Energy Recovery, Inc.
Form 10-K
March 15, 2011

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington D.C. 20549
Form 10-K

(Mark One)

þ	**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934** **For the fiscal year ended December 31, 2010**
	or
o	**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: 001-34112
Energy Recovery, Inc.
(Exact Name of Registrant as Specified in Its Charter)

Delaware	**01-0616867**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification No.)*

1717 Doolittle Drive, San Leandro, CA 94577
(Address of Principal Executive Offices)

Registrant s telephone number, including area code:
(510) 483-7370

Securities registered pursuant to Section 12(b) of the Securities Exchange Act of 1934:

Title of Each Class	Name of Exchange on Which Registered
Common stock, $0.001 par value	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Securities Exchange Act of 1934:
None

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o   No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o   No þ

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 þ   No o

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

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 the definitions of large accelerated filer , accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

The aggregate market value of the voting stock held by non-affiliates amounted to $133.0 million on June 30, 2010.

The number of shares of the registrant s common stock outstanding as of March 7, 2011 was 52,603,629.

DOCUMENTS INCORPORATED BY REFERENCE

Parts of the Proxy Statement for the Registrant s Annual Meeting of Shareholders to be held in June 2011 are incorporated by reference into Part III of this Annual Report on Form 10-K.

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PART I

Item 1. *Business*

Overview

Energy Recovery, Inc. develops, manufactures and sells high-efficiency energy recovery devices and pumps primarily for use in seawater desalination. Our products make desalination affordable by reducing energy costs. We have one operating segment, the manufacture and sale of high-efficiency energy recovery products and pumps and related parts and services. Additional information on segment reporting is contained in Note 11 of Notes to the Consolidated Financial Statements in this Form 10-K.

During fiscal year 2010, we successfully integrated the operations of our new subsidiary, Pump Engineering, Inc. (PEI), which we acquired in December 2009. We consolidated our sales, support engineering and corporate services organizations and aligned our manufacturing activities to the same operational and quality standards. We also completed the build-out of our ceramics factory in San Leandro, California, and commissioned all major pieces of equipment. Although the industry down-turn prevented us from ramping up our ceramics production as planned, we still expect to manufacture a substantial portion of our ceramics needs in-house by the end of 2011. We expect our investment in the material science and manufacturing of ceramics to advance product quality and to reduce production costs as production volume increases. For a discussion of risks attendant to our planned in-house manufacture of some ceramic components of our PX devices, see Risk Factors Our plans to manufacture a portion of our ceramic components may prove to be more costly or less reliable than outsourcing, in Item 1A, which is incorporated herein by reference.

Despite the slow-down in our industry, we continued to strengthen our competitive position as the leading supplier of energy recovery devices for desalination. In 2010, we manufactured and shipped the world s largest turbochargers for the world s largest desalination plant in Magtaa, Algeria. Our newest and most advanced pressure exchanger product to date, the PX-300, also gained market acceptance and was sold for both large and small projects. We expect this product to represent a higher percentage of our net revenue in 2011. In 2010, we continued to focus engineering resources on enhancing our turbochargers, PX devices and pump offerings. We also initiated the development of several new product lines for applications outside desalination. We anticipate that at least one of these products will advance to beta testing in 2011.

In 2011, we expect that the desalination industry will continue to experience the delayed effects of the global economic downturn, which is likely to affect our revenue, especially revenue from sales of products for large desalination projects, manufacturing through-put and profitability for 2011.

Our company was incorporated in Virginia in April 1992 and reincorporated in Delaware in March 2001. We became a public company in July 2008. The company has five wholly owned subsidiaries: Osmotic Power, Inc., Energy Recovery, Inc. International, Energy Recovery Iberia, S.L., ERI Energy Recovery Ireland Ltd. and Pump Engineering, Inc. They were incorporated in September 2005, July 2006, September 2006, April 2010 and November 2009, respectively.

The mailing address of our headquarters is 1717 Doolittle Drive, San Leandro, California 94577. Our main telephone number is (510) 483-7370. Additional information about ERI is available on our website at http://www.energyrecovery.com. Information contained in the website is not part of this report.

Our Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports and the Proxy Statement for our Annual Meeting of Stockholders are made available, free of charge, on our website, http://www.energyrecovery.com, as soon as reasonably practicable after the reports have been filed with or furnished to the Securities and Exchange Commission.

Our Products

We make energy recovery devices and high pressure and circulation pumps primarily for use in seawater desalination plants that use reverse osmosis technology. Our products are sold under the trademarks

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AquaBold[tm], AquaSpire[tm], ERI[tm], PX[tm], Pressure Exchanger[tm], PX Pressure Exchanger[tm], PEI[tm], Pump Engineering[tm] and Quadribaric[tm]. Our energy recovery products reduce plant operating costs by capturing and reusing the otherwise lost pressure energy from the reject stream of the desalination process. Use of energy recovery devices can reduce energy consumption by up to an estimated 60% compared to desalination without energy recovery. By reducing energy costs, our devices increase the cost-competitiveness of reverse osmosis desalination compared to other means of fresh water production, including thermal desalination. Our pumps are designed for high efficiency and complement the operation of our energy recovery devices.

Energy Recovery Devices. We develop and sell two main lines of energy recovery devices: PX Pressure Exchanger devices and turbochargers. Each line includes a range of models and sizes to address the breadth of required process flow rates, plant designs and sizes.

Our current PX offerings include: the PX-300, the 65 series (the PX-260, PX-220 and PX-180); the 4S series (PX-140S, PX-90S, PX-70S, PX-45S and PX-30S) and brackish PX devices (for the desalination of water with a lower concentration of salt than seawater).

Our turbocharger offerings include: the HTCAT series (HTCAT-1800, HTCAT-2400, HTCAT-3600, HTCAT-4800, HTCAT-7200 and HTCAT-9600); the HALO line (HALO-50, HALO-75, HALO-100, HALO-150, HALO-225, HALO-300, HALO-450, HALO-500, HALO-600, HALO-900 and HALO-1200); and the LPT series for brackish water desalination applications (LPT-63, LPT-125, LPT-250, LPT-500, LPT-1000 LPT-2000 and LPT-3200).

High Pressure and Circulation Pumps. We manufacture and sell high pressure feed, circulation and booster pumps for use with our energy recovery devices in reverse osmosis desalination plants. Our current line of pumps includes the AquaBold series (AquaBold 2x3x5, AquaBold 3x4x7 and AquaBold 4x6x9); the AquaSpire series (AquaSpire-300, AquaSpire-450, AquaSpire-600, AquaSpire-900, AquaSpire-1200, AquaSpire-1800, AaquaSpire-2400, AquaSpire-3600, AquaSpire-4800, AquaSpire-7200 and AquaSpire-9600) and a line of small circulation pumps.

Technical Support and Replacement Parts. We provide engineering and technical support to customers during product installation and plant commissioning. We also offer replacement parts and services for our PX devices and turbochargers . Our PX devices and turbochargers are also used to retrofit or replace older energy recovery devices in existing desalination plants.

Customers

Our customers include a limited number of major international engineering, procurement and construction firms which design and build large desalination plants, and a number of original equipment manufacturers (OEMs), companies that supply equipment and packaged solutions for small to medium-sized desalination plants.

Large engineering, procurement and construction firms. Historically, most of our revenue has come from sales of products to the large engineering, procurement and construction firms worldwide that have the required desalination expertise to engineer, undertake procurement for, construct and sometimes own and operate large desalination plants or mega-projects. We work with these firms to specify our products for their plants. The time between project tender to product shipment can range from six to 16 months. Each mega-project typically represents a revenue opportunity of between $2 million to $10 million.

A limited number of these engineering, procurement and construction firms account for 10% or more of our net revenue. For the year ended December 31, 2010, two customers Thiess Degremont J.V. (a joint venture of Thiess Pty Ltd. and Degremont S.A.) and Hydrochem (S) Pte Ltd (a Hyflux company) accounted for approximately 23% and

12% of our net revenue, respectively. For the year ended December 31, 2009, three customers IDE Technologies, Ltd., Acciona Agua, and UTE Mostaganem (a consortium of Inima and Aqualia) accounted for approximately 20%, 11%, and 11% of our net revenue, respectively. For the year ended December 31, 2008, two customers accounted for approximately 16% and 11% of our net revenue Hyflux Limited and Befesa Agua S.A. (including affiliated joint ventures), respectively. No other customers accounted for more than 10% of our total revenue during any of this period.

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Original Equipment Manufacturers. We also sell our products and services to suppliers of pumps and other water-related equipment for assembly and use in small to medium-sized desalination plants located in hotels, power plants, cruise ships, farm operations, island bottlers, and small municipalities. These original equipment manufacturers also purchase our products for quick water or emergency water solutions. In this market, the time from project tender to shipment ranges from one to three months.

Competition

The market for energy recovery devices and pumps in desalination plants is competitive. As the demand for fresh water increases and the market expands, we expect competition to persist and intensify.

We have two main competitors for our energy recovery devices: Flowserve Corporation (Flowserve) based in Irving, Texas and Fluid Equipment Development Company (FEDCO) based in Monroe, Michigan. We compete with these companies on the basis of price, technology, materials, efficiency and life cycle maintenance costs. We believe that our products have a competitive advantage, even though these companies may offer competing products at prices lower than ours, because we believe that our products are the most cost-effective energy recovery devices for reverse osmosis desalination over time.

In the market for large desalination projects, our PX devices and large turbochargers compete primarily with Flowserve s DWEER product. We believe that our PX devices have a competitive advantage over the DWEER because they are made with highly durable and corrosion-proof ceramic parts, have a simple design with one moving part, have a small physical footprint, provide system redundancy and scaling capability, and offer lower life cycle maintenance costs. We believe our large turbocharger products have a competitive advantage over the DWEER product, particularly in countries where energy costs are low and upfront capital costs are a key factor in purchase decisions, because our turbocharger products have lower upfront capital costs, a simple design with one moving part, a small physical footprint and a long operating life which leads to low total life cycle costs.

In the market for small to medium-sized desalination plants, our products compete with Flowserve s Pelton turbines and FEDCO turbochargers. We believe that our PX devices have a competitive advantage over these products because our devices provide up to 98% energy transfer efficiency, have lower life cycle maintenance costs, and are made of highly durable and corrosion-proof ceramic parts. We believe that our turbochargers compete favorably with Pelton turbines on the basis of efficiency and price, and that our turbochargers have design advantages over competing turbochargers that enhance efficiency and serviceability.

In the market for high pressure pumps, our products compete with pumps manufactured by Clyde Union Ltd. based in Glasgow, Scotland; FEDCO, Flowserve, Duchting Pumpen Maschinenfabrik GmbH & Co KG based in Witten, Germany; KSB Aktiengesellschaft based in Frankenthal, Germany; Torishima Pump Mfg. Co., Ltd. based in Osaka, Japan and Sulzer Pumps, Ltd. based in Winterthur, Switzerland and other companies. We believe that our pump products have a competitive advantage over these competitive products because our pumps are developed specifically for reverse osmosis desalination, are highly efficient and feature product lubricated bearings.

Sales and Marketing

We market and sell our products directly to customers through our sales organization and, in some countries, through authorized, independent sales agents. In 2010, we integrated our PEI and ERI sales operations. Our current sales organization now has two groups, the Mega-Projects Group, which is responsible for sales of our PX devices and large turbochargers for desalination projects exceeding 50,000 cubic meters per day; and our OEM Group, which is responsible for sales of PX devices, turbochargers and pumps for plants designed to produce less than 50,000 cubic meters per day.

A significant portion of our revenue is from outside of the United States. Sales in the United States represented 7.3%, 6.4%, and 6.7% of our net revenue for the fiscal years 2010, 2009, and 2008, respectively. Additional geographical information regarding our net revenues is included in Note 11 to the Consolidated Financial Statements in this Form 10-K.

Since many of the large engineering, procurement, and construction firms that specialize in large projects are located in the Mediterranean region, we have a sales and technical center in Madrid, Spain. Our office in Dubai, United Arab Emirates serves the Middle East where many desalination plants and key engineering, procurement and construction firms are located. We also have a sales office in Shanghai, China to address this emerging market for our energy recovery products. We have U.S. sales offices in California and Michigan.

Manufacturing

We have manufacturing facilities in San Leandro, California where our PX devices are made, assembled and tested, and in New Boston, Michigan where our turbochargers and pumps are manufactured and tested. We purchase unfinished ceramic components for our PX products from several suppliers and in 2010, we started to produce some ceramic components in our new ceramics factory in our San Leandro facility. For our PX devices, we depend on two suppliers for our vessel housing and a single supplier for stainless steel castings. For our turbochargers and pumps, we rely on a limited number of foundries for castings. We finish machining and assemble in-house all ceramic components of our PX devices and many components of our turbochargers and pumps to protect the proprietary nature of our methods of manufacturing and product designs and to maintain quality standards.

For a discussion of risks attendant to our manufacturing activities, see Risk Factors We depend on a limited number of suppliers for some of our components. If our suppliers are not able to meet our demand and/or requirements, our business could be harmed, and Risk Factors We depend on a limited number of vendors for our supply of ceramics, which is a key component of our PX products. If any of our ceramics vendors cancels its commitments or is unable to meet our demand and/or requirements, our business could be harmed, in Item 1A, which is incorporated herein by reference. For a discussion of risks attendant to our planned in-house manufacture of some ceramic components of our PX devices, see Risk Factors Our plans to manufacture a portion of our ceramic components may prove to be more costly or less reliable than outsourcing, in Item 1A, which is incorporated herein by reference.

Research and Development

Design, quality and innovation are key facets of our corporate culture. Our development efforts are focused on enhancing our existing energy recovery devices and pumps for the desalination market and advancing our know-how in the material science and manufacturing of ceramics. In 2010, our engineering work also led to the development of several potential new product lines for applications inside and outside of seawater desalination. Research and development expense totaled $3.9 million for 2010, $3.0 million for 2009, and $2.4 million for 2008. We expect research and development costs to increase in the future as we continue to advance our existing technology and to develop new energy recovery and efficiency-enhancing solutions for markets outside seawater desalination.

