these sales which represented 50% of the total proceeds of \$396,000 from these sales. We share the proceeds of such sales equally with the owners of the Wisconsin facilities in accordance with the contractual provisions related to such facilities.

With the completion of modifications to the gas conditioning system and front-end manure processing systems, we expect our Huckabay Ridge facility to be capable of achieving an operating rate equal to its annualized production target of 635,000 MMBtus per year. However, we expect production at the Huckabay Ridge facility to vary during 2008 until gas conditioning operations are optimized. The biogas production process is currently performing as anticipated at the Huckabay Ridge facility. In addition, with the receipt of the Type V waste management permit for the Huckabay Ridge facility from the State of Texas, grease trap waste is the predominant material delivered to the site and used in the digesters with the manure. We are confident that there is a large quantity of grease trap waste available for co-digestion at the Huckabay Ridge facility from the surrounding area and that substrate supply will fully support production objectives for the foreseeable future.

## **Table of Contents**

As a result of the anticipated increased RNG<sup>®</sup> production, our operation and maintenance expenses are expected to increase during 2008 to reflect the commercial operation of the Huckabay Ridge facility. During the first five months of production, these costs were higher than normal due to start-up expenses, and we are likely to experience some additional start-up related expenses during the third quarter of 2008. Commissioning costs for the Huckabay Ridge facility were capitalized prior to the commencement of commercial operations on February 1, 2008.

The Huckabay Ridge facility operated at production levels significantly lower than that of expected steady state operations due to reliability issues related to the gas conditioning system. We expect production levels to continue to vary as we make improvements to the gas conditioning system, which improvements are expected to be completed later this year.

General and administrative expenses are expected to increase relative to last year as we prepare for the development of additional planned digester facilities. We will continue to incur increased costs associated with the growth of our business. For 2008, we expect an overall increase in general and administrative expenses as compared to 2007, as we increase our payroll to handle increased activities and incur non-capital development costs associated with various projects.

In addition to the Huckabay Ridge facility, our other planned Texas projects are in various stages of our normal development process. Development activities include finalizing off-take agreements, firming up manure and substrate-supply on the best possible terms, identifying and establishing construction contractors, and finalizing standard designs, taking into account our experience from the Huckabay Ridge facility. Our Cnossen and Rio Leche projects are in the engineering and early stages of construction. We held a ground breaking ceremony for our Rio Leche project on June 11, 2008, and expect to hold such a ceremony for the Cnossen project on August 6, 2008.

We have commenced construction on the JBS Swift project in Grand Island, Nebraska. On July 24, 2008 we received \$7,000,000 in tax exempt bond financing, less certain closing costs, from the city of Grand Island, Nebraska for the project. The funds are currently restricted for use on the project and held by a trustee, to be disbursed to cover certain documented project expenses. The terms of this financing are set forth in greater detail in our Current Report on Form 8-K, dated July 22, 2008, as filed with the Securities and Exchange Commission on July 25, 2008.

All requisite water and air permits for the Riverdale, Hanford and Bar 20 projects in California have been approved. We have applied for approval of tax-exempt bond financing from an authority of the state of California for these projects. The California Debt Limit Allocation Committee approved \$32,500,000, \$32,900,000 and \$26,100,000 for the projects, respectively. We anticipate these arrangements will be similar to the tax exempt bond financing obtained for the Texas projects. We do not yet have any binding commitments for any further financing and we cannot assure you that any such financing will be available to us on favorable terms, or at all.

## ***Cash Flow Outlook***

During the remainder of 2008 and early 2009, we expect to fund our business activities principally from available cash balances, investment earnings, raising additional funds through debt and or equity financings by Environmental Power, Microgy or their affiliates and project-specific financing, to the extent available. The requirement for additional financing will be in direct proportion to the number of projects on which we begin construction, as well as our construction schedule. We will require significant additional capital over the next twelve months in order to continue to fund our planned construction program on its current schedule.

