

ENVIRONMENTAL POWER CORP

Form 10-Q

May 15, 2007

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

WASHINGTON, DC 20549

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**FORM 10-Q**

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(Mark one)

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

For the quarterly period ended March 31, 2007

OR

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

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

Commission file number 001-32393

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**Environmental Power Corporation**

(Exact name of registrant as specified in its charter)

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Delaware  
(State or other jurisdiction of

incorporation or organization)

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

(address of principal executive offices) (zip code)

75-3117389  
(IRS Employer

Identification No.)

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(603) 431-1780

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

Number of shares of Common Stock outstanding at March 31, 2007: 9,787,384 shares

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**PART I. FINANCIAL INFORMATION**

**Cautionary Statement Regarding Forward-Looking Statements**

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

uncertainties involving development-stage companies,

uncertainties regarding financing,

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

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

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

financing and cash flow requirements and uncertainties,

inexperience with the design and construction of our facilities,

difficulties involved in developing and executing a business plan,

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

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

unpredictable developments, including plant outages and repair requirements,

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

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

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

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

uncertainties relating to general economic and industry conditions, and the amount and rate of growth in expenses,

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

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

Condensed Consolidated Balance Sheets as of March 31, 2007 (unaudited) and December 31, 2006

|   | March 31,<br>2007<br>(unaudited) | December 31, 2006     |
|---|----------------------------------|-----------------------|
| <b>ASSETS</b>   |                                  |                       |
| Current Assets  |                                  |                       |
| Cash and cash equivalents                             | \$ 9,514,467                     | \$ 13,794,325         |
| Restricted cash                                       | 53,815,666                       | 55,485,420            |
| Receivables   | 16,638,879                       | 13,207,473            |
| Fuel inventory  | 1,059,672                        | 1,189,323             |
| Other current assets                                  | 238,417                          | 251,954               |
| Total Current Assets                                  | \$ 81,267,101                    | \$ 83,928,495         |
| Property, Plant, and Equipment, net                   | \$ 477,642                       | \$ 460,803            |
| Construction in Progress                              | 18,393,653                       | 14,074,353            |
| Lease Rights, net                                     | 1,379,232                        | 1,416,483             |
| Accrued Power Generation Revenues                     | 71,548,583                       | 73,332,067            |
| Goodwill  | 4,912,866                        | 4,912,866             |
| Licensed Technology Rights, net                       | 2,653,921                        | 2,700,296             |
| Notes Receivable, net                                 | 1,917,704                        | 1,917,704             |
| Deferred Financing Costs                              | 2,639,012                        | 2,661,251             |
| Other Assets  | 258,667                          | 463,147               |
| <b>TOTAL ASSETS</b>                                   | <b>\$ 185,448,381</b>            | <b>\$ 185,867,465</b> |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>           |                                  |                       |
| Current Liabilities                                   |                                  |                       |
| Accounts payable and accrued expenses                 | \$ 13,991,824                    | \$ 13,348,345         |
| Working capital loan                                  | 5,726,000                        | 4,154,000             |
| Total Current Liabilities                             | \$ 19,717,824                    | \$ 17,502,345         |
| Deferred Gain, net                                    | \$ 2,852,798                     | \$ 2,929,901          |
| Secured Promissory Notes Payable and Other Borrowings | 62,999,394                       | 63,426,119            |
| Accrued Lease Expenses                                | 71,548,583                       | 73,332,067            |
| Total Liabilities                                     | \$ 157,118,599                   | \$ 157,190,432        |
| Minority Interest                                     | \$ 100                           | \$ 100                |
| Series A Preferred Stock(1)                           | \$ 10,156,021                    | \$ 10,156,021         |
| Shareholders' Equity                                  |                                  |                       |
| Preferred stock (2)                                   | 100                              | 100                   |
| Common stock (3)                                      | 98,756                           | 97,404                |
| Additional paid-in capital                            | 55,974,443                       | 54,640,990            |
| Accumulated deficit                                   | (36,876,017)                     | (35,193,961)          |
| Treasury stock (4)                                    | (385,402)                        | (385,402)             |
| Notes receivable from officers and board members      | (638,219)                        | (638,219)             |
| Total Shareholders' Equity                            | \$ 18,173,661                    | \$ 18,520,912         |