For a discussion of risks attendant to our research and development activities, see Risk Factors The success of our business depends in part on our ability to enhance and scale our existing products, develop new products for desalination, and diversify into new markets by developing or acquiring new technology, in Item 1A, which is incorporated herein by reference.

Intellectual Property

We seek patent protection for new technology, inventions and improvements that are likely to be incorporated into our products. We rely on trade secret law and contractual safeguards to protect the proprietary tooling, processing techniques and other know-how used in the production of our products.

We have ten U.S. patents and sixteen patents outside the U.S. that are counterparts of several of the U.S. patents. The U.S. patents expire between 2011 and 2027, and the corresponding international patents expire at various dates

through 2021. We have also applied for five additional U.S. patents and there are thirty-six pending foreign applications corresponding to the U.S. patents and patent applications and two pending international applications.

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We have registered the following trademarks with the United States Patent and Trademark office: ERI, PX, PX Pressure Exchanger, Pressure Exchanger, the ERI logo and Making Desalination Affordable. We have also applied for and received registrations in international trademark offices.

For a discussion of risks attendant to intellectual property rights, see Risk Factors If we are unable to protect our technology or enforce our intellectual property rights, our competitive position could be harmed and we could be required to incur significant expenses to enforce our rights, in Item 1A, which is incorporated herein by reference.

Employees

As of December 31, 2010, we had 129 employees: 46 in manufacturing; 40 in corporate services and management; 25 in sales and marketing; and 18 in engineering/ research and development. Fifteen (15) of these employees were located outside of the United States. We also from time to time engage a relatively small number of independent contractors. We have not experienced any work stoppages. Our employees are not unionized.

Item 1A. *Risk Factors*

Almost all of our revenue is derived from sales of energy recovery devices and pumps used in reverse osmosis desalination; a decline in demand for desalination or the reverse osmosis method of desalination will reduce demand for our products and will cause our sales and revenue to decline.

Products for the desalination market have historically accounted for a high percentage of our revenue. We expect that the revenue from these products will continue to account for most of our revenue in the foreseeable future. Any factors adversely affecting the demand for desalination, including changes in weather patterns, increased precipitation in areas of high human population density, new technology for producing fresh water, increased water conservation or reuse, political changes and unrest, changes in the global economy, or changes in industry or governmental regulations, would reduce the demand for our energy recovery products and services and would cause a significant decline in our revenue. Similarly, any factors adversely affecting the demand for energy recovery products in reverse osmosis desalination, including, new energy technology or reduced energy costs, new methods of desalination that reduce pressure and energy requirements, improvements in membrane technology would reduce the demand for our energy recovery devices and would cause a significant decline in our revenue. Some of the factors that may affect sales of our energy recovery devices and pumps may be out of our control.

We depend on the construction of new desalination plants for revenue, and as a result, our operating results have experienced, and may continue to experience, significant variability due to volatility in capital spending, availability of project financing, and other factors affecting the water desalination industry.

We derive substantially all of our revenue from sales of products and services used in desalination plants for municipalities, hotels, resorts and agricultural operations in dry or drought-ridden regions of the world. The demand for our products may decrease if the construction of desalination plants declines for political, economic or other factors, especially in these regions. Other factors that could affect the number and capacity of desalination plants built or the timing of their completion include: the availability of required engineering and design resources, a weak global economy, shortage in the supply of credit and other forms of financing, changes in government regulations, permitting requirements or priorities, or reduced capital spending for desalination. Each of these factors could result in reduced or uneven demand for our products. Pronounced variability or delays in the construction of desalination plants or reductions in spending for desalination could negatively impact our sales and revenue and make it difficult for us to accurately forecast our future sales and revenue, which could lead to increased inventory and use of working capital.

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Our revenue and growth model depend upon the continued viability and growth of the seawater reverse osmosis desalination industry using current technology.

If there is a downturn in the seawater reverse osmosis desalination industry, our sales would be directly and adversely impacted. Changes in seawater reverse osmosis desalination technology could also reduce the demand for our devices. For example, a reduction in the operating pressure used in seawater reverse osmosis desalination plants could reduce the need for, and viability of, our energy recovery devices. Membrane manufacturers are actively working on lower pressure membranes for seawater reverse osmosis desalination that could potentially be used on a large scale to desalinate seawater at a much lower pressure than is currently necessary.

Engineers are also evaluating the possibility of diluting seawater prior to reverse osmosis desalination to reduce the required membrane pressure. Similarly, an increase in the membrane recovery rate would reduce the number of energy recovery devices required and would reduce the demand for our product. A significant reduction in the cost of power may reduce demand for our product or favor a less expensive product from a competitor.

Any of these changes would adversely impact our revenue and growth. Water shortages and demand for desalination can also be adversely affected by water conservation and water reuse initiatives.

New planned seawater reverse osmosis projects can be cancelled and/or delayed, and cancellations and/or delays may negatively impact our revenue.

Planned seawater reverse osmosis desalination projects can be cancelled or postponed due to delays in, or failure to obtain, approval, financing or permitting for plant construction because of political factors, including political unrest in key desalination markets, such as the Middle East, or adverse and increasingly uncertain financial conditions or other factors. Even though we may have a signed contract to provide a certain number of energy recovery devices by a certain date, shipments may be suspended or delayed at the request of customers. Such shipping delays negatively impact our results of operations and revenue. As a result of these factors, we have experienced and may in the future experience significant variability in our revenue, on both an annual and a quarterly basis.

We rely on a limited number of engineering, procurement and construction firms for a large portion of our revenue. If these customers delay or cancel their commitments, do not purchase our products in connection with future projects, or are unable to attract and retain sufficient qualified engineers to support their growth, our revenue could significantly decrease, which would adversely affect our financial condition and future growth.

There are a limited number of large engineering, procurement and construction firms in the desalination industry and these customers account for a substantial portion of our net revenue. One or more of these customers represents 10% or more of our total revenue each year and the customers in this category vary from year to year. See Note 12 Concentrations to the Consolidated Financial Statements regarding the impact of customer concentrations on our Consolidated Financial Statements. Since we do not have long-term contracts with these large customers but sell to them on a purchase order or project basis, these orders may be postponed or delayed on short or no notice. If any of these customers reduces or delays its purchases, cancels a project, decides not to specify our products for future projects, fails to attract and retain qualified engineers and other staff, fails to pay amounts due us, experiences financial difficulties or reduced demand for its services, we may not be able to replace that lost business and our projected revenue may significantly decrease, which will adversely affect our financial condition and future growth.

We face competition from a number of companies that offer competing energy recovery and pump solutions. If any of these companies produce superior technology or offer more cost-effective products, our competitive position in the market could be harmed and our profits may decline.

The market for energy recovery devices and pumps for desalination plants is competitive and evolving. We expect competition, especially competition on price and warranty terms, to persist and intensify as the

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desalination market grows, and new competitors may enter the market. Some of our current and potential competitors may have significantly greater financial, technical, marketing and other resources than we do, longer operating histories or greater name recognition. They may also be able to devote greater resources to the development, promotion, sale and support of their products and respond more quickly to new technology. These companies may also have more extensive customer bases, broader customer relationships across product lines, or long-standing or exclusive relationships with our current or potential customers. They may also have more extensive products and product lines that would enable them to offer multi-product or packaged solutions or competing products at lower prices or with other more favorable terms and conditions. As a result, our ability to penetrate the market or sustain our market share may be adversely impacted, which would affect our business, operating results and financial condition. In addition, if another one of our competitors were to merge or partner with another company, the change in the competitive landscape could adversely affect our continuing ability to compete effectively.

Global economic conditions and the current crisis in the financial markets could have an adverse effect on our business and results of operations.

Current economic conditions may continue to negatively impact our business and make forecasting future operating results more difficult and uncertain. A weak global economy may cause our customers to delay product orders or shipments, or delay or cancel planned or new desalination projects, including retrofits, which would reduce our revenue. Turmoil in the financial and credit markets may also make it difficult for our customers to obtain needed project financing, resulting in lower sales. Negative economic conditions may also affect our suppliers, which could impede their ability to remain in business and supply us with parts, resulting in delays in the availability or shipment of our products. In addition, most of our cash and cash equivalents are currently invested in money market funds backed by United States Treasury securities. Given the current weak global economy and the instability of financial institutions, we cannot be assured that we will not experience losses on our deposits, which would adversely affect our financial condition. If current economic conditions persist or worsen and negatively impact the desalination industry, our business, financial condition or results of operations could be materially and adversely affected.

Our operating results may fluctuate significantly, which makes our future operating results difficult to predict and could cause our operating results to fall below expectations or our guidance.

Our operating results may fluctuate due to a variety of factors, many of which are outside of our control. Since a single order for our energy recovery devices may represent significant revenue, we have experienced significant fluctuations in revenue from quarter to quarter and year to year and we expect such fluctuations to continue. As a result, comparing our operating results on a period-to-period basis may not be meaningful. You should not rely on our past results as an indication of our future performance. If our revenue or operating results fall below the expectations of investors or securities analysts or below any guidance we may provide to the market, the price of our common stock would likely decline substantially.

In addition, factors that may affect our operating results include, among others:

- fluctuations in demand, sales cycles and pricing levels for our products and services;
- the cyclical nature of equipment purchasing for planned reverse osmosis desalination plants, which typically results in increased product shipments in the fourth quarter;
- changes in customers budgets for desalination plants and the timing of their purchasing decisions;
- adverse changes in the local or global financing conditions facing our customers;

delays or postponements in the construction of desalination plants;

our ability to develop, introduce and timely ship new products and product enhancements that meet customer demand and contractual and technical requirements, including scheduled delivery dates, performance tests and product certifications;

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- the ability of our customers to obtain other key plant components such as high pressure pumps or membranes;
- our ability to implement scalable internal systems for reporting, order processing, product delivery, purchasing, billing and general accounting, among other functions;
- our ability to maintain efficient factory throughput in our new facility and minimize overhead given significant variability in orders from quarter to quarter and year to year;
- unpredictability of governmental regulations and political decision-making as to the approval or building of a desalination plant;
- our ability to control costs, including our operating expenses;
- our ability to purchase key components, including ceramics, from third party suppliers;
- our ability to compete against other companies that offer energy recovery solutions;
- our ability to attract and retain highly skilled employees, particularly those with relevant industry experience; and
- general economic conditions in our domestic and international markets, including conditions that affect the valuation of the U.S. dollar against other currencies.

If we are unable to collect unbilled receivables, our operating results will be adversely affected.

Our contracts with large engineering, procurement and construction firms generally contain holdback provisions that delay final installment payments up to 24 months after the product has been shipped and revenue has been recognized. Typically, between 10 and 20%, and in some instances up to 30% of the revenue we receive pursuant to our customer contracts is subject to such holdback provisions and are accounted for as unbilled receivables until we deliver invoices for payment. Such holdbacks can result in relatively high current and non-current unbilled receivables. If we are unable to invoice and collect these performance holdbacks or if our customers fail to make these payments when due under the sales contracts, our results of operations will be adversely affected.

If we lose key personnel upon whom we are dependent, we may not be able to execute our strategies. Our ability to increase our revenue will depend on hiring highly skilled professionals with industry-specific experience, particularly given the unique and complex nature of our devices.

Given the specialized nature of our business, we must hire highly skilled professionals for certain positions with industry-specific experience. Given the relative recent growth in the reverse osmosis desalination industry, the number of qualified candidates for certain positions is limited. Our ability to grow depends on recruiting and retaining skilled employees with relevant experience, competing with larger, often better known companies and offering competitive total compensation packages. Our failure to retain existing or attract future talented and experienced key personnel could harm our business.

The success of our business depends in part on our ability to enhance and scale our existing products, develop new products for desalination, diversify into new markets by developing or acquiring new technology and to generate and fulfill sales orders for new products.

Our future success depends in part on our ability to enhance and scale existing products and to develop new products for desalination and applications outside desalination. While new or enhanced products and services have the potential to meet specified needs of new or existing markets, their pricing may not meet customer expectations and they may not compete favorably with products and services of current or potential competitors. New products may be delayed or cancelled if they do not meet specifications, performance requirements or quality standards, or perform as expected in a production environment. Product designs also may not scale as expected. We may have difficulty finding new markets for our existing technology or developing or acquiring new products for new markets. Customers may not accept or be slow to adopt new products and services and potential new markets may be too costly to penetrate. In addition, we may not be

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able to offer our products and services at prices that meet customer expectations without increasing our costs and eroding our margins. We may also have difficulty executing plans to break into new markets, expanding our operations to successfully manufacture new products or scaling our operations to accommodate increased business. If we are unable to develop competitive new products, open new cost-effective markets, and scale our business to support increased sales and new markets, our business and results of operations will be adversely affected.

Our plans to manufacture a portion of our ceramic components may prove to be more costly or less reliable than outsourcing.

We outsource the production of our ceramic components to a limited number of ceramic vendors. In 2010, to diversify our supply of ceramics and retain more control over our intellectual property, we developed our own ceramics plant at our headquarters in San Leandro, California to manufacture some of our ceramics components. If we are less efficient at producing our ceramic components or are unable to achieve required yields that are equal to or greater than the vendors to which we outsource, then our cost of manufacturing may be adversely affected. If we are unable ramp-up the internal production of our ceramics parts or manufacture these parts in-house cost-effectively and/or one of our ceramics suppliers goes out of business, we may be exposed to increased risk of supply chain disruption and capacity shortages and our business and financial results, including our cost of goods sold and margins may be adversely affected. During the ramp-up phase of bringing our ceramics facility on line, we expect our cost of goods sold to be negatively affected until we optimize production throughput.

The durable nature of the PX device may reduce or delay potential aftermarket revenue opportunities.

Our PX devices utilize ceramic components that have to date demonstrated high durability, high corrosion resistance and long life in seawater reverse osmosis desalination applications. Because most of our PX devices have been installed for a limited number of years, it is difficult to accurately predict their performance or endurance over a longer period of time. In the event that our products are more durable than expected, our opportunity for aftermarket revenue may be deferred.