Having been issued the requisite permits and obtained volume cap allocations for tax-exempt bond financing for our three California projects, we are now entering the build-out phase for these projects. Our construction schedule presently contemplates a start-to-completion cycle of twelve months. Proceeds from the California bond issue, if successful, are expected to total approximately \$85 million and will be used to cover not only construction costs but also debt-service and other normal reserves. Terms of the bond financing are expected to require that we first invest equity in an amount equal to at least 20% of the estimated costs of construction (similar to the terms of the bond-financings for our Texas projects) before bond funds become available to us. Based on our current planned construction schedule, we estimate that we will need to raise approximately \$18 million to fund our equity requirements for the California projects over the next year. In addition, we will need to raise equity for the remaining Texas projects over the next year. The aggregate amount has not been defined and will depend upon several factors, including timing of equipment-procurement and the outcome of discussions with our local partner on Mission to improve project economics prior to buildout.

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

With the recent closing on the tax-exempt bond issue for the Microgy Grand Island project, financing of that project is complete and no further equity is expected to be required.

As of June 30, 2008, we had unrestricted cash on hand of \$13 million. We will need to augment these cash resources by additional capital over the next year to cover our project equity requirements described above, as well as ongoing general and administrative expenses and dividend requirements. We have been in discussions with investment banks regarding various financing alternatives and, while we cannot assure success, we believe that we have the ability to raise additional capital on reasonable terms. We have also been in discussions with the holders of our series A preferred stock, whose approval would be required should we elect to pursue a financing other than the issuance of common stock.

Because our anticipated capital needs are based on estimates and assumptions and arise over the next several months, we are currently planning to raise such funding in increments as needed, with the goal of raising the first such increment late in the third quarter or early in the fourth quarter of 2008, although we may raise larger amounts if we can do so on favorable terms. Although we do not have any binding commitments for such financings, we are currently exploring several options and structures for such financing.

## **Table of Contents**

On June 30 2008, our unrestricted cash balance was \$13,395,000, as compared to \$26,069,000 as of December 31, 2007. In addition, our current restricted cash balances were \$46,489,000 and \$45,785,000, at June 30, 2008 and December 31, 2007, respectively. We have completed the draw down of funds and construction of the Huckabay Ridge facility. The restricted cash represents the remaining proceeds of our \$60 million tax-exempt bond financing. For each of the three additional planned RNG<sup>®</sup> facilities in Texas, we are able to spend up to \$15,000,000 from restricted cash, subject to certain restrictions and provided that we have first funded at least 20% of the expected cost of each such facility.

We believe that our current cash balance will be sufficient to fund our minimum lease and debt obligations, current contractual commitments, and our corporate overhead requirements through at least the end of 2008. However, we will require substantial additional financing, at both the project and parent company levels, to complete the construction of currently planned facilities, as noted above, including those already under construction. We currently have no binding commitments for such financing, and we cannot assure you that such financing will be available on terms favorable to us, or at all. If such financing is not obtained in a timely fashion, we will have to alter our construction schedule, and may have to substantially curtail our construction activities.

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

Our most significant risk exposure is changing interest rates which may effect 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 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 expect to finance Microgy's projects going forward with debt financing, which will be subject to prevailing interest rates.

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

As Microgy establishes multi-digester projects for the production of RNG<sup>®</sup>, we could become increasingly exposed to market risk with respect to natural gas prices, to the extent that this risk is not mitigated by long term off-take agreements. Historically, natural gas prices have been volatile, and we expect such volatility to continue. Fluctuations in the commodity price of natural gas may have a materially adverse impact on the profitability of some of our facilities; particularly where we do not have a long-term contract for the sale of the facility's output at a fixed or predictable price. At such time as Microgy's facilities begin to produce commercial quantities of gas for sale as a commodity, we intend to explore various strategies, including hedging transactions and the like, in order to mitigate the associated commodity price risk. In connection with our Texas bond financing, we are required to maintain certain gas price protection arrangements for the gas output of our Texas facilities. In connection with this obligation, Microgy Holdings LLC has entered into an agreement to sell up to 2,000 MMBtu per day of the output of our Huckabay Ridge facility to a counterparty under a collared product pricing arrangement for a term of 18 months beginning April 2007 and ending in October 2008. Beginning October 1, 2008 Microgy will begin deliveries of RNG<sup>®</sup> from the Huckabay facility to Pacific Gas and Electric. The parties signed a 10-year agreement which allows PG&E to purchase up to 8,000 MMBtu of pipeline quality renewable natural gas daily from Microgy's California and Huckabay facilities at a fixed rate reflecting the renewable character of our natural gas.