**TOTAL LIABILITIES AND SHAREHOLDERS EQUITY**

**\$ 185,448,381**      \$ 185,867,465

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- (1) Preferred stock, \$.01 par value, 2,000,000 shares authorized; 281,241 shares issued as of March 31, 2007 and December 31, 2006. Liquidation value of \$15,000,000 at March 31, 2007.
  - (2) Preferred stock of subsidiary, no par value, 10 shares authorized; 10 shares issued as of March 31, 2007 and December 31, 2006, respectively.
  - (3) \$.01 par value; 21,400,000 shares authorized; 9,875,814 issued and 9,787,384 outstanding as of March 31, 2007; 21,400,000 shares authorized; 9,740,455 issued and 9,652,025 outstanding as of December 31, 2006.
  - (4) 88,430 shares at cost, as of March 31, 2007 and December 31, 2006.
- See Notes to Consolidated Financial Statements.

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

Condensed Consolidated Statements of Operations (unaudited) for the Three Months Ended March 31, 2007 and March 31, 2006

**Income Statement**

|  | <b>3 Months Ended</b> |                       |
|--|-----------------------|-----------------------|
|  | <b>March 31, 2007</b> | <b>March 31, 2006</b> |
|  | <b>(unaudited)</b>    | <b>(unaudited)</b>    |
| <b>REVENUES</b>                            |                       |                       |
| Power generation revenues                  | 13,945,858            | 13,480,803            |
| Microgy revenue                            | 215,273               | 883,406               |
| <b>TOTAL REVENUES</b>                      | <b>14,161,131</b>     | <b>14,364,209</b>     |
| <b>COSTS AND EXPENSES:</b>                 |                       |                       |
| Buzzard                                    |                       |                       |
| Operating expenses (1)                     | 7,326,996             | 6,936,992             |
| Lease expenses (2)                         | 5,573,669             | 5,514,084             |
| Microgy                                    |                       |                       |
| Cost of goods sold                         | 217,320               | 773,039               |
| General and administrative (3)             | 2,907,727             | 2,470,836             |
| Depreciation and amortization              | 112,010               | 127,401               |
| <b>TOTAL COSTS AND EXPENSES</b>            | <b>\$ 16,137,722</b>  | <b>\$ 15,822,352</b>  |
| <b>OPERATING LOSS</b>                      | <b>(1,976,591)</b>    | <b>(1,458,143)</b>    |
| <b>OTHER INCOME (EXPENSE):</b>             |                       |                       |
| Interest income                            | 183,279               | 118,141               |
| Interest expense                           | (212,995)             | (154,141)             |
| Amortization of deferred gain              | 77,103                | 77,103                |
| Other income (Note K)                      | 583,116               |                       |
| <b>TOTAL OTHER INCOME</b>                  | <b>\$ 630,503</b>     | <b>\$ 40,703</b>      |
| <b>LOSS BEFORE TAXES</b>                   | <b>\$ (1,346,088)</b> | <b>\$ (1,417,440)</b> |
| <b>INCOME TAX EXPENSE</b>                  | <b>100</b>            | <b>7,962</b>          |
| <b>NET LOSS</b>                            | <b>(1,346,188)</b>    | <b>(1,425,402)</b>    |
| Preferred Securities Dividend Requirements | (335,868)             | (1,250)               |
| Loss Applicable to Common Shareholders     | \$ (1,682,056)        | \$ (1,426,652)        |
| Weighted Average Common Shares Outstanding |                       |                       |
| Basic                                      | 9,787,384             | 9,592,916             |
| Diluted                                    | 9,787,384             | 9,592,916             |
| <b>LOSS PER COMMON SHARE</b>               |                       |                       |
| Basic                                      | \$ (0.17)             | \$ (0.15)             |
| Diluted                                    | \$ (0.17)             | \$ (0.15)             |

(1) Operating expenses include fuel costs, maintenance costs, plant labor costs, operator costs, and other costs.

(2) Lease expenses include principal, interest payments, equity rents, additional rents, and accrued lease expenses.

(3) General and administrative expenses labor expenses, travel &amp; entertainment expenses, insurance costs, and professional service fees.

See Notes to Consolidated Financial Statements.