Our sales cycle can be long and unpredictable, and our sales efforts require considerable time and expense. As a result, our sales are difficult to predict and may vary substantially from quarter to quarter, which may cause our operating results to fluctuate.

Our sales efforts involve substantial education of our current and prospective customers about the use and benefits of our energy recovery products. This education process can be time consuming and typically involves a significant product evaluation process. While the sales cycle for our OEM customers, which are involved with smaller desalination plants, averages one to three months, the average sales cycle for our international engineering, procurement and construction firm customers, which are involved with larger desalination plants, ranges from nine to 16 months and has, in some cases, extended up to 24 months. In addition, these customers generally must make a significant commitment of resources to test and evaluate our technologies. As a result, our sales process involving these customers is often subject to delays associated with lengthy approval processes that typically accompany the design, testing and adoption of new, technologically complex products. This long sales cycle makes quarter-by-quarter revenue predictions difficult and results in our investing significant resources well in advance of orders for our products.

Since a significant portion of our annual sales typically occurs during the fourth quarter, any delays could affect our fourth quarter and annual revenue and operating results.

A significant portion of our annual sales typically occurs during the fourth quarter, which we believe generally reflects engineering, procurement and construction firm customer buying patterns. A downturn in the market and delays in, or

cancellation of, expected sales during the fourth quarter would reduce our quarterly and annual revenue from what we anticipated. Such a reduction might cause our quarterly and annual revenue or quarterly and annual operating results to fall below the expectations of investors and securities analysts or below any guidance we may provide to the market, causing the price of our common stock to decline.

We depend on a limited number of vendors for our supply of ceramics, which is a key component of our PX products. If any of our ceramics vendors cancels its commitments or is unable to meet our demand and/or requirements, our business could be harmed.

We rely on a limited number of vendors to produce ceramics components for our PX products. If any of our ceramic suppliers were to have financial difficulties, cancel or materially change their commitments with us or fail to meet the quality or delivery requirements needed to satisfy customer orders for our products and we are unable to make up that shortfall through in-house production, we could lose customer orders, be unable to develop or sell our products cost-effectively or on a timely basis, if at all, and have significantly decreased revenue, which would harm our business, operating results and financial condition.

We depend on a limited number of suppliers for some of our components. If our suppliers are not able to meet our demand and/or requirements, our business could be harmed.

We rely on a limited number of suppliers to produce vessel housings and stainless steel castings for our PX devices and castings for our PEI turbochargers and pumps. Our reliance on a limited number of manufacturers for these parts involves a number of risks, including reduced control over delivery schedules, quality assurance, manufacturing yields, production costs and lack of guaranteed production capacity or product supply. We do not have long term supply agreements with these suppliers and instead secure manufacturing availability on a purchase order basis. Our suppliers have no obligation to supply products to us for any specific period, in any specific quantity or at any specific price, except as set forth in a particular purchase order. Our requirements represent a small portion of the total production capacities of these suppliers and our suppliers may reallocate capacity to other customers, even during periods of high demand for our products. We have in the past experienced and may in the future experience quality control issues and delivery delays with our suppliers due to factors such as high industry demand or the inability of our vendors to consistently meet our quality or delivery requirements. If our suppliers were to cancel or materially change their commitments with us or fail to meet quality or delivery requirements needed to satisfy customer orders for our products, we could lose time-sensitive customer orders, be unable to develop or sell our products cost-effectively or on a timely basis, if at all, and have significantly decreased revenue, which would harm our business, operating results and financial condition. We may qualify additional suppliers in the future which would require time and resources. If we do not qualify additional suppliers, we may be exposed to increased risk of capacity shortages due to our complete dependence on our current supplier.

We are subject to risks related to product defects, which could lead to warranty claims in excess of our warranty provisions or result in a significant or a large number of warranty or other claims in any given year.

We provide a warranty for our PX and PEI brand products for a period of one to two years and provide up to a 6 year warranty for the ceramic components of our PX brand products. As our ceramics technology evolves, we may increase the ceramics warranty beyond 6 years. We test our products in our manufacturing facilities through a variety of means. However, there can be no assurance that our testing will reveal latent defects in our products, which may not become apparent until after the products have been sold into the market, or will replicate the harsh, corrosive and varied conditions of the desalination plants and other plants in which they are installed. In addition, certain components of our turbochargers and pumps are custom-made and may not scale or perform as required in production environments. Accordingly, there is a risk that we may have significant warranty claims or breach supply agreements due to product defects. We may incur additional operating expenses if our warranty provisions do not reflect the actual cost of resolving issues related to defects in our products. If these additional expenses are significant, they could adversely affect our business, financial condition and results of operations. While the number of warranty claims has not been significant to date, we have only offered up to a six year warranty on the ceramic components of our PX products in new sales agreements executed after August 7, 2007, and we have only offered PEI products since December 2009 when we acquired Pump Engineering, LLC. Accordingly, we cannot quantify the error rate of our products and the

ceramic components of our PX products with statistical accuracy and cannot assure that a large number of warranty claims will not be filed in a given year. As a result, our operating expenses may increase if a significant or large number of warranty or other claims are filed in any specific year, particularly towards the end of any given warranty period.

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If we are unable to protect our technology or enforce our intellectual property rights, our competitive position could be harmed and we could be required to incur significant expenses to enforce our rights.

Our competitive position depends on our ability to establish and maintain proprietary rights in our technology and to protect our technology from copying by others. We rely on trade secret, patent, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which may offer only limited protection. We hold a limited number of United States patents and patents outside the U.S. that are counterparts to several of the U.S. patents and when their terms expire, we could become more vulnerable to increased competition. We do not hold issued patents in many of the countries where competing products are used though we do have pending applications in countries where we have substantial sales activity. Accordingly, the protection of our intellectual property in some of those countries may be limited. We also do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims, and even if patents are issued, they may be contested, circumvented or invalidated. Moreover, while we believe our remaining issued patents are essential to the protection of our technology, the rights granted under any of our issued patents or patents that may be issued in the future may not provide us with proprietary protection or competitive advantages, and, as with any technology, competitors may be able to develop similar or superior technologies to our own now or in the future. In addition, our granted patents may not prevent misappropriation of our technology, particularly in foreign countries where intellectual property laws may not protect our proprietary rights as fully as those in the United States. This may render our patents impaired or useless and ultimately expose us to currently unanticipated competition. Protecting against the unauthorized use of our products, trademarks and other proprietary rights is expensive, difficult and, in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual property rights or to determine the validity and scope of the proprietary rights of others. This litigation could result in substantial costs and diversion of management resources, either of which could harm our business.

Claims by others that we infringe their proprietary rights could harm our business.

Third parties could claim that our technology infringes their proprietary rights. In addition, we or our customers may be contacted by third parties suggesting that we obtain a license to certain of their intellectual property rights they may believe we are infringing. We expect that infringement claims against us may increase as the number of products and competitors in our market increases and overlaps occur. In addition, to the extent that we gain greater visibility, we believe that we will face a higher risk of being the subject of intellectual property infringement claims. Any claim of infringement by a third party, even those without merit, could cause us to incur substantial costs defending against the claim, and could distract our management from our business. Furthermore, a party making such a claim, if successful, could secure a judgment that requires us to pay substantial damages. A judgment against us could also include an injunction or other court order that could prevent us from offering our products. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms, or at all. Alternatively, we may be required to develop non-infringing technology, which could require significant effort and expense and may ultimately not be successful. Any of these events could seriously harm our business. Third parties may also assert infringement claims against our customers. Because we generally indemnify our customers if our products infringe the proprietary rights of third parties, any such claims would require us to initiate or defend protracted and costly litigation on their behalf in one or more jurisdictions, regardless of the merits of these claims. If any of these claims succeeds, we may be forced to pay damages on behalf of our customers.

Our business entails significant costs that are fixed or difficult to reduce in the short-term while demand for our products is variable and subject to downturns, which may adversely affect our operating results.

Our business requires investments in facilities, equipment, R&D and training that are either fixed or difficult to reduce or scale in the short term. At the same time, the market for our products is variable and has experienced downturns due to factors such as economic recessions, increased precipitation, uncertain global financial markets, and political

changes, many of which are outside our control. During periods of reduced product demand, we may experience periods of excess manufacturing capacity, resulting in high overhead , which may cause gross margin,

cash flow and profitability to vary in the short and long term. Similarly, while we believe that our existing manufacturing facilities are capable of meeting current demand and demand for the foreseeable future, the continued success of our business depends on our ability to expand our manufacturing, research and development and testing facilities to meet market needs. If we are unable to respond timely to an increase in demand, our revenue, gross margin, cash flow and profitability may be adversely affected.

If we need additional capital to fund future growth, it may not be available on favorable terms, or at all.

We have historically relied on outside financing to fund our operations, capital expenditures and expansion. In our initial public offering in July 2008, we issued approximately 10,000,000 shares of common stock at $8.50 per share before underwriting discount and issuing expenses. We may require additional capital from equity or debt financing in the future to fund our operations, or respond to competitive pressures or strategic opportunities. We may not be able to secure such additional financing on favorable terms, or at all. The terms of additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer significant dilution in their percentage ownership of our company, and any new securities we issue could have rights, preferences or privileges senior to those of existing or future holders of our common stock. If we are unable to obtain necessary financing on terms satisfactory to us, if and when we require it, our ability to grow or support our business and to respond to business challenges could be significantly limited.

If foreign and local government entities no longer guarantee and subsidize, or are willing to engage in, the construction and maintenance of desalination plants and projects, the demand for our products would decline and adversely affect our business.

Our products are used in seawater reverse osmosis desalination plants which are often constructed and maintained with local, regional or national government guarantees and subsidies, including tax-free bonds. The rate of construction of desalination plants depends on each governing entity s willingness and ability to obtain and allocate funds for such projects, which capabilities may be affected by the current weak global financial system and credit market and the weak global economy. In addition, some desalination projects in the Middle East and North Africa have been funded by budget surpluses resulting from once high crude oil and natural gas prices. Since prices for crude oil and natural gas vary, governments in those countries may not have the necessary funding for such projects and may cancel the projects or divert funds allocated for them to other projects. Political unrest, coups or changes in government administrations may also result in policy or priority changes that may also cause governments to cancel, delay or re-contract planned or ongoing projects. Government embargoes may also prohibit sales into certain countries. As a result, the demand for our products could decline and negatively affect our revenue base, our overall profitability and pace of our expected growth. For example, in late 2009, the Algerian government increased the percentage of required government ownership in desalination plants, which led to the cancellation of the government s contract with a large U.K. engineering, procurement and construction firm and the cancellation or delay in sales of our products.

Our products are highly technical and may contain undetected flaws or defects which could harm our business and our reputation and adversely affect our financial condition.

The manufacture of our products is highly technical and some designs and components of our turbochargers and pumps are custom-made. Our products may contain latent defects or flaws. We test our products prior to commercial release and during such testing have discovered and may in the future discover flaws and defects that need to be resolved prior to release. Resolving these flaws and defects can take a significant amount of time and prevent our technical personnel from working on other important tasks. In addition, our products have contained and may in the future contain one or more flaws that were not detected prior to commercial release to our customers. Some flaws in

our products may only be discovered after a product has been installed and used by customers. Any flaws or defects discovered in our products after commercial release could result in loss of revenue or delay in revenue recognition, loss of customers and increased service and warranty cost, any of which could adversely affect our business, operating results and

financial condition. In addition, we could face claims for product liability, tort or breach of warranty. Our contracts with our customers contain provisions relating to warranty disclaimers and liability limitations, which may not be upheld or for reasons of good long-term customer relations, we may not be willing to enforce. Defending a lawsuit, regardless of its merit, is costly and may divert management s attention and adversely affect the market s perception of us and our products. In addition, if our business liability insurance coverage proves inadequate or future coverage is unavailable on acceptable terms or at all, our business, operating results and financial condition could be harmed.

Our international sales and operations subject us to additional risks that may adversely affect our operating results.

Historically, we have derived a significant portion of our revenue from customers whose seawater reverse osmosis desalination facilities that use our energy recovery products are outside the United States. Many of these projects are located in emerging growth countries with relatively young or unstable market economies or changing political environments. These countries may be affected significantly by the current weak global economy and unstable credit markets. We also rely on sales and technical support personnel stationed in Spain, Asia and the Middle East and we expect to continue to add personnel in other countries. Governmental changes, political unrest or reforms, or other disruptions or changes in the business, regulatory or political environments of the countries in which we sell our products or have staff could have a material adverse effect on our business, financial condition and results of operations.

Sales of our products have to date been denominated principally in U.S. dollars. If the U.S. dollar strengthens against most other currencies, it will effectively increase the price of our products in the currency of the countries in which our customers are located. This may result in our customers seeking lower-priced suppliers, which could adversely impact our margins and operating results. A larger portion of our international revenue may be denominated in foreign currencies in the future, which would subject us to increased risks associated with fluctuations in foreign exchange rates.

Our international contracts and operations subject us to a variety of additional risks, including:

- political and economic uncertainties, which the current global economic crisis may exacerbate;
- uncertainties related to the application of local contract and other laws, including reduced protection for intellectual property rights;
- trade barriers and other regulatory or contractual limitations on our ability to sell and service our products in certain foreign markets;
- difficulties in enforcing contracts, beginning operations as scheduled and collecting accounts receivable, especially in emerging markets;
- increased travel, infrastructure and legal compliance costs associated with multiple international locations;
- competing with non-U.S. companies not subject to the U.S. Foreign Corrupt Practices Act;
- difficulty in attracting, hiring and retaining qualified personnel; and
- increasing instability in the capital markets and banking systems worldwide, especially in developing countries, that may limit project financing availability for the construction of desalination plants.

As we continue to expand our business globally, our success will depend, in large part, on our ability to anticipate and effectively manage these and other risks associated with our international operations. Our failure to manage any of these risks successfully could harm our international operations and reduce our international sales, which in turn could adversely affect our business, operating results and financial condition.

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If we fail to manage future growth effectively, our business would be harmed.

Future growth in our business, if it occurs, will place significant demands on our management, infrastructure and other resources. To manage any future growth, we will need to hire, integrate and retain highly skilled and motivated employees. We will also need to continue to improve our financial and management controls, reporting and operational systems and procedures. If we do not effectively manage our growth, our business, operating results and financial condition would be adversely affected.