---

**Table of Contents**

***Substrate Costs***

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

**Item 4. Controls and Procedures**

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2008. 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.

Based on the evaluation of our disclosure controls and procedures as of June 30, 2008, our chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were not effective at a reasonable assurance level as a result of the material weakness in our internal control over financial reporting described below.

Our management, with the participation of our chief executive officer and chief financial officer, evaluated whether any changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the fiscal quarter ended June 30, 2008 have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on the evaluation we conducted, management has concluded that the material weakness in our internal control over financial reporting described below continued to impact our internal control over financial reporting as of June 30, 2008.

A material weakness is a significant deficiency (as defined in Public Company Accounting Oversight Board Auditing Standard No. 5), or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. In connection with the preparation of our financial statements for the year ended December 31, 2007 and our related evaluation of our internal controls and procedures, we identified aspects of our controls and procedures that require either improvement or better documentation. In most instances, the required step is simply a more formal approach to a routine process in order to meet reasonable-assurance levels. As we enter a growth phase, we have retained additional financial expertise and have already implemented a number of measures to address identified areas requiring attention. Some of the specific remedial measures that we have already adopted to address these points are described in Part II, Item 9A of our Annual Report on Form 10-K for the year ended December 31, 2007, referred to as the 2007 Form 10-K, which description is incorporated herein by reference. Identification and implementation of remaining requirements have been and remain paramount objectives as we planned and now

## **Table of Contents**

complete our transition to new headquarters in Tarrytown, New York. Management is confident that the measures necessary to address the identified issues will be completed and any remaining requirements will be implemented this year.

During the last two quarters of the year ended December 31, 2007, management completed testing of our internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) and identified certain items as material weaknesses. These material weaknesses are described in greater detail in Part II, Item 9A of the 2007 Form 10-K, which description is incorporated herein by reference. Management has implemented or is in the process of implementing remedial measures in our internal controls over financial reporting as they relate to these control areas. These remedial measures are also described in greater detail in Part II, Item 9A of the 2007 Form 10-K, which description is incorporated herein by reference.

Because some of these improvements are still in the process of being implemented or have only recently been implemented, our management has determined that the controls described in Part II, Item 9A of the 2007 Form 10-K remained inadequate and ineffective as of June 30, 2008. However, we believe that we have taken or are taking the appropriate steps to remediate these material weaknesses and to ensure that our disclosure controls and procedures will be effective at a reasonable assurance level in future periods. We will continue to implement and test our remediation activities.

Except as noted above, there was no change 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 June 30, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Notwithstanding the weaknesses discussed above, the Company has never been required to restate the financial statements for a material misstatement.

## **PART II. OTHER INFORMATION**

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

We are not a party to any material legal proceedings.

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

You should carefully consider the following risk factors, in addition to other information included in this quarterly report on Form 10-Q and the other reports that we file with the Securities and Exchange Commission, in evaluating our business. If any of the following risks occur, our business, financial condition and operating results could be materially adversely affected. The following risk factors include any material changes to and supersede the risk factors previously disclosed in our annual report on Form 10-K for the year ended December 31, 2007.