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Condensed Consolidated Statements of Cash Flows (unaudited) for the Three Months Ended March 31, 2007 and March 31, 2006

**Statement of Cash Flows**

|   | 3 Months Ended |                |
|---|----------------|----------------|
|   | March 31, 2007 | March 31, 2006 |
|   | (unaudited)    | (unaudited)    |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>        |                |                |
| Net loss  | \$ (1,346,188) | \$ (1,425,402) |
| <i>Non-cash adjustments</i>                         |                |                |
| Depreciation and amortization                       | 119,424        | 127,401        |
| Amortization of deferred gain                       | (77,103)       | (77,103)       |
| Accrued interest expense                            | 137,758        | 112,663        |
| Non-cash, stock based compensation expense          | 538,448        | 164,214        |
| Settlement of Sunnyside liability                   | (583,030)      |                |
| Accrued power generation revenues                   | 1,783,484      | 1,061,551      |
| Accrued lease expenses                              | (1,783,484)    | (1,061,551)    |
| <i>Changes in operating assets and liabilities:</i> |                |                |
| Increase in receivables                             | (3,431,404)    | (5,046,234)    |
| Decrease (increase) in fuel inventory               | 129,651        | (59,705)       |
| Decrease in unbilled revenues                       |                | 53,655         |
| Decrease in other current assets                    | 13,537         | 30,139         |
| Decrease in notes receivable                        |                | 130,000        |
| (Decrease) in billings in excess of revenues        |                | (333,998)      |
| (Increase) decrease in other assets                 | 204,480        | (2,850)        |
| Increase in accounts payable and accrued expenses   | 308,861        | 472,134        |
| Net cash used in operating activities               | \$ (3,985,566) | \$ (5,855,086) |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>        |                |                |
| (Increase) decrease in restricted cash              | \$ 1,669,754   | \$ (39,463)    |
| Construction of projects                            | (3,684,632)    | (732,042)      |
| Capitalized interest & finance costs                | (612,430)      |                |
| Property, plant and equipment, expenditures         | (52,637)       | (21,964)       |
| Net cash used for investing activities              | \$ (2,679,945) | \$ (793,469)   |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>        |                |                |
| Dividend payments on preferred stock of subsidiary  | \$ (1,250)     | \$ (1,250)     |
| Borrowings (repayments) of capital leases           | 18,547         | (5,140)        |
| Exercise of stock options and warrants              | 796,356        | 662,198        |
| Net borrowings under working capital loan           | 1,572,000      | 3,914,000      |
| Net cash provided by financing activities           | \$ 2,385,653   | \$ 4,569,808   |
| (DECREASE) IN CASH AND CASH EQUIVALENTS             | (4,279,858)    | (2,078,747)    |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD      | 13,794,325     | 14,840,230     |
| CASH AND CASH EQUIVALENTS, END OF PERIOD            | \$ 9,514,467   | \$ 12,761,483  |

Supplemental disclosure of non cash investing and financing activity Non-cash dividend to Series A Preferred Stock Holders  
See Notes to Consolidated Financial Statements.

(335,868)



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**ENVIRONMENTAL POWER CORPORATION AND SUBSIDIARIES**

Condensed Consolidated Statement of Equity (unaudited) for Three Months Ended March 31, 2007