Our failure to achieve or maintain adequate internal control over financial reporting in accordance with SEC rules or prevent or detect material misstatements in our annual or interim consolidated financial statements in the future could materially harm our business and cause our stock price to decline.

As a public company, SEC rules require that we maintain internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and preparation of published financial statements in accordance with generally accepted accounting principles, or GAAP, in the United States. Accordingly, we are required to document and test our internal controls and procedures to assess the effectiveness of our internal control over financial reporting. In addition, our independent registered public accounting firm is required to report on the effectiveness of our internal control over financial reporting. In the future, we may identify material weaknesses and deficiencies which we may not be able to remediate in a timely manner. Our acquisition of Pump Engineering, LLC and possible future acquisitions may increase this risk by expanding the scope and nature of operations over which we must develop and maintain internal control over financial reporting. If there are material weaknesses or deficiencies in our internal control, we will not be able to conclude that we have maintained effective internal control over financial reporting or our independent registered public accounting firm may not be able to issue an unqualified report on the effectiveness of our internal control over financial reporting. As a result, our ability to report our financial results on a timely and accurate basis may be adversely affected and investors may lose confidence in our financial information, which in turn could cause the market price of our common stock to decrease. We may also be required to restate our financial statements from prior periods. In addition, testing and maintaining internal control will require increased management time and resources. Any failure to maintain effective internal control over financial reporting could impair the success of our business and harm our financial results and you could lose all or a significant portion of your investment. If we have material weaknesses in our internal control over financial reporting, the accuracy and timing of our financial reporting may be adversely affected.

Changes to financial accounting standards may affect our results of operations and cause us to change our business practices.

We prepare our financial statements to conform to GAAP. These accounting principles are subject to interpretation by the SEC and various other bodies. A change in those policies can have a significant effect on our reported results and may affect our reporting of transactions completed before a change is announced. Changes to those rules or the interpretation of our current practices may adversely affect our reported financial results or the way we conduct our business.

Our past acquisition and future acquisitions could disrupt our business, impact our margins, cause dilution to our stockholders or harm our financial condition and operating results.

In December 2009, we acquired privately-held competitor Pump Engineering, LLC and, in the future, we may invest in other companies, technologies or assets. We may not realize the expected benefits from our past or future acquisitions. We may not be able to find other suitable acquisition candidates and we may not be able to complete acquisitions on favorable terms, if at all. If we do complete acquisitions, we cannot assure that they will ultimately strengthen our competitive or financial position or that they will not be viewed negatively by customers, financial

markets, investors or the media. Acquisitions could also result in shareholder dilution or significant acquisition-related charges for restructuring, share-based compensation and the amortization of purchased technology and intangible assets. Expenses resulting from impairment of acquired goodwill, intangible assets and purchased technology could also increase over time if the fair value of those assets decreases. A future change in our market conditions, a downturn in our business, or a long-term

decline in the quoted market price of our stock may result in a reduction of the fair value of acquisition-related assets. Any such impairment of goodwill or intangible assets could harm our operating results and financial condition. In addition, when we make an acquisition, we may have to assume some or all of that entity s liabilities which may include liabilities that are not fully known at the time of the acquisition. Future acquisitions may reduce our cash available for operations and other uses. If we continue to make acquisitions, we may require additional cash or use shares of our common stock as payment, which would cause dilution for our existing stockholders.

Any acquisitions that we make, including our 2009 acquisition of Pump Engineering, LLC, entail a number of risks that could harm our ability to achieve their anticipated benefits. We could have difficulties integrating and retaining key management and other personnel, aligning product plans and sales strategies, coordinating research and development efforts, supporting customer relationships, aligning operations and integrating accounting, order processing, purchasing and other support services. Since acquired companies have different accounting and other operational practices, we may have difficulty harmonizing order processing, accounting, billing, resource management, information technology and other systems company-wide. We may also have to invest more than anticipated in product or process improvements. Especially with acquisitions of privately held or non-US companies, we may face challenges developing and maintaining internal controls consistent with the requirements of the Sarbanes-Oxley Act and US public accounting standards. Acquisitions may also disrupt our ongoing operations, divert management from day-to-day responsibilities and disrupt other strategic, research and development, marketing or sales efforts. Geographic and time zone differences and disparate corporate cultures may increase the difficulties and risks of an acquisition. If integration of our acquired businesses or assets is not successful or disrupts our ongoing operations, acquisitions may increase our expenses, harm our competitive position, adversely impact our operating results and financial condition and fail to achieve anticipated revenue, cost, competitive or other objectives.

Insiders and principal stockholders will likely have significant influence over matters requiring stockholder approval.

Our directors, executive officers and other principal stockholders beneficially own, in the aggregate, a substantial amount of our outstanding common stock. Although they do not have majority control of the outstanding stock, these stockholders will likely have significant influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, such as a merger or other sale of our company or its assets.

Anti-takeover provisions in our charter documents and under Delaware law could discourage delay or prevent a change in control of our company and may affect the trading price of our common stock.

Provisions in our amended and restated certificate of incorporation and bylaws may have the effect of delaying or preventing a change of control or changes in our management. Our amended and restated certificate of incorporation and amended and restated bylaws include provisions that:

- authorize our board of directors to issue, without further action by the stockholders, up to 10,000,000 shares of undesignated preferred stock;

- require that any action to be taken by our stockholders be effected at a duly called annual or special meeting and not by written consent;

- specify that special meetings of our stockholders can be called only by our board of directors, the chairman of the board, the chief executive officer or the president;

establish an advance notice procedure for stockholder approvals to be brought before an annual meeting of our stockholders, including proposed nominations of persons for election to our board of directors;

establish that our board of directors is divided into three classes, Class I, Class II and Class III, with each class serving staggered terms;

provide that our directors may be removed only for cause;

provide that vacancies on our board of directors may be filled only by a majority vote of directors then in office, even though less than a quorum;

specify that no stockholder is permitted to cumulate votes at any election of directors; and

require a super-majority of votes to amend certain of the above-mentioned provisions.

In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law regulating corporate takeovers. Section 203 generally prohibits us from engaging in a business combination with an interested stockholder subject to certain exceptions.

Item 1B. ***Unresolved Staff Comments***

None.

Item 2. ***Properties***

We lease approximately 170,000 square feet of space in San Leandro, California for product manufacturing, research and development and executive headquarters under a lease that expires in July 2019. Additionally, we own a commercial building in New Boston, Michigan, which provides 48,000 square feet of space for administration, research and development, and manufacturing for our subsidiary, Pump Engineering, Inc. We believe these facilities will be adequate for our purposes for the foreseeable future.

Item 3. ***Legal Proceedings***

We are not party to any material litigation, and we are not aware of any pending or threatened litigation against us that we believe would adversely affect our business, operating results, financial condition or cash flows. In the future, we may be subject to legal proceedings in the ordinary course of our business.

Item 4. ***[Reserved]***

PART II

Item 5. ***Market for the Registrant s Common Stock Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Market Information

Since July 2, 2008, our common stock has been quoted on the Nasdaq Global Market under the symbol ERII .

The following table sets forth the high and low sales prices of our common stock for the periods indicated.

	High	Low
2009		
First Quarter	$ 8.67	$ 4.50
Second Quarter	$ 8.79	$ 5.60
Third Quarter	$ 7.40	$ 4.89
Fourth Quarter	$ 7.28	$ 5.40
2010		

First Quarter	$ 7.25	$ 5.75
Second Quarter	$ 6.40	$ 3.15
Third Quarter	$ 4.23	$ 3.08
Fourth Quarter	$ 3.99	$ 3.30

Dividend Policy

We have never declared or paid any cash dividends on our capital stock and we do not currently intend to pay any cash dividends on our capital stock for the foreseeable future. We expect to retain future earnings, if any, to fund the development and growth of our business. Any future determination to pay dividends on our capital stock will be, subject to applicable law, at the discretion of our board of directors and will depend

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upon, among other factors, our results of operations, financial condition, capital requirements and contractual restrictions in loan agreements or other agreements.

Stockholders

As of March 8, 2011, there were approximately 83 stockholders of record of our common stock as reported by our transfer agent, one of which is Cede & Co., a nominee for Depository Trust Company (DTC). All of the shares of common stock held by brokerage firms, banks and other financial institutions as nominees for beneficial owners are deposited into participant accounts at DTC, and are therefore considered to be held of record by Cede & Co. as one stockholder.

Stock Performance Graph

The following graph shows the cumulative total shareholder return of an investment of $100 on July 2, 2008 in (i) our common stock and (ii) common stock of a selected group of peer issuers (Peer Group) and (iii) on June 30, 2008 in the Nasdaq Composite Index. Cumulative total return assumes the reinvestment of dividends, although dividends have never been declared on our stock, and is based on the returns of the component companies weighted according to their capitalizations as of the end of each quarterly period. The Nasdaq Composite Index tracks the aggregate price performance of equity securities traded on the Nasdaq. The Peer Group tracks the weighted average price performance of equity securities of seven companies in our industry, including Consolidated Water Company Limited, Flowserve Corporation, Hyflux Ltd, Kurita Water Industries Limited, Pentair Inc., Tetra Tech, Inc. and The Gorman-Rupp Company. The returns of each component issuer of the Peer Group is weighted according to the respective issuer s stock market capitalization at the beginning of each period for which a return is indicated. Our stock price performance shown in the graph below is not indicative of future stock price performance.

The following graph and its related information is not soliciting material, is not deemed filed with the SEC, and is not to be incorporated by reference into any filing of the Company under the 1933 Act or 1934 Act, whether made before or after the date hereof and irrespective of any general incorporation language contained in such filing.

COMPARISON OF 30 MONTH CUMULATIVE TOTAL RETURN*
Among Energy Recovery Inc., The NASDAQ Composite Index
And A Peer Group

* $100 invested on 7/2/08 in stock or 6/30/08 in index, including reinvestment of dividends. Fiscal year ending December 31.

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	6/30/08 or 7/2/08(1)	12/31/08	12/31/09	12/31/10
Energy Recovery, Inc.	**100.00**	**77.11**	**69.99**	**37.23**
NASDAQ Composite	**100.00**	**68.38**	**99.29**	**116.72**
Peer Group	**100.00**	**62.14**	**89.14**	**100.52**

(1) The index measurement date is 6/30/08; stock measurement dates are 7/2/08

Use of Proceeds

On July 1, 2008, our registration statement (No. 333-150007) on Form S-1 was declared effective for our initial public offering, pursuant to which we registered the offering and sale of an aggregate 16,100,000 shares of common stock at price of $8.50 per share. Of the aggregate offering price of $136.9 million, $86.5 million related to 10,178,566 shares sold by us and $50.4 million related to 5,921,434 shares sold by selling stockholders. The offering closed on July 8, 2008 with respect to the primary shares and on July 11, 2008 with respect to the over-allotment shares. The managing underwriters were Citigroup Global Markets Inc. and Credit Suisse Securities (USA) LLC.

As a result of the offering, we received net proceeds of approximately $76.7 million, after deducting underwriting discounts and commissions of $6.1 million and additional offering-related expenses of approximately $3.7 million. No payments for such expenses were made directly or indirectly to (i) any of our officers or directors or their associates, (ii) any persons owning 10% or more of any class of our equity securities, or (iii) any of our affiliates.

During the period from the offering through December 31, 2010, we used approximately $20.0 million, including amounts held in escrow, for the acquisition of Pump Engineering, LLC.

We anticipate that we will use the remaining net proceeds from our IPO for working capital and other general corporate purposes, including to finance our growth, develop new products, fund capital expenditures, or to expand our existing business through acquisitions of other businesses, products or technologies. Pending such uses, we have deposited a substantial amount of the remaining net proceeds in a U.S. Treasury based money market fund. There has been no material change in the planned use of proceeds from our IPO from that described in the final prospectus filed with the SEC pursuant to Rule 424(b).

Recent Sales of Unregistered Securities

None.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None.

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Item 6. *Selected Financial Data*

The following selected financial data should be read in conjunction with the Management s Discussion and Analysis of Financial Condition and Results of Operations and the financial statements and notes thereto included in this Report on Form 10-K.

	Years Ended December 31,				
	2010	**2009**	**2008**	**2007**	**2006**
Consolidated Statement of Income Data:					
Net revenue	$ 45,853	$ 47,014	$ 52,119	$ 35,414	$ 20,058
Cost of revenue	23,781	17,595	18,933	14,852	8,131
Gross profit	22,072	29,419	33,186	20,562	11,927
Operating expenses:					
General and administrative	17,038	13,756	11,321	4,299	3,372
Sales and marketing	8,205	6,472	6,549	5,230	3,648
Research and development	3,943	3,041	2,415	1,705	1,267
Gain on fair value remeasurement	(2,147)				
Total operating expenses	27,039	23,269	20,285	11,234	8,287
Income (loss) from operations	(4,967)	6,150	12,901	9,328	3,640
Other income (expense):					
Interest expense	(73)	(46)	(79)	(105)	(77)
Interest and other income (expense)	(194)	54	873	517	58
Income (loss) before provision for (benefit from) income taxes	(5,234)	6,158	13,695	9,740	3,621
Provision for (benefit from) income taxes	(1,626)	2,472	5,032	3,947	1,239
Net income (loss)	$ (3,608)	$ 3,686	$ 8,663	$ 5,793	$ 2,382
Earnings (loss) per share-basic	$ (0.07)	$ 0.07	$ 0.19	$ 0.15	$ 0.06
Earnings (loss) per share-diluted	$ (0.07)	$ 0.07	$ 0.18	$ 0.14	$ 0.06
Number of shares used in per share calculations:					
Basic	52,072	50,166	44,848	39,060	38,018
Diluted	52,072	52,644	47,392	41,433	40,244

	As of December 31,				
	2010	**2009**	**2008**	**2007(1)**	**2006(1)**
Consolidated Balance Sheet Data:					
Cash and cash equivalents	$ 55,338	$ 59,115	$ 79,287	$ 240	$ 42
Total assets	133,917	142,969	120,612	28,227	17,937
Long-term liabilities	2,770	4,505	420	620	234

Total liabilities	13,117	22,000	13,613	8,166	9,810
Total stockholders equity	120,800	120,969	106,999	20,061	8,127

(1) Certain prior period balances have been reclassified to conform to the current period presentation.

Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

This Annual Report on Form 10-K and certain information incorporated by reference contain forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements in this report include, but are not limited to, statements about our expectations, objectives, anticipations, plans, hopes, beliefs, intentions or strategies regarding the future.

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Forward-looking statements represent our current expectations about future events and are based on assumptions and involve risks and uncertainties. If the risks or uncertainties occur or the assumptions prove incorrect, then our results may differ materially from those set forth or implied by the forward-looking statements. Our forward-looking statements are not guarantees of future performance or events.

Forward-looking statements in this report include, without limitation, statements about the following:

- *our plan to enhance our existing energy recovery devices and to develop and manufacture new and enhanced versions of these devices;*
- *our belief that sales of our PX-300 device will represent a higher percentage of our net revenue in 2011;*
- *our belief that the ceramics components of our PX device will result in low life cycle maintenance costs and that our turbocharger devices have long operating lives;*
- *our objective of finding new applications for our technology and developing new products for use outside of desalination;*
- *our expectation that our 2011 revenue, especially revenue derived from sales of products to large desalination projects, will be impacted by the effects of the global economic downturn and credit crises;*
- *our belief that our products are the most cost effective energy recovery devices over time;*
- *our plan to manufacture a portion of our ceramics components internally and our expectation that in-house production of ceramics will reduce production costs;*
- *our expectation that our expenditures for research and development will increase;*
- *our expectation that we will continue to rely on sales of our energy recovery devices for a substantial portion of our revenue;*
- *our belief that our current facilities will be adequate through 2011;*
- *our expectation that sales outside of the United States will remain a significant portion of our revenue;*
- *our expectation that future sales and marketing expense will increase as revenues increase;*
- *our belief that our existing cash balances and cash generated from our operations will be sufficient to meet our anticipated capital requirements for at least the next 12 months; and*
- *our expectation that, as we expand our international sales, a small portion of our revenue could continue to be denominated in foreign currencies.*

All forward-looking statements included in this document are subject to additional risks and uncertainties further discussed under Item 1A: Risk Factors and are based on information available to us as of March 14, 2011. We assume no obligation to update any such forward-looking statements. It is important to note that our actual results could differ materially from the results set forth or implied by our forward-looking statements. The factors that could cause our actual results to differ from those included in such forward-looking statements are set forth under the heading Item 1A: Risk Factors, and our results disclosed from time to time in our reports on Forms 10-Q and 8-K and

our Annual Reports to Stockholders.

The following discussion should be read in conjunction with our Consolidated Financial Statements and related notes included elsewhere in this report.

Overview

We are in the business of designing, developing and manufacturing energy recovery devices for seawater reverse osmosis desalination. Our company was founded in 1992 and we introduced the initial version of our Pressure Exchanger[tm] energy recovery device in early 1997. In December 2009, we acquired Pump

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Engineering, LLC, which manufactures centrifugal energy recovery devices, known as turbochargers, and high pressure pumps.

A significant portion of our net revenue typically has been generated by sales to a limited number of large engineering, procurement and construction firms, which are involved with the design and construction of larger desalination plants. Sales to these firms often involve a long sales cycle, which can range from 6 to 16 months. A single large desalination project can generate an order for numerous energy recovery devices and generally represents an opportunity for significant revenue. We also sell our devices to many small to medium size original equipment manufacturers, or OEMs, which commission smaller desalination plants, order fewer energy recovery devices per plant and have shorter sales cycles.

Due to the fact that a single order for our energy recovery devices by a large engineering, procurement and construction firm for a particular plant may represent significant revenue, we often experience significant fluctuations in net revenue from quarter to quarter and from year to year. In addition, historically our engineering, procurement and construction firm customers tend to order a significant amount of equipment for delivery in the fourth quarter and, as a consequence, a significant portion of our annual sales typically occurs during that quarter. In fiscal year 2010, the fourth quarter revenues did not reflect as high of a percentage of the annual revenues as in past years due to shipment delays caused by customer project delays.

A limited number of our customers account for a substantial portion of our net revenue and accounts receivables. Revenue from customers representing 10% or more of total revenue varies from period to period. For the year ended December 31, 2010, two customers accounted for approximately 35% of our net revenue, for the year ended December 31, 2009, three customers accounted for approximately 42% of our net revenue, and for the year ended December 31, 2008, two customers accounted for approximately 27% of our net revenue. No other customers accounted for more than 10% of the Company s net revenue during any of these periods. See Note 12 *Concentrations* in the Notes to Consolidated Financial Statements for further customer concentration detail.

During the years ended December 31, 2010, 2009 and 2008, most of our revenue was attributable to sales outside of the United States. We expect sales outside of the United States to remain a significant portion of our revenue for the foreseeable future.

Our revenue is principally derived from the sales of our energy recovery devices. We also derive revenue from the sale of our high pressure and circulation pumps, which we manufacture and sell in connection with our energy recovery devices for use in desalination plants. We also receive incidental revenue from the sale of spare parts and from services, including start-up and commissioning services, that we provide for our customers. We expect our revenue in 2011 to be affected by the delayed effects of the global economic downturn on our industry.

Critical Accounting Policies and Estimates

Our Consolidated Financial Statements are prepared in accordance with generally accepted accounting principles in the United States, or GAAP. These accounting principles require us to make estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the Consolidated Financial Statements as well as the reported amounts of revenue and expense during the periods presented. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that we make these estimates and judgments. To the extent there are material differences between these estimates and actual results, our consolidated financial results will be affected. The accounting policies that reflect our more significant estimates and judgments and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition, warranty costs, share-based compensation, inventory valuation, allowances for doubtful accounts, income taxes (including our evaluation of the need for any valuation allowance on our deferred

tax assets), valuation of goodwill and other intangible assets, and our evaluation and measurement of contingencies, including contingent consideration.

Cash and Cash Equivalents

We consider all highly liquid investments with an original or remaining maturity of three months or less at the time of purchase to be cash equivalents. Cash equivalents are stated at cost, which approximates fair value. Our cash and cash equivalents are maintained in demand deposit accounts with large financial institutions and invested in institutional money market funds. We frequently monitor the creditworthiness of the financial institutions and institutional money market funds in which we invest our surplus funds. We have not experienced any credit losses from our cash investments.

Allowances for Doubtful Accounts

We record a provision for doubtful accounts based on historical experience and a detailed assessment of the collectability of our accounts receivable. In estimating the allowance for doubtful accounts, we consider, among other factors, (1) the aging of the accounts receivable, (2) our historical write-offs, (3) the credit worthiness of each customer and (4) general economic conditions.

Inventories

Inventories are stated at the lower of cost (using the weighted average cost method) or market. We calculate inventory valuation adjustments for excess and obsolete inventories based on current inventory levels, expected useful life and estimated future demand of the products and spare parts.

Property and Equipment

Property and equipment is recorded at cost and reduced by accumulated depreciation. Depreciation expense is recognized over the estimated useful lives of the assets using the straight-line method. Estimated useful lives are generally three to ten years. We own our manufacturing facility in New Boston, Michigan, which is depreciated over an estimated useful life of 39 years. A small portion of our manufacturing equipment was acquired under capital lease obligations. These assets are amortized over periods consistent with depreciation of owned assets of similar types, generally five to seven years. Certain equipment used in the development and manufacturing of ceramic components is generally depreciated over estimated useful lives of up to ten years. Leasehold improvements represent remodeling and retrofitting costs for leased office and manufacturing space and are depreciated over the shorter of either the estimated useful lives or the term of the lease using the straight-line method. Software purchased for internal use consists primarily of amounts paid for perpetual licenses to third party software providers and are depreciated over the estimated useful lives, generally three to five years. Estimated useful lives are periodically reviewed and, when appropriate, changes are made prospectively. When certain events or changes in operating conditions occur, asset lives may be adjusted and an impairment assessment may be performed on the recoverability of the carrying amounts.

Maintenance and repairs are charged directly to expense as incurred, whereas improvements and renewals are generally capitalized in their respective property accounts. When an item is retired or otherwise disposed of, the cost and applicable accumulated depreciation are removed and the resulting gain or loss is recognized in the results of operations.

Goodwill and Other Intangible Assets

The purchase price of an acquired company is allocated between intangible assets and the net tangible assets of the acquired business with the residual purchase price recorded as goodwill. The determination of the value of the intangible assets acquired involves certain judgments and estimates. These judgments can include, but are not limited to, the cash flows that an asset is expected to generate in the future and the appropriate weighted average cost of

capital.

Acquired intangible assets with determinable useful lives are amortized on a straight-line or accelerated basis over the estimated periods benefited, ranging from one to 20 years. Acquired intangible assets with contractual terms are generally amortized over their respective legal or contractual lives. Customer relationships and other noncontractual intangible assets with determinable lives are amortized over periods generally

ranging from five to 20 years. Patents developed internally are recorded at cost and amortized on a straight-line basis over their expected useful life of 16 to 20 years. When certain events or changes in operating conditions occur, an impairment assessment is performed and lives of intangible assets with determinable lives may be adjusted. Goodwill is not amortized, but is evaluated annually for impairment or when indicators of a potential impairment are present. The annual evaluation for impairment of goodwill is based on valuation models that incorporate assumptions and internal projections of expected future cash flows and operating plans. As of December 31, 2010 and 2009, acquired intangibles, including goodwill, relate to the acquisition of Pump Engineering, LLC during the fourth quarter of 2009. See Note 4. *Goodwill and Intangible Assets* to the Consolidated Financial Statements included in this report for further discussion of intangible assets.

Fair Value of Financial Instruments

Our financial instruments include cash and cash equivalents, restricted cash, accounts receivable and accrued expenses, accounts payable, and debt. The carrying amounts for these financial instruments reported in the consolidated balance sheets approximate their fair values.

Fair Value Measurements

We follow the authoritative guidance for fair value measurements and disclosures, which among other things, defines fair value, establishes a consistent framework for measuring fair value and expands disclosure for each major asset and liability category measured at fair value on either a recurring or nonrecurring basis. Fair value is defined as an exit price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability.

The framework for measuring fair value provides a hierarchy that prioritizes the inputs to valuation techniques used in measuring fair value as follows

Level 1 Quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2 Inputs other than quoted prices included within Level 1 that are either directly or indirectly observable; and

Level 3 Unobservable inputs in which little or no market activity exists, therefore requiring an entity to develop its own assumptions about the assumptions that market participants would use in pricing.

Our cash and restricted cash balances are measured at fair value on a recurring basis using market prices on active markets for identical securities (Level 1). The carrying amounts of accounts receivable, accounts payable and other accrued expenses approximate fair value because of the short maturity of those instruments. The carrying amount of the contingent consideration arising from our acquisition of Pump Engineering, LLC is measured at fair value on a recurring basis using unobservable inputs in which little or no market activity exists (Level 3). We estimate fair value of the contingent consideration based on an assessment of the weighted probability of payment under various scenarios.

Revenue Recognition

We recognize revenue when the earnings process is complete, as evidenced by an agreement with the customer, transfer of title occurs, fixed pricing is determinable and collection is reasonably assured. Transfer of title typically occurs upon shipment of the equipment pursuant to a written purchase order or contract. The portion of the sales agreement related to the field services and training for commissioning of a desalination plant is deferred using the

residual value method. Under this method, revenue allocated to undelivered elements is based on vendor objective evidence of fair value of such undelivered elements, and the residual revenue is allocated to the delivered elements, assuming that the delivered elements have stand-alone value. Vendor objective evidence of fair value for such undelivered elements is based upon the price we charge for such product or service when it is sold separately. We may modify our pricing in the future, which could

result in changes to our vendor objective evidence of fair value for such undelivered elements. The services element of our contracts represents an incidental portion of the total contract price.

Under our revenue recognition policy, evidence of an arrangement has been met when it has an executed purchase order or a stand-alone contract. Typically, smaller projects utilize purchase orders that conform to standard terms and conditions that require the customer to remit payment generally within 30 to 90 days from product delivery. In some cases, if credit worthiness cannot be determined, prepayment is required from the smaller customers.

For large projects, stand-alone contracts are utilized. For these contracts, consistent with industry practice, our customers typically require their suppliers, including ERI, to accept contractual holdback provisions whereby the final amounts due under the sales contract are remitted over extended periods of time. These retention payments typically range between 10% and 20%, and in some instances up to 30%, of the total contract amount and are due and payable when the customer is satisfied that certain specified product performance criteria have been met upon commissioning of the desalination plant, which may be 12 months to 24 months from the date of product delivery as described further below.

The specified product performance criteria for our PX device generally pertains to the ability of our product to meet its published performance specifications and warranty provisions, which our products have demonstrated on a consistent basis. This factor, combined with historical performance metrics measured over the past 10 years, provides our management with a reasonable basis to conclude that its PX device will perform satisfactorily upon commissioning of the plant. To ensure this successful product performance, we provide service, consisting principally of supervision of customer personnel, and training to the customers during the commissioning of the plant. The installation of the PX device is relatively simple, requires no customization and is performed by the customer under the supervision of our personnel. We defer the value of the service and training component of the contract and recognizes such revenue as services are rendered. Based on these factors, our management has concluded that delivery and performance have been completed when the product has been delivered (title transfers) to the customer.

We perform an evaluation of credit worthiness on an individual contract basis to assess whether collectability is reasonably assured. As part of this evaluation, our management considers many factors about the individual customer, including the underlying financial strength of the customer and/or partnership consortium and management s prior history or industry specific knowledge about the customer and its supplier relationships.

Under the stand-alone contracts, the usual payment arrangements are summarized as follows:

- an advance payment due upon execution of the contract, typically 10% to 20% of the total contract amount;
- a payment upon delivery of the product due on average between 90 and 150 days from product delivery, and in some cases up to 180 days, typically in the range of 50% to 70% of the total contract amount; and
- a retention payment due subsequent to product delivery as described further below, typically in the range of 10% to 20%, and in some cases up to 30%, of the total contract amount.