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

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

We have a history of losses. For the six months ended June 30, 2008 we incurred a loss from continuing operations of \$8,775,000. For the twelve months ended December 31, 2007, we incurred a net loss of \$11,200,000 from continuing operations. For the years ended December 31, 2006, and 2005, we incurred net losses of \$11,400,000, and \$8,800,000, respectively, from continuing operations. 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. These ongoing losses will adversely affect our financial condition through at least 2008. As a result of these losses, we anticipate that we will, in all likelihood, have to rely on external financing for most of our capital and operational requirements. Future losses are likely to continue unless we successfully implement our business plan. If we are not successful in reaching and maintaining profitable operations, we may not be able to attract sufficient capital to continue our operations. Our inability to obtain adequate financing would likely result in the need to curtail or cease our business operations and, consequently, a much lower price for our common stock.

## **Table of Contents**

*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 experienced challenges during the startup and commissioning process for the Huckabay Ridge facility, and is currently in the process of making significant upgrades to the gas conditioning system in order to achieve anticipated performance levels. While we gained valuable knowledge as to our processes, 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 offset credits or other tradable environmental attributes;

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 common stock will be materially adversely affected.

## **Table of Contents**

***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 2009, 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. 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. Such financing may not be available to us on acceptable terms, or at all. If we are unable to obtain the required financing, your investment in our common stock will be materially adversely affected.

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

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

***Microgy is expected to derive a significant portion of its revenues from the sale of gas as a commodity; as a result, it will be exposed to risk relating to volatility in the commodity price of natural gas, which could have a material adverse impact on its profitability.***

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

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, we cannot assure you that any such risk management vehicles will be available or successful. As a result, any such facility, and Microgy as a whole, may experience substantial adverse fluctuations in its natural gas revenues and related profitability.

---

**Table of Contents**

*We expect revenues from sales of greenhouse gas offset 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 offset 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 offset credits or other environmental attributes.

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

We have invested, and expect to invest, substantial funds and resources in the Huckabay Ridge facility and the other multi-digester, renewable natural gas facilities in Texas. We have pledged all of our interest in these facilities as collateral security for the loan to our subsidiary, Microgy Holdings, from the Gulf Coast Industrial Development Authority of Texas relating to the \$60 million tax-exempt bond financing we completed in November 2006. While the loan is non-recourse to Environmental Power, Environmental Power is required to provide at least 20% of the construction costs of these facilities, as well as to cover any cost overruns in construction, which represents a substantial investment of corporate resources. If Microgy Holdings were to default on this loan, we would lose some or all of our investment in the Texas facilities, which would have a material adverse effect on our business, financial condition and results of operations.

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

Microgy plans to generate revenue from the development and ownership of facilities that market renewable, green energy in addition to providing pollution control features to the agricultural and food industry markets. Microgy's green competitors include other energy producers using biomass combustion, biomass anaerobic digestion, geothermal, solar, wind, new hydro and other renewable sources. These companies represent a significant class of competitors because they will compete with Microgy for sale of marketable renewable energy credits and participation in various renewable portfolios and other programs.

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

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

---

**Table of Contents**

for access to substances that make desirable substrates with other users of these substances, such as recyclers of waste grease and producers of biodiesel and other biofuels. The effect of such competition could be reflected in higher costs associated with obtaining access to these resources, as well as an insufficient supply of these resources for the profitable operation of Microgy's facilities. If Microgy cannot obtain and maintain these supplies, or cannot obtain or maintain them at reasonable costs, the profitability of Microgy's business will be adversely affected.

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

Microgy's facilities, and the anaerobic digestion process on which they are based, are complex and, therefore, sensitive to extreme weather events. For instance, the anaerobic digestion process requires temperatures within a certain band, and extreme cold or heat may negatively impact the process or increase operating costs as a result of the need to counter such temperatures. For instance, Texas experienced record cold temperatures in early 2007 which negatively impacted the startup of the Huckabay Ridge facility. Furthermore, our Grand Island, Nebraska facility, currently under construction, is located in a region known for intense thunderstorms and tornado activity. In addition, unusually heavy rains can upset the proper mix of inputs necessary for the anaerobic digestion process, and facilities can also be sensitive to lightning strikes. While Microgy considers typical local weather conditions in the design of its facilities, Microgy cannot anticipate 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.