|  | Preferred<br>Stock<br>Shares | Preferred<br>Stock<br>Amount | Common<br>Stock<br>Shares | Common<br>Stock<br>Amount | Additional<br>Paid-in<br>Capital | Accum.<br>Deficit      | Accum. Other<br>Comp.<br>Loss | Treasury<br>Stock<br>Shares | Treasury<br>Stock<br>Amount | Deferred<br>Compensation | Receivable<br>- Officers<br>&<br>Directors | Total                |
|--|------------------------------|------------------------------|---------------------------|---------------------------|----------------------------------|------------------------|-------------------------------|-----------------------------|-----------------------------|--------------------------|--|----------------------|
| <b>Balance at December 31, 2004</b>                        | <b>10</b>                    | <b>\$ 100</b>                | <b>4,971,417</b>          | <b>\$ 49,714</b>          | <b>\$ 14,946,486</b>             | <b>\$ (5,331,347)</b>  | <b>\$ (204,858)</b>           | <b>88,430</b>               | <b>\$ (385,402)</b>         | <b>\$ 1,783,745</b>      | <b>\$ (640,110)</b>                        | <b>\$ 10,218,889</b> |
| Dividends paid at subsidiary                               |                              |                              |                           |                           |                                  | (5,000)                |                               |                             |                             |                          |  | (5,000)              |
| Exercise of stock options & warrants for cash              |                              |                              |                           |                           | 264,730                          |                        |                               |                             |                             | 635,240                  |  | 899,970              |
| Exercise of stock options                                  |                              |                              | 61,931                    | 619                       | 282,357                          |                        |                               |                             |                             |                          |  | 282,976              |
| Issuance of common stock                                   |                              |                              | 4,600,000                 | 46,000                    | 25,961,264                       |                        |                               |                             |                             |                          |  | 26,007,264           |
| Principal repayment on officer loan                        |                              |                              |                           |                           |                                  |                        |                               |                             |                             |                          | 1,891                                      | 1,891                |
| Conversion liability adjustment, net loss                  |                              |                              |                           |                           |                                  | (11,413,620)           | (294,537)                     |                             |                             |                          |  | (11,708,157)         |
| <b>Balance at December 31, 2005</b>                        | <b>10</b>                    | <b>\$ 100</b>                | <b>9,633,348</b>          | <b>\$ 96,333</b>          | <b>\$ 41,454,837</b>             | <b>\$ (16,749,967)</b> | <b>\$ (499,395)</b>           | <b>88,430</b>               | <b>\$ (385,402)</b>         | <b>\$ 2,418,985</b>      | <b>\$ (638,219)</b>                        | <b>\$ 25,697,036</b> |
| Dividends paid on preferred                                |                              |                              |                           |                           |                                  | (197,715)              |                               |                             |                             |                          |  | (197,715)            |
| Warrants issued in connection with sale of preferred stock | 281,241                      | 10,156,021                   |                           |                           | 3,893,968                        |                        |                               |                             |                             |                          |  | 3,893,968            |
| Employee Stock Based Compensation                          |                              |                              | 2,053                     | 21                        | 2,036,087                        |                        |                               |                             |                             |                          |  | 2,036,108            |
| Exercise of stock options                                  |                              |                              | 105,054                   | 1,050                     | 706,092                          |                        |                               |                             |                             |                          |  | 707,142              |
| Official Conversion Feature                                |                              |                              |                           |                           | 4,131,022                        | (4,131,022)            |                               |                             |                             |                          |  |                      |
| Amortization of deferred compensation expense              |                              |                              |                           |                           | 2,418,985                        |                        |                               |                             |                             | (2,418,985)              |  |                      |
| Conversion liability adjustment, net loss                  |                              |                              |                           |                           |                                  | (14,115,257)           | 499,395                       |                             |                             |                          |  | (13,615,862)         |
| <b>Balance at December 31, 2006</b>                        | <b>281,251</b>               | <b>\$ 10,156,121</b>         | <b>9,740,455</b>          | <b>\$ 97,404</b>          | <b>\$ 54,640,990</b>             | <b>\$ (35,193,961)</b> | <b>\$</b>                     | <b>88,430</b>               | <b>\$ (385,402)</b>         | <b>\$</b>                | <b>\$ (638,219)</b>                        | <b>\$ 18,520,936</b> |
| Dividends on Preferred Stock                               |                              |                              |                           |                           |                                  | (335,868)              |                               |                             |                             |                          |  | (335,868)            |
| Employee stock based compensation                          |                              |                              |                           |                           | 538,448                          |                        |                               |                             |                             |                          |  | 538,448              |
| Exercise of stock options                                  |                              |                              | 135,359                   | 1,352                     | 795,004                          |                        |                               |                             |                             |                          |  | 796,356              |
| Loss   |                              |                              |                           |                           |                                  | (1,346,188)            |                               |                             |                             |                          |  | (1,346,188)          |
| <b>Balance at March 31, 2007</b>                           | <b>281,251</b>               | <b>\$ 10,156,121</b>         | <b>9,875,814</b>          | <b>\$ 98,756</b>          | <b>\$ 55,974,443</b>             | <b>\$ (36,876,017)</b> | <b>\$</b>                     | <b>88,430</b>               | <b>\$ (385,402)</b>         | <b>\$</b>                | <b>\$ (638,219)</b>                        | <b>\$ 18,173,778</b> |

See Notes to Consolidated Financial Statements.