Under the terms of the retention payment component, we are generally required to issue to the customer a product performance guarantee that takes the form of an irrevocable standby letter of credit, which is issued to the customer approximately 12 to 24 months after the product delivery date. The letter of credit is either collateralized by restricted cash on deposit with a financial institution or funds available through a credit facility. The letter of credit remains in place for the performance period as specified in the contract, which is generally 12 to 36 months and, in some cases, up to 65 months from issuance. The performance period generally runs concurrent with our standard product warranty period. Once the letter of credit has been put in place, we invoice the customer for this final retention payment under

the sales contract. During the time between the product delivery and the issuance of the letter of credit, the amount of the final retention payment is classified on the balance sheet as an unbilled receivable, of which a portion may be classified as long term

to the extent that the billable period extends beyond one year. Once the letter of credit is issued, we invoice the customer and reclassify the retention amount from unbilled receivable to accounts receivable where it remains until payment.

We do not provide our customers with a right of product return. However, we will accept returns of products that are deemed to be damaged or defective when delivered that are covered by the terms and conditions of the product warranty. Product returns have not been significant. Reserves are established for possible product returns related to the advance replacement of products pending the determination of a warranty claim.

Shipping and handling charges billed to customers are included in sales. The cost of shipping to customers is included in cost of revenue.

Warranty Costs

We sell products with a limited warranty for a period ranging from one to six years. We accrue for warranty costs based on estimated product failure rates, historical activity and expectations of future costs. Periodically, we evaluate and adjust the warranty costs to the extent actual warranty costs vary from the original estimates.

Share-Based Compensation

We measure and recognize share-based compensation expense based on the fair value measurement for all share-based payment awards made to our employees and directors, including restricted stock units, restricted shares and employee stock options, over the requisite service period generally the vesting period of the awards for awards expected to vest. The fair value of restricted stock units and restricted stock is based on our stock price on the date of grant. The fair value of stock options is calculated on the date of grant using the Black-Scholes option-pricing model, which requires a number of complex assumptions, including expected life, expected volatility, risk-free interest rate, and dividend yield. The estimation of awards that will ultimately vest requires judgment and, to the extent actual results or updated estimates differ from our current estimates, such amounts are recorded as a cumulative adjustment in the period in which the estimates are revised. See Note 9 *Share-Based Compensation* to the Consolidated Financial Statements included in this report for further discussion of share-based compensation.

Foreign Currency

Our reporting currency is the U.S. dollar, while the functional currencies of our foreign subsidiaries are their respective local currencies. The asset and liability accounts of our foreign subsidiaries are translated from their local currencies at the rates in effect at the balance sheet date. Revenue and expenses are translated at average rates of exchange prevailing during the period. Gains and losses resulting from the translation of our subsidiary balance sheets are recorded as a component of accumulated other comprehensive income. Realized gains and losses from foreign currency transactions are recorded in other income and expense in the Consolidated Statements of Operations.

Income Taxes

Current tax assets and liabilities are based upon an estimate of taxes refundable or payable for each of the jurisdictions in which the company is subject to tax. In the ordinary course of business there is inherent uncertainty in quantifying income tax positions. We assess income tax positions and record tax benefits for all years subject to examination based upon our evaluation of the facts, circumstances and information available at the reporting dates. For those tax positions where it is more likely than not that a tax benefit will be sustained, we record the largest amount of tax benefit with a greater than 50% likelihood of being realized upon ultimate settlement with a taxing authority that has full knowledge of all relevant information. For those income tax positions where it is not more likely than not that a

tax benefit will be sustained, no tax benefit is recognized in the financial statements. When applicable, associated interest and penalties are recognized as a

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component of income tax expense. Accrued interest and penalties are included within the related tax asset or liability on the Consolidated Balance Sheets.

Deferred income taxes are provided for temporary differences arising from differences in basis of assets and liabilities for tax and financial reporting purposes. Deferred income taxes are recorded on temporary differences using enacted tax rates in effect for the year in which the temporary differences are expected to reverse. The effect of a change in tax rates on deferred tax assets and liabilities is recognized in income in the period that includes the enactment date. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Significant judgment is required in determining whether and to what extent any valuation allowance is needed on our deferred tax assets. At December 31, 2010 and 2009, we have not provided any valuation allowance against our deferred tax assets, based on our evaluation of the weight of available evidence including available taxable income in prior carry back years and our five year history of profitability (2005 through 2009). During 2010, we incurred an operating and net loss and we expect such losses to continue into 2011 as our industry seeks to recover from the global downturn. To the extent that we continue to incur operating and net losses in future periods and recovery of our industry is delayed beyond our expectations, the resulting continuing losses over time will increase the likelihood that our judgments regarding the realizability of our deferred tax assets will change and that we will at some point determine that it is more likely than not that some portion or possibly all of our deferred tax assets are not realizable, which will require us to record a valuation allowance which in turn will adversely affect our future results of operations.

Our operations are subject to income and transaction taxes in the U.S. and in foreign jurisdictions. Significant estimates and judgments are required in determining our worldwide provision for income taxes. Some of these estimates are based on interpretations of existing tax laws or regulations. The ultimate amount of tax liability may be uncertain as a result.

Results of Operations

2010 Compared to 2009

The following table sets forth certain data from our historical operating results as a percentage of revenue for the years indicated:

	For the Year Ended December 31,					
	2010		**2009**		**Change Favorable (Unfavorable)**	
Results of Operations: (1)						
Net revenue	$ 45,853	100%	$ 47,014	100%	$ (1,161)	(2)%
Cost of revenue	23,781	52%	17,595	37%	(6,186)	(35)%
Gross profit	22,072	48%	29,419	63%	(7,347)	(25)%
Operating expenses:						
General and administrative	17,038	37%	13,756	29%	(3,282)	(24)%
Sales and marketing	8,205	18%	6,472	14%	(1,733)	(27)%
Research and development	3,943	9%	3,041	6%	(902)	(30)%
Gain on fair value remeasurement	(2,147)	(5)%		0%	2,147	100%

Total Operating Expenses	27,039	59%	23,269	49%	(3,770)	(16)%
Income (loss) from operations	(4,967)	(11)%	6,150	13%	(11,117)	(181)%
Other income (expense):						
Interest expense & finance charges	(73)	*	(46)	*	(27)	(59)%
Interest and other income (expense)	(194)	*	54	*	(248)	(459)%
Net income (loss) before provision for income tax	(5,234)	(11)%	6,158	13%	(11,392)	(185)%
Provision for (benefit from) income tax expense	(1,626)	(4)%	2,472	5%	4,098	166%
Net Income (Loss)	$ (3,608)	(8)%	$ 3,686	8%	$ (7,294)	(198)%

* Less than 1%.

(1) Percentages may not add up to 100% due to rounding.

Net Revenue

Our net revenue decreased by $1.2 million, or 2%, to $45.9 million for the year ended December 31, 2010 from $47.0 million for the year ended December 31, 2009. Revenues from the sales of PX devices and related products and services decreased by approximately $17.3 million while revenues from the sales of turbochargers and pumps increased by approximately $16.1 million. The decrease in revenue from sales of PX devices was primarily due to the timing of larger orders, a global decline in the construction of new projects, and competition. Additionally, there was a slight decrease in the average sales price of PX units during fiscal year 2010. The increase in revenue from sales of turbochargers and pumps was primarily due to a full year of shipments by our subsidiary, Pump Engineering, Inc., which was acquired late in the fourth quarter of 2009, and the timing of larger orders. Revenues from the sales of our turbochargers and related products had a very small impact on our 2009 revenue base, totaling only $0.2 million for the 2009 fiscal year.

For the year ended December 31, 2010, the sales of PX devices and related products and services accounted for approximately 61% of our revenue and sales of turbochargers and pumps accounted for approximately 39%. For the year ended December 31, 2009, the sales of PX devices and related products and services accounted for approximately 96% of our revenue and sales of turbochargers and pumps accounted for approximately 4%. Turbochargers and related high pressure pumps, manufactured by our subsidiary, Pump Engineering, Inc., had a negligible impact on our product offerings in 2009 as the subsidiary was acquired late in the fourth quarter of 2009.

The following geographic information includes net revenue to our domestic and international customers based on the customers requested delivery locations, except for certain cases in which the customer directed us to deliver our products to a location that differs from the known ultimate location of use. In such cases, the ultimate location of use is reflected in the table below instead of the delivery location. The amounts below are in thousands, except percentage data.

	Years Ended December 31,	
	2010	**2009**
Domestic net revenue	$ 3,334	$ 3,022
International net revenue	42,519	43,992
Total net revenue	$ 45,853	$ 47,014
Revenue by country:		
Australia	31%	19%
Algeria	12	24
Israel	2	21
Others	55	36
Total	100%	100%

The impact of the current global economic climate on future demand for our products is uncertain. The weakening global economy may cause our customers to delay or cancel plans for future orders of our products.

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Gross Profit

The following table reflects the impact of product sales activities to our overall gross margin for the periods indicated (in thousands, except percentages):

	Years Ended December 31,					
	2010			2009		
	PX and Related Products and Services	Turbochargers and Pumps	Total	PX and Related Products and Services	Turbochargers and Pumps(1)	Total
Net revenue	$ 27,850	$ 18,003	$ 45,853	$ 45,091	$ 1,923	$ 47,014
Cost of revenue	11,262	12,519	23,781	16,041	1,554	17,595
Gross profit	$ 16,588	$ 5,484	$ 22,072	$ 29,050	$ 369	$ 29,419
Gross margin %	60%	30%	48%	64%	19%	63%

(1) Turbochargers and related high pressure pumps had a negligible impact on overall gross profit as a percentage of revenue in fiscal year 2009 as the acquisition of Pump Engineering, LLC occurred late in the fourth quarter of 2009.

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including share-based compensation), manufacturing overhead, warranty costs, depreciation expense, and manufactured components. The largest component of our cost of revenue is raw materials, primarily ceramic materials. For the year ended December 31, 2010, gross profit as a percentage of net revenue was 48%, as compared to 63% for the year ended December 31, 2009.

The decrease in gross profit as a percentage of net revenue was primarily due to a shift of product sales to lower margin turbochargers and high-pressure pumps, a result of our acquisition of Pump Engineering, LLC in late 2009, and an increase in overhead costs related to our PX devices, largely attributed to the underutilization of our newly expanded manufacturing facility. Additionally, the amortization of an inventory valuation step-up of $0.9 million, stemming from our acquisition of Pump Engineering, LLC, and a slight decline in the average selling prices of our PX devices also served to negatively impact gross margin in fiscal year 2010.

Future gross profit is highly dependent on the product and customer mix of our net revenues, overall market demand and competition, and the volume of production in our own ceramics factory and our assembly operations that determines our operating leverage. Accordingly, we are not able to predict our future gross profit levels with certainty. In addition, our recent production facility expansion will continue to have a negative impact to our margins if our production volume does not increase in the foreseeable future.

General and Administrative Expense

General and administrative expense increased by $3.3 million, or 24%, to $17.0 million for the year ended December 31, 2010 from $13.8 million for the year ended December 31, 2009. The increase of general and

administrative expense was attributable primarily to the amortization of acquired intangible assets and an increase in general and administrative headcount related to the acquisition of Pump Engineering, LLC in December 2009 and an increase in occupancy costs related to our new corporate headquarters. General and administrative expense as a percentage of our net revenue increased to 37% for the year ended December 31, 2010 from 29% for the year ended December 31, 2009 as general and administrative costs increased period over period while net revenue decreased.

Of the $3.3 million net increase in general and administrative expense, increases of $2.4 million related to amortization of intangible assets, $1.2 million related to occupancy costs, $0.5 million related to compensation and employee-related benefits, and $0.2 million related to local taxes and other administrative costs. These increases in costs were offset in part by decreases of $0.6 million related to professional and other services, $0.3 million related to changes in bad debt and other reserves, and $0.1 million related to Value Added Taxes (VAT). Share-based compensation expense included in general and administrative expense was $1.8 million for the year ended December 31, 2010 and $1.5 million for the year ended December 31, 2009.

General and administrative average headcount increased to 40 for the year ended December 31, 2010 from 36 for the prior year largely as a result of the acquisition of Pump Engineering, LLC in December 2009. Increased compensation and employee benefit costs related to this increase in headcount were largely offset by the effects of cost cutting measures implemented at our corporate headquarters in 2010.

Sales and Marketing Expense

Sales and marketing expense increased by $1.7 million, or 27%, for the year ended December 31, 2010 compared to the year ended December 31, 2009. This increase was primarily related to an increase in sales and marketing headcount as a result of the Pump Engineering acquisition in December 2009. Sales and marketing average headcount increased to 26 for the year ended December 31, 2010 from 22 for the year ended December 31, 2009. As a percentage of our net revenue, sales and marketing expense increased to 18% for the year ended December 31, 2010 from 14% for the year ended December 31, 2009, primarily due to lower net revenue for the current period.

The $1.7 million net increase in sales and marketing expense for the year ended December 31, 2010 was primarily related to increases in compensation, employee-related benefits, and commissions to outside sales representatives as a result of the acquisition of Pump Engineering, LLC in December 2009. Sales and marketing headcount increased due to the acquisition. Additionally, Pump Engineering has historically relied on outside sales agents rather than inside sales representatives to generate sales, resulting in higher commission rates. Share-based compensation expense included in sales and marketing expense was $599,000 for the year ended December 31, 2010 and $488,000 for the year ended December 31, 2009.

Research and Development Expense

Research and development expense increased by $0.9 million, or 30%, to $3.9 million for the year ended December 31, 2010 from $3.0 million for the year ended December 31, 2009. Research and development expense as a percentage of our net revenue increased to 9% for the year ended December 31, 2010 compared to 6% for the year ended December 31, 2009, as research and development expense increased for those periods while net revenue decreased.

Of the $0.9 million increase in research and development expense for the year ended December 31, 2010, $0.4 million related to increased compensation and employee-related benefits as a result of our acquisition of Pump Engineering, LLC in December 2009, $0.2 million related to increased occupancy costs and consulting and professional fees, and $0.3 million related to an increase in research and development direct project costs.