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

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

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

Neither Microgy nor, we believe, Microgy's licensor has filed any patent applications on the intellectual property which forms the basis of Microgy's technology. Should Microgy or its licensor decide to file patent applications, we cannot assure you that any patent applications relating to Microgy's existing or future products or technologies will result in patents being issued, that any issued patents will afford adequate protection to Microgy, or that such patents will not be challenged, invalidated, infringed or circumvented. Furthermore, we cannot assure you that others have not developed, or will not develop, similar technologies that will compete with Microgy's without infringing upon Microgy's intellectual property rights or those of its licensor.

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

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

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

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

## **Table of Contents**

thereafter. For example, grease-trap waste from restaurants and other food service providers is a desirable and highly available form of substrate for our facilities in Texas. However, the Texas environmental authorities required that we obtain a solid-waste permit for each of our planned facilities in Texas to the extent we desire to use grease-trap waste as substrate in the operation of such facilities. Furthermore, for our planned California facilities, we have had to obtain water discharge permits, 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.

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

Microgy's facilities produce and emit into the atmosphere carbon dioxide as a result of the anaerobic digestion process that they employ. While such facilities capture 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 offset credits, reduce the greenhouse offset credits claimed for such facilities or take similar actions. Any of the foregoing could harm the profitability of Microgy's facilities.

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

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

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

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

the success or failure of the facilities currently underway;

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

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

other unforeseen activities or issues.

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

*We have identified material weaknesses in our internal control over financial reporting that have not yet been effectively remediated. Any inability on our part to remediate these material weaknesses promptly and effectively, or any material weaknesses in our internal control over financial reporting that we discover and report in the future, may result in material misstatements of our financial statements, class action litigation or delisting of our stock.*

We identified material weaknesses in our internal control over financial reporting as discussed in Part II Item 9A of our Annual Report on Form 10-K for the year ended December 31, 2007. As discussed above under Part II Item 4 of this Quarterly Report on Form 10-Q, these material weaknesses have not yet been fully remediated. If the remedial measures described in Item 4 are insufficient to address any of the identified material weaknesses, or if additional material weaknesses or significant deficiencies in our internal control are discovered in the future, we may fail to meet our future reporting obligations on a timely basis, our financial statements may contain material misstatements, our operating results

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

may be harmed, we may be subject to class action litigation, and our common stock may be delisted from The NASDAQ Capital Market. For example, material weaknesses that remain unremediated could result in material post-closing adjustments in future financial statements. Any failure to address

**Table of Contents**

the identified material weaknesses or any additional material weaknesses or significant deficiencies in our internal control could also adversely affect the results of the periodic management evaluations regarding the effectiveness of our internal control over financial reporting that are required to be included in our annual reports on Form 10-K. Internal control deficiencies could also cause investors to lose confidence in our reported financial information. We cannot assure you that the measures we have taken to date or any future measures will remediate the material weaknesses identified or that any additional material weaknesses will not arise in the future due to a failure to implement and maintain adequate internal control over financial reporting or circumvention of these controls. In addition, even if we are successful in strengthening our controls and procedures, those controls and procedures may not be adequate to prevent or identify irregularities or facilitate the fair presentation of our financial statements or reports we file with the Securities and Exchange Commission.

**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 are now available for sale in the market pursuant to Rule 144 under the Securities Act of 1933. As of June 30, 2008, we had approximately 1,275,320 shares of restricted common stock outstanding, including approximately 2,823,659 shares of common stock issuable upon conversion of our series A preferred stock all of which shares are eligible for resale without volume and manner of sale restrictions in accordance with Rule 144. We are currently authorized to issue 50,000,000 shares of common stock.

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

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

As of June 30, 2008, we had outstanding options and warrants to acquire up to approximately 5,185,776 shares of our common stock at prices ranging from \$1.75 to \$10.50 per share. The shares of common stock issuable upon exercise of these options will be freely transferable without restriction, except to the extent that they are held by our affiliates. Any shares held by our affiliates may only be sold in compliance with the volume limitations of Rule 144. These volume limitations restrict the number of shares that may be sold by an affiliate in any three-month period to the greater of 1% of the number of shares then outstanding, which equals approximately 156,000 shares as of June 30, 2008, 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.

## **Table of Contents**

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 June 30, 2008, management and directors, including Richard E. Kessel, Joseph E. Cresci, Roger Ballentine, Kamlesh R. Tejwani, Robert I. Weisberg, John R. Cooper, August Schumacher, Jr., Lon Hatamiya, Steven Kessner, Michael E. Thomas and Dennis Haines, beneficially owned approximately 15.3% 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 15.3% 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 June 1, 2008 to June 30, 2008, our daily trading volume ranged from a low of 29,200 shares to a high of 239,900 shares, and averaged 83,875 shares. We cannot guarantee that a consistently active trading market will develop in the future. As a result, a holder of our common stock may find it difficult to dispose of our common stock.

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

The market price for our common stock has been volatile, and it is likely to continue to be so. In addition, the market price for our common stock could be subject to significant fluctuations in response to variations in quarterly operating results, announcements of technological innovations or new facilities and products by us or our competitors, or our failure to achieve operating results consistent with any securities analysts' projections of our performance. Furthermore, the stock market has experienced extreme price and volume fluctuations and volatility that have particularly affected the market price of many emerging growth and development stage companies such as ours. Such fluctuations and volatility have often been unrelated or disproportionate to the operating performance of such companies. As a result of fluctuations related or unrelated to our performance, the value of our common stock may be materially adversely affected.



---

**Table of Contents**

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

We have historically needed to raise capital to fund our operating losses. We expect to continue to incur operating losses through at least 2008. In November 2006, we completed a tax-exempt bond financing in Texas to finance a portion of the construction costs of our Texas facilities, as well as a \$15 million private placement of our series A preferred stock and common stock warrants. In October 2007, we completed a public offering resulting in net proceeds to us of approximately \$26.6 million. We will require and will continue to seek corporate and project financing to fund our ongoing overhead and growth plans as well as the cost of any development we may decide to pursue for our facilities. We cannot assure you that such capital will be available in sufficient amounts or on terms acceptable to us, if at all. Any such financing could be in the form of debt or equity instruments or a combination of debt and equity instruments. To the extent any such financing involves equity or convertible debt, we may issue a significant number of shares of our common stock or preferred stock, which will dilute your investment in our common stock, and we may issue such shares at prices that may be lower than the price you paid for our common stock. In addition, if we issue shares of preferred stock, such preferred stock may have rights and preferences that are superior to those of our common stock. Indeed, the shares of 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, of which 15,712,534 are issued and outstanding and 5,185,776 have been reserved for issuance upon the exercise of options and warrants outstanding as of June 30, 2008. An additional 2,823,660 shares have been reserved for issuance in connection with the conversion of shares of our series A preferred stock issued in our November 2006 private placement. We may also issue warrants to purchase up to 4.99% of our common stock, on a fully diluted basis, to Cargill, Incorporated pursuant to the terms of our business development agreement. In May 2007, we issued warrants to purchase 175,912 shares of our common stock at an exercise price \$5.37 per share, representing 1% of our fully diluted common stock at the time to Cargill as required by the business development agreement. Additionally, in October 2007, we issued 5,400,000 shares of common stock in an underwritten public offering. We also have the authority to issue preferred stock as previously described, debt securities convertible into common stock, and options and warrants to purchase shares of our common stock. We may issue shares of common stock or securities convertible into common stock at values below our market price up to a maximum of 19.9% of our outstanding common stock without stockholder approval, which values may be substantially below the price paid for our common stock by our stockholders. We also do not need stockholder approval to issue an unlimited number of shares of common stock or securities convertible into common stock (provided sufficient shares of common stock are authorized and unreserved) at or above the market price for our common stock pursuant to certain NASDAQ Stock 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 two times the stated value of each share of preferred stock, plus any accrued but unpaid dividends;