Average headcount in our research and development department increased to 17 for the year ended December 31, 2010 from 11 for the year ended December 31, 2009, primarily due to the acquisition of Pump Engineering, LLC in December 2009. Share-based compensation expense included in research and development expense was $214,000 for year ended December 31, 2010 and $246,000 for the year ended December 31, 2009.

We anticipate that our research and development expenditures will increase substantially in the future as we expand and diversify our product offerings.

Gain on Fair Value Remeasurement

We acquired Pump Engineering, LLC in December 2009. Under the business combinations guidance of U.S. GAAP, we initially recognized a liability of $5.5 million as an estimate of the acquisition date fair value of contingent and other consideration, consisting of $3.5 million of contingent consideration subject to pay-out to the sellers upon the acquired company s achievement of certain milestones and $2.0 of other consideration securing the sellers

indemnification obligations. The fair value measurement of the $3.5 million of contingent consideration was based on the weighted probability of achievement, as of the acquisition date, that the milestones would be achieved. In the fourth quarter of 2010, some of the milestones were not met. Accordingly, we remeasured the contingent consideration at $1.4 million to reflect its estimated fair value at December 31, 2010 and recognized a gain of $2.1 million in our Consolidated Statement of Operations. See

Note 3 *Business Combinations* to the Consolidated Financial Statements included in this report for further discussion of the gain on fair value remeasurement.

Non-operating Income (Expense), Net

Non-operating income (expense), net, changed unfavorably by $275,000 to $(267,000) of other net expense for the year ended December 31, 2010 from $8,000 of other net income for the year ended December 31, 2009. The unfavorable variance was primarily due to a loss of $0.1 million on the sale of equipment in 2010, a decrease of $0.1 million in interest income and a decrease of $0.1 million increase in net foreign currency losses year over year.

2009 Compared to 2008

The following table sets forth certain data from our historical operating results as a percentage of revenue for the years indicated:

	For the Year Ended December 31,					
	2009		**2008**		**Change Favorable (Unfavorable)**	
Results of Operations: (1)						
Net revenue	$ 47,014	100%	$ 52,119	100%	$ (5,105)	(10)%
Cost of revenue	17,595	37%	18,933	36%	1,338	7%
Gross profit	29,419	63%	33,186	64%	(3,767)	(11)%
Operating expenses:						
General and administrative	13,756	29%	11,321	22%	(2,435)	(22)%
Sales and marketing	6,472	14%	6,549	13%	77	1%
Research and development	3,041	6%	2,415	5%	(626)	(26)%
Total Operating Expenses	23,269	49%	20,285	39%	(2,984)	(15)%
Income from operations	6,150	13%	12,901	25%	(6,751)	(52)%
Other income (expense):						
Interest expense & finance charges	(46)	*	(79)	*	33	42%
Interest and other income	54	*	873	2%	(819)	(94)%
Net income before provision for income tax	6,158	13%	13,695	26%	(7,537)	(55)%
Provision for income tax expense	2,472	5%	5,032	10%	2,560	51%
Net Income	$ 3,686	8%	$ 8,663	17%	$ (4,977)	(57)%

* Less than 1%.

(1) Percentages may not add up to 100% due to rounding.

Net Revenue

Our net revenue decreased by $5.1 million, or 10%, to $47.0 million for the year ended December 31, 2009 from $52.1 million for the year ended December 31, 2008. The decrease in net revenue was primarily due to customer project delays attributable to the global economic downturn and financial market crisis. The average sales price of our PX units increased resulting largely from more sales of our higher-capacity PX-260 devices and served to offset some of the impacts of the customer order delays. Lastly, we experienced an increase in our service related revenue due to efforts targeted at increasing after-market sales and services which also partially reduced the negative impacts stemming from the economic downturn. The acquisition of Pump Engineering, LLC on December 21, 2009 had a very small impact on our 2009 revenue base and amounted to $0.2 million.

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For the year ended December 31, 2009, the sales of PX devices accounted for approximately 91% of our revenue, pump sales accounted for approximately 4% and spare parts and service accounted for 5%. For the year ended December 31, 2008, the sales of PX devices accounted for approximately 95% of revenue, pump sales accounted for approximately 3%, and spare parts and service accounted for 2%.

The following geographic information includes net revenue to our domestic and international customers based on the customers requested delivery locations, except for certain cases in which the customer directed us to deliver our products to a location that differs from the known ultimate location of use. In such cases, the ultimate location of use is reflected in the table below instead of the delivery location. The amounts below are in thousands, except percentage data.

	Years Ended December 31,	
	2009	**2008**
Domestic net revenue	$ 3,022	$ 3,517
International net revenue	43,992	48,602
Total net revenue	$ 47,014	$ 52,119
Revenue by country:		
Algeria	24%	24%
Israel	21	2
Australia	19	3
China	4	11
Spain	3	16
Others	29	44
Total	100%	100%

Gross Profit

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including share-based compensation), manufacturing overhead, warranty costs, depreciation expense, excess and obsolete inventory expense, and manufactured components. The largest component of our cost of revenue is raw materials, primarily ceramic materials, which we obtain from several suppliers. For the year ended December 31, 2009, gross profit as a percentage of net revenue was 63%, as compared to 62% for the year ended December 31, 2008 when adjusting for a one-time reversal of a warranty provision in 2008 for the amount of $688,000, or 1%. The slight increase in gross profit as a percentage of net revenue, when adjusting for the one-time warranty provision reversal in 2008, was largely due to a higher average selling price during the year ended December 31, 2009, as compared to the prior year, resulting largely from increased sales of our higher-capacity PX-260 devices on a net basis. The benefits of the higher average selling price in 2009 vs. 2008, however, was largely offset by an increase in period overhead costs associated with the opening of our new manufacturing facility in November 2009 and, to a lesser extent, an increase in ceramics materials costs in 2009. Pump Engineering, Inc. s gross margin during the 11-day post acquisition stub period had a negligible impact on our overall gross margin percentage in 2009 as the merger of the companies occurred late in the fourth quarter of 2009.

General and Administrative Expense

General and administrative expense increased by $2.4 million, or 22%, to $13.8 million for the year ended December 31, 2009 from $11.3 million for the year ended December 31, 2008. As a percentage of net revenue, general and administrative expense was 29% for the year ended December 31, 2009 and 22% for the year ended December 31, 2008. The increase of general and administrative expense was attributable primarily to the increase in general and administrative headcount to support our growth in operations and to support the requirements for operating as a public company. The average number of administrative employees was 36 for the year ended December 31, 2009 compared to 24 for the prior year.

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Of the $2.4 million increase in general and administrative expense, compensation and employee-related benefits comprised of $2.1 million of the increase, followed by a $0.6 million increase in occupancy and other administrative costs, a $0.2 million increase in intangibles amortization due to the recent Pump Engineering, LLC acquisition and an increase of $0.2 million in bad debt expense. Professional services and Value Added Taxes (VAT), on the other hand, partially offset the administrative increases above by $0.4 million and $0.3 million, respectively. Share-based compensation expense included in general and administrative expense was $1.5 million for the year ended December 31, 2009 and $512,000 for the year ended December 31, 2008.

Sales and Marketing Expense

Sales and marketing expense decreased by $77,000 or 1%, for the year ended December 31, 2009 compared to the year ended December 31, 2008. This slight decrease, on a net basis, was primarily related to lower commission costs resulting from our lower sales revenue base in 2009 vs. 2008 and lower outside promotional costs. Our larger employee staff base in 2009 vs. 2008, however, offset much of the commission cost decrease. Our average sales and marketing headcount during the year ended December 31, 2009 was 22 compared to 19 for the comparable period in 2008.

As a percentage of our net revenue, sales and marketing expense increased to 14% for the year ended December 31, 2009 from 13% for the year ended December 31, 2008. The increase in 2009 was attributable primarily to the decrease in our net revenue during that period.

The $0.1 million net decrease in sales and marketing expense for the year ended December 31, 2009 was made up of a number of components. Increases in base compensation and related benefit costs of $1.0 million in 2009 were offset by decreases in commissions earned by employees and outside representatives of $1.0 million during the period. Additionally, there was a decrease in outside service promotional costs of $0.2 million during the year offset in part by an increase in facility and other marketing support costs of $0.1 million. Share-based compensation expense included in sales and marketing expense was $488,000 for the year ended December 31, 2009 and $279,000 for the year ended December 31, 2008.

Research and Development Expense

Research and development expense increased by $0.6 million, or 26%, to $3.0 million for the year ended December 31, 2009 from $2.4 million for the year ended December 31, 2008. Of the $0.6 million increase, compensation and employee-related benefits accounted for $0.6 million and occupancy and other miscellaneous costs accounted for $0.2 million, offset partially by a decrease in consulting and professional service fees of $0.2 million. As a percentage of our net revenue, research and development expense increased to 7% for the year ended December 31, 2009 compared to 5% for the year ended December 31, 2008. The increase in research and development cost in 2009 was attributable primarily to our ceramics initiative.

Our average headcount in the research and development department increased to eleven for the year ended December 31, 2009 from eight for the comparable period in the prior year. Share-based compensation expense included in research and development expense was $246,000 for year ended December 31, 2009 and $140,000 for the year ended December 31, 2008.

Other Income (Expense), Net

Other net income (expense) decreased by $786,000 to $8,000 for the year ended December 31, 2009 from $794,000 for the year ended December 31, 2008. The reduction in 2009 versus 2008 was primarily due to a decrease in interest earnings of $552,000 resulting from dramatically lower interest rates in 2009 compared to 2008. In addition, other

asset losses and an unfavorable change in exchange rates related to accounts receivable denominated in foreign currencies resulted in an unfavorable variance of approximately $266,000, offset in part by a reduction in net interest expense of $32,000 stemming from the reduction of equipment loans.

Liquidity and Capital Resources

Our primary source of cash historically has been proceeds from the issuance of common stock, customer payments for our products and services and borrowings under our credit facility. From January 1, 2005 through December 31, 2010, we issued common stock for aggregate net proceeds of $83.9 million, excluding common stock issued in exchange for promissory notes. The proceeds from the sales of common stock have been used to fund our operations and capital expenditures.

As of December 31, 2010, our principal sources of liquidity consisted of unrestricted cash and cash equivalents of $55.3 million, which are invested primarily in money market funds, and accounts receivable of $9.6 million. In July 2008, we received approximately $76.7 million of net proceeds from our IPO.

In February 2009, we terminated a March 2008 credit agreement (2008 credit agreement) with a financial institution and transferred $9.1 million in cash to a restricted cash account as collateral for outstanding irrevocable standby letters of credit that were collateralized by the credit agreement as of the date of its termination and collateral for the outstanding equipment promissory note. During the years ended December 31, 2010 and 2009, $2.0 million and $6.8 million of the restricted cash was released, respectively. As of December 31, 2010, $2.3 million remains restricted as collateral for the remaining outstanding irrevocable standby letters of credit issued under the terminated 2008 credit agreement.

Upon the termination of the 2008 credit agreement, a new Loan and Security Agreement between Citibank, N.A. and our company (2009 loan and security agreement) became effective. The new agreement, as amended in May 2010, allows us to draw advances up to $10.0 million on a revolving line of credit or utilize up to $15.9 million as collateral for irrevocable standby letters of credit, provided that the aggregate of the outstanding advances and collateral do not exceed the total available credit line of $16.0 million. Advances under the revolving line of credit incur interest based on either a prime rate index or LIBOR plus 1.375%. The amended agreement expires in May 2012 and is collateralized by substantially all of our assets.

As of December 31, 2010, we were non-compliant with two financial covenants related to the 2009 loan and security agreement. Section 6.6(c) of the loan and security agreement sets forth a covenant that requires our company to meet a minimum net income requirement for the fiscal year. The covenant was not satisfied due to a net loss that we reported for the 2010 fiscal year. Additionally, we were non-compliant with one financial covenant related to the timing of financial reporting. We are in discussion with Citibank seeking a waiver for this matter. As of December 31, 2010, $7.6 million of the $16.0 million credit line has been utilized as collateral for outstanding irrevocable standby letters of credit, there are no outstanding draws or other outstanding balance on the credit line, and the unutilized credit line balance of $8.4 million remains available for our use. Although there is no assurance that we will be successful in obtaining the waiver, our cash and cash equivalents balance of $55.3 million at December 31, 2010 significantly exceeds the amount of credit utilized to date and we expect that we will be able to resolve the matter with Citibank or, if necessary, obtain alternative arrangements without a material adverse effect on our company.

During the years ended December 31, 2010 and 2009, we provided certain customers with irrevocable standby letters of credit to secure our obligations for the delivery and performance of products in accordance with sales arrangements. These standby letters of credit were issued primarily under our 2009 loan and security agreement. The standby letters of credit generally terminate within 12 to 36 months from issuance. As of December 31, 2010, the amounts outstanding on irrevocable standby letters of credit collateralized under our credit agreement totaled approximately $7.6 million.

We have unbilled receivables pertaining to customer contractual holdback provisions, whereby we invoice the final installment due under a sales contract 12 to 24 months after the product has been shipped to the customer and revenue

has been recognized. The customer holdbacks represent amounts intended to provide a form of security for the customer rather than a form of long-term financing; accordingly, these receivables have not been discounted to present value. At December 31, 2010 and 2009, we had $2.3 million and $5.5 million of current unbilled receivables, respectively.

On March 28, 2007, we entered into a $1.0 million equipment promissory note. The equipment promissory note bears an interest rate of 7.81% and matures in September 2012. The amounts outstanding on the equipment promissory note as of December 31, 2010 and 2009 were $213,000 and $341,000, respectively.

On December 1, 2005, we entered into a $222,000 fixed-rate installment note, or fixed note, with a maturity date of December 15, 2010. The fixed note bears an annual interest rate of 10%. These notes are secured by our accounts receivable, inventories, property, equipment and other general intangibles except for intellectual property. The amounts outstanding on the fixed note as of December 31, 2008 was $89,000. In February 2009, we paid the remaining balance of the fixed promissory note for a total of $83,000, including accrued interest.