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

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



**Table of Contents**

Our series A preferred stock may also have a material adverse effect on our financial condition and results of operations. We have agreed not to issue securities senior to or on a par with the series A preferred stock and to limit our ability to incur additional indebtedness while such preferred stock is outstanding, which could materially and adversely affect our ability to raise funds necessary to continue our business. In addition, the series A preferred stock provides for various triggering events, such as our common stock not being listed for trading on the American Stock Exchange, NASDAQ Global Market, 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. Some of the triggering events include matters over which we may have some, little, or no control. Any such redemption could leave us with little or no working capital for our business. Furthermore, by virtue of their voting power and other rights and preferences, the outstanding series A preferred stock could have the effect of blocking or discouraging certain acquisitions of the company or reducing the proceeds available to common stockholders as a result of any such acquisitions.

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

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

Not applicable.

**Item 3. Defaults Upon Senior Securities**

Not applicable.

**Item 4. Submission of Matters to a Vote of Security Holders (Need votes From Scott)**

We held our Annual Meeting of Stockholders on June 11, 2008. At the Annual Meeting, our stockholders elected a Board of Directors to serve for the ensuing year until their respective successors have been duly elected and qualified. The results of the voting were as follows:

Elected as a Director	Number of Shares Voted in Favor	Number of Shares Withheld
Roger S. Ballentine	11,007,570	66,715
John R. Cooper	10,387,772	686,513
Joseph E. Cresci	11,009,609	64,676
Lon Hatamiya	10,385,779	688,506
Richard E. Kessel	11,010,179	64,106
Steven Kessner	10,388,079	686,206
August Schumacher, Jr.	10,387,630	686,655
Kamlesh R. Tejwani	10,998,435	75,850
Robert I. Weisberg	10,387,630	686,655

**Table of Contents**

In addition, our stockholders acted upon and approved the following item by the following vote:

<b>Item</b>	<b>Votes For</b>	<b>Votes Against</b>	<b>Abstained</b>	<b>Broker Non-Votes</b>
The ratification of our board of directors selection of Vitale, Caturano & Company, Ltd. as our Independent auditors for the fiscal year ending December 31, 2008.	<u>11,028,202</u>	<u>17,794</u>	<u>28,289</u>	0

**Item 5. Other Information**

Not Applicable

**Item 6. Exhibits**

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

**Table of Contents**

**SIGNATURES**

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

**ENVIRONMENTAL POWER CORPORATION**

By: /s/ Michael E. Thomas

Michael E. Thomas

Senior Vice President, Chief Financial Officer and Treasurer

(principal financial and accounting officer and authorized officer)

July 31, 2008

**Table of Contents**

**Table of Contents**

**Exhibit Index**

- 3.1 Restated Certificate of Incorporation of the Registrant, as amended (Incorporated by reference to Exhibit 3.01 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2007, as filed with the SEC on November 14, 2007 (SEC File No. 001-32393)).
- 3.2 Second Amended and Restated Bylaws of the Registrant (Incorporated by reference to Exhibit 3.01 to the Registrant's Current Report on Form 8-K dated December 7, 2007, as filed with the SEC on December 13, 2007 (SEC File No. 001-32393)).
- 3.3 Certificate of Designations, Preferences and Rights of the Registrant's Series A 9% Cumulative Convertible Preferred Stock (Incorporated by reference to exhibit 3.1 to the Registrant's Current Report on Form 8-K dated November 9, 2006, as filed with the SEC on November 14, 2006 (SEC File No. 001-32393)).
- 31.1 Rule 13a-14(a)/15d-14(a) Certifications of the Registrant's Chief Executive Officer.
- 31.2 Rule 13a-14(a)/15d-14(a) Certifications of the Registrant's Chief Financial Officer.
- 32.1 Section 1350 Certifications of the Registrant's Chief Executive Officer.
- 32.2 Section 1350 Certifications of the Registrant's Chief Financial Officer.