Cash Flows from Operating Activities

Net cash provided by operating activities was $1.7 million and $12.8 million for the years ended December 31, 2010 and 2009, respectively. For the years ended December 31, 2010 and 2009, net loss of $(3.6) million and net income of $3.7 million, respectively, were adjusted to $4.1 million and $7.2 million, respectively, by non-cash items totaling $7.7 million and $3.5 million, respectively. Non-cash adjustments include depreciation, amortization, unrealized gains and losses on foreign exchange, share-based compensation, provisions for doubtful accounts, warranty reserves and excess and obsolete inventory reserves. In 2010, non-cash items also included a $2.1 million gain related to the fair value remeasurement of contingent consideration for the 2009 acquisition of Pump Engineering, LLP.

The net cash in(out)flow effect from changes in assets and liabilities was approximately $(2.4) million and $5.6 million for the years ended December 31, 2010 and 2009, respectively. Net changes in assets and liabilities are primarily attributable to changes in inventory as a result of the timing of order processing and product shipments, changes in accounts receivable and unbilled receivables as a result of timing of invoices and collections for large projects, and changes in prepaid expenses and accrued liabilities as a result of the timing of payments to employees, vendors and other third parties.

Net cash provided by operating activities was $12.8 million and $1.4 million for the years ended December 31, 2009 and 2008, respectively. For the years ended December 31, 2009 and 2008, cash provided by net income of $3.7 million and $8.7 million, respectively, was adjusted to $7.2 million and $10.1 million, respectively, by non-cash items (depreciation, amortization, unrealized gains and losses on foreign exchange, share-based compensation, provisions for doubtful accounts, warranty reserves and excess and obsolete inventory) totaling $3.5 million and $1.4 million, respectively. The net cash in(out)flow effect from changes in assets and liabilities was approximately $5.6 million and $(8.7) million for the years ended December 31, 2009 and 2008, respectively. See above for factors contributing to changes in assets and liabilities.

Cash Flows from Investing Activities

Cash flows used in investing activities primarily relate to company acquisitions, capital expenditures to support our growth, as well as increases in our restricted cash used to collateralize our letters of credit.

Net cash used in investing activities was $5.5 million and $31.9 million for the years ended December 31, 2010, and 2009, respectively. The decrease of $26.4 million in net cash used by investing activities was primarily attributable to the purchase of Pump Engineering, LLC in 2009, which resulted in a cash payment, net of cash acquired, of $13.6 million. Additionally, during fiscal year 2010, restricted cash of $0.9 million, related to the acquisition of Pump Engineering, LLC, and restricted cash of $3.0 million, used to collateralize outstanding irrevocable standby letters of credit, were released. Comparatively, there was a net increase in restricted cash of $10.5 million $5.5 million related to escrow amounts for the acquisition of Pump Engineering, LLC and $5.0 million for use as collateral of standby letters of credit during fiscal year 2009. The decreases in cash used in investing activities in 2010 compared to 2009

were slightly offset by an increase in capital expenditures of $1.8 million during 2010 for the completion of seismic upgrades and the build out of a ceramics manufacturing capabilities at our headquarters.

Net cash (used in) provided by investing activities was $(31.9) million and $0.7 million for the years ended December 31, 2009, and 2008, respectively. The increase in net cash used by investing activities was primarily attributable to the purchase of Pump Engineering, LLC, which resulted in a cash payment of $14.5 million ($13.6 million, net of cash acquired), and a $5.5 million transfer to restricted cash. Additionally, transfers to restricted cash to cover remaining outstanding irrevocable standby letters of credit issued under terminated credit agreements also served to increase our cash use in 2009 over 2008. Lastly, the balance of the cash use increase in 2009 over 2008 stemmed from our capital expenditure increase of $3.9 million to support the initial build-out of our new integrated manufacturing and administrative facility, which commenced operation in November 2009, and $3.2 million to support seismic upgrades and the build-out of ceramics manufacturing capabilities at our new facility, which was completed in 2010.

Cash Flows from Financing Activities

Net cash provided by (used in) financing activities was $0.1 million and $(1.1) million for the years ending December 31, 2010 and 2009, respectively. The favorable change in net cash flows from financing activities is primarily due the repayment of $1.6 million of long-term debt obligations in December 2009 owed by our subsidiary, Pump Engineering, Inc. and an increase of $0.2 million in proceeds received for warrant and stock option exercises. Favorable changes in financing cash flows were slightly offset by an increase in capital lease payments of $0.2 million, a decrease in collections on promissory notes of $0.2 million, and a decrease in excess tax benefits related to share-based compensation arrangements of $0.2 million.

Net cash (used in) provided by financing activities was $(1.1) million and $77.1 million for the years ending December 31, 2009 and 2008, respectively. The decrease in net cash flows from financing activities is primarily due to the receipt of IPO net proceeds of $76.7 million in July 2008. Additionally, in December 2009, we repaid $1.7 million of long-term debt obligations owed by our subsidiary, Pump Engineering, Inc. Remaining changes in financing cash use include a decrease in repayments of promissory notes by stockholders of $0.4 million, partially offset by excess tax benefits related to share-based compensation arrangements of $0.3 million.

Liquidity and Capital Resource Requirements

We believe that our existing cash balances and cash generated from our operations will be sufficient to meet our anticipated capital requirements for at least the next 12 months. However, we may need to raise additional capital or incur additional indebtedness to continue to fund our operations in the future. Our future capital requirements will depend on many factors, including our rate of revenue growth, if any, the expansion of our sales and marketing and research and development activities, the timing and extent of our expansion into new geographic territories, the timing of introductions of new products and the continuing market acceptance of our products. We may enter into potential material investments in, or acquisitions of, complementary businesses, services or technologies, in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

Contractual Obligations

We lease facilities and equipment under fixed non-cancelable operating leases that expire on various dates through 2019. We have purchased property and equipment under capital leases and notes payable. We have entered into purchase commitments with a vendor for the purchase and installation of specialized ceramics manufacturing equipment of which approximately $0.2 million is remaining as of December 31, 2010. We expect to receive and install this equipment during the first quarter of 2011. Additionally, we have entered into a supply agreement with a vendor in order to manage the cost and availability of key raw materials. The agreement is subject to minimum annual purchase requirements and is noncancelable. Lastly, in the course of our normal operations, we also entered into

purchase commitments with our suppliers for various key raw materials and component parts. The purchase commitments covered by these arrangements are subject to change based on our sales forecasts for future deliveries.

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The following is a summary of our contractual obligations as of December 31, 2010 (in thousands):

	Payments Due by Period				
Payments Due During Year Ending December 31,	**Operating Leases**	**Capital Leases(1)**	**Notes Payable**	**Purchase Obligations(2)**	**Total**
2011	1,579	176	128	5,587	7,470
2012	1,529	111	85	1,600	3,325
2013	1,563	46		1,600	3,209
2014	1,559				1,559
2015	1,477				1,477
Thereafter	5,990				5,990
	$ 13,697	$ 333	$ 213	$ 8,787	$ 23,030

(1) Present value of net minimum capital lease payments is $304, as reflected on the balance sheet.

(2) Includes $0.2 million related to specialized equipment orders, $5.2 million related to minimum purchase commitments under supply agreements, and $3.4 million related to open purchase orders for materials and supplies.

This table excludes agreements with guarantees or indemnity provisions that we have entered into with customers and others in the ordinary course of business. Based on our historical experience and information known to us as of December 31, 2010, we believe that our exposure related to these guarantees and indemnities as of December 31, 2010 was not material.

Off-Balance Sheet Arrangements

During the periods presented, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purpose.

Recent Accounting Pronouncements

See Note 2, *Summary of Significant Accounting Policies* to the Consolidated Financial Statements regarding the impact of certain recent accounting pronouncements on our Consolidated Financial Statements.

Item 7A. ***Quantitative and Qualitative Disclosure About Market Risk***

Foreign Currency Risk

Currently, the majority of our revenue contracts have been denominated in United States dollars. In some circumstances, we have priced certain international sales in Euros. The amount of revenue recognized denominated in Euros amounted to $2.1 million, zero, and $7.1 million in 2010, 2009, and 2008, respectively. We experienced a net foreign currency gain (loss) of approximately $(152,000), $(44,000), and $220,000 related to our revenue contracts for the years ended December 31, 2010, 2009, and 2008, respectively.

As we expand our international sales, we expect that a portion of our revenue could continue to be denominated in foreign currencies. As a result, our cash and cash equivalents and operating results could be increasingly affected by changes in exchange rates. Our international sales and marketing operations incur expense that is denominated in foreign currencies. This expense could be materially affected by currency fluctuations. Our exposures are to fluctuations in exchange rates for the United States dollar versus the Euro. Changes in currency exchange rates could adversely affect our consolidated operating results or financial position. Additionally, our international sales and marketing operations maintain cash balances denominated in foreign currencies. In order to decrease the inherent risk associated with translation of foreign cash balances into our reporting currency, we have not maintained excess cash balances in foreign currencies. We have not hedged our exposure to changes in foreign currency exchange rates because expenses in foreign currencies

have been insignificant to date, and exchange rate fluctuations have had little impact on our operating results and cash flows.

Interest Rate Risk

We had unrestricted cash and cash equivalents totaling $55.3 million, $59.1 million, and $79.3 million at December 31, 2010, 2009, and 2008, respectively. These amounts were invested primarily in money market funds. The unrestricted cash and cash equivalents are held for working capital purposes. We do not enter into investments for trading or speculative purposes. We believe that we do not have any material exposure to changes in the fair value as a result of changes in interest rates due to the short term nature of our cash equivalents and short-term investments. Declines in interest rates, however, would reduce future investment income.

Concentration of Credit Rate Risk

The market risk inherent in our financial instruments and in our financial position represents the potential loss arising from disruptions caused by recent financial market conditions. Currently, our cash and cash equivalents are primarily deposited in a money market fund backed by U.S. Treasury securities; however, substantially all of our cash and cash equivalents are in excess of federally insured limits at a very limited number of financial institutions. This represents a high concentration of credit risk.

Item 8. ***Financial Statements and Supplementary Data***

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders of
Energy Recovery, Inc.
San Leandro, California

We have audited the accompanying consolidated balance sheets of Energy Recovery, Inc. as of December 31, 2010 and 2009 and the related consolidated statements of operations, stockholders equity and comprehensive income (loss), and cash flows for each of the three years in the period ended December 31, 2010. In connection with our audits of the financial statements, we have also audited the financial statement schedule (schedule) listed in Item 15(a)(2). These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements and schedule. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Energy Recovery, Inc. at December 31, 2010 and 2009, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2010, in conformity with accounting principles generally accepted in the United States of America.

Also, in our opinion, the financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Energy Recovery, Inc. s internal control over financial reporting as of December 31, 2010, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 14, 2011 expressed an unqualified opinion thereon.

/s/ BDO USA, LLP

San Jose, California
March 14, 2011

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ENERGY RECOVERY, INC.

CONSOLIDATED BALANCE SHEETS

	December 31, 2010	December 31, 2009
	(In thousands, except share data and par value)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 55,338	$ 59,115
Restricted cash	4,636	5,271
Accounts receivable, net of allowance for doubtful accounts of $44 and $196 at December 31, 2010 and 2009, respectively	9,649	12,683
Unbilled receivables, current	2,278	5,544
Inventories	9,772	10,359
Deferred tax assets, net	2,097	1,466
Prepaid expenses and other current assets	4,428	1,741
Total current assets	88,198	96,179
Restricted cash, non-current	2,244	5,555
Property and equipment, net	22,314	16,958
Goodwill	12,790	12,790
Other intangible assets, net	8,352	10,987
Deferred tax assets, non-current, net		447
Other assets, non-current	19	53
Total assets	$ 133,917	$ 142,969
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 1,429	$ 1,952
Accrued expenses and other current liabilities	5,248	9,492
Income taxes payable	13	350
Accrued warranty reserve	1,028	605
Deferred revenue	2,341	4,628
Current portion of long-term debt	128	265
Current portion of capital lease obligations	160	203
Total current liabilities	10,347	17,495
Long-term debt	85	246
Capital lease obligations, non-current	144	369
Deferred tax liabilities, non-current, net	317	
Other non-current liabilities	2,224	3,890

Total liabilities		13,117		22,000
Commitments and Contingencies (Note 15)				
Stockholders equity:				
Preferred stock, $0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding				
Common stock, $0.001 par value; 200,000,000 shares authorized; 52,596,170 and 51,215,653 shares issued and outstanding at December 31, 2010 and 2009, respectively		53		51
Additional paid-in capital		112,025		108,626
Notes receivable from stockholders		(38)		(90)
Accumulated other comprehensive loss		(80)		(66)
Retained earnings		8,840		12,448
Total stockholders equity		120,800		120,969
Total liabilities and stockholders equity	$	133,917	$	142,969

See accompanying Notes to Consolidated Financial Statements

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ENERGY RECOVERY, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

	Years Ended December 31,		
	2010	**2009**	**2008**
	(In thousands, except per share data)		
Net revenue	$ 45,853	$ 47,014	$ 52,119
Cost of revenue	23,781	17,595	18,933
Gross profit	22,072	29,419	33,186
Operating expenses:			
General and administrative	17,038	13,756	11,321
Sales and marketing	8,205	6,472	6,549
Research and development	3,943	3,041	2,415
Gain on fair value remeasurement	(2,147)		
Total operating expenses	27,039	23,269	20,285
Income (loss) from operations	(4,967)	6,150	12,901
Other income (expense):			
Interest expense	(73)	(46)	(79)
Interest and other income (expense)	(194)	54	873
Income (loss) before provision for income taxes	(5,234)	6,158	13,695
Provision for (benefit from) income taxes	(1,626)	2,472	5,032
Net Income (loss)	$ (3,608)	$ 3,686	$ 8,663
Earnings (loss) per share:			
Basic	$ (0.07)	$ 0.07	$ 0.19
Diluted	$ (0.07)	$ 0.07	$ 0.18
Number of shares used in per share calculations:			
Basic	52,072	50,166	44,848
Diluted	52,072	52,644	47,392