**Table of Contents****Notes to Condensed Consolidated Financial Statements****NOTE A BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements of Environmental Power Corporation ( we , us , EPC , or the Company and our subsidiaries have been prepared in accordance with the instructions to Form 10-Q and with Article 10 of Regulation S-X and include all of the information and footnotes required by generally accepted accounting principles for interim financial information. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The results of operations for the three months ended March 31, 2007 are not necessarily indicative of results to be expected for the year ending December 31, 2007. The information in this quarterly report should be read in conjunction with Management Discussion and Analysis of Financial Condition and Results of Operations and consolidated financial statements and footnotes included in our Annual Report on Form 10-K for the year ended December 31, 2006.

**NOTE B EARNINGS PER COMMON SHARE**

We compute earnings per common share using the treasury stock method in accordance with SFAS No. 128, Earnings per Share . We compute basic earnings per share by dividing net income for the period, less Buzzard s preferred stock dividends, less any dividends on our Series A 9% Cumulative Convertible Preferred Stock, referred to as the series A preferred stock, by the weighted average number of shares of common stock outstanding during the period. For purposes of calculating diluted earnings per share, we consider shares issuable in connection with stock options to be dilutive common stock equivalents when the exercise price is less than the average market price of our common stock for the period. We exclude anti-dilutive common stock equivalents from the calculation of diluted earnings per share. For the purposes of calculating anti-dilutive options, all warrants and options were calculated using the treasury stock method. The preferred stock was calculated using the as-if converted method.

For the three months ended March 31, 2007 and 2006, we excluded 8,011,298 and 2,404,293 stock options, respectively, because of their anti-dilutive effect. The following table outlines the calculation of basic earnings per share and diluted earnings per share for the three months ended March 31, 2007 and 2006.

|  | <b>Three Months Ended</b> |                           |
|--|---------------------------|---------------------------|
|  | <b>March 31,<br/>2007</b> | <b>March 31,<br/>2006</b> |
| <b>Earnings Per Share</b>                  |                           |                           |
| (Loss) Income applicable to shareholders   | \$ (1,346,188)            | \$ (1,425,402)            |
| Dividends to preferred stockholders        | (335,868)                 | (1,250)                   |
| <b>Earnings (Numerator)</b>                | <b>\$ (1,682,056)</b>     | <b>\$ (1,426,652)</b>     |
| Basic Shares (Denominator)                 | 9,787,384                 | 9,592,916                 |
| <b>Basic EPS</b>                           | <b>\$ (0.17)</b>          | <b>\$ (0.15)</b>          |
| Assumed exercise of dilutive stock options |                           |                           |
| <b>Diluted Shares</b>                      | <b>9,787,384</b>          | <b>9,592,916</b>          |
| Diluted EPS                                | \$ (0.17)                 | \$ (0.15)                 |

**NOTE C STOCK OPTIONS AND STOCK-BASED COMPENSATION**

We maintain incentive compensation plans under which restricted stock awards, stock options, stock units and stock appreciation rights may be granted to employees, directors and independent contractors. To date, we have granted stock options, stock appreciation rights, and restricted stock awards. Stock options under the plans provide for either nonqualified stock options or incentive stock options. Stock options are granted at the market price on the date of grant and generally vest at a rate of 25%-33% per year. The stock options generally expire 10 years from the date of grant. We issue new shares of common stock upon exercise of stock options.



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We adopted SFAS 123R, effective January 1, 2006, using the modified prospective transition method, and as a result, did not retroactively adjust results from prior periods. Under this transition method, stock-based compensation was recognized for expense related to the remaining nonvested portion of all stock awards granted prior to January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123; and expense related to all stock awards granted on or subsequent to January 2, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. We apply the Black-Scholes valuation model in determining the fair value of option awards to employees. The resulting compensation expense is recognized over the requisite service period, which is generally the option vesting term of three to four years. Prior to fiscal 2006, stock-based compensation was included as a pro forma disclosure in the Notes to the Consolidated Financial Statements as permitted by SFAS 123.

Compensation expense is recognized only for those awards expected to vest, with forfeitures estimated based on our historical experience and future expectations. Prior to the adoption of SFAS 123R, the effect of forfeitures on the pro forma expense amounts was recognized using the same method.

As a result of accounting under SFAS 123R, the impact on net income in our consolidated statement of operations for the three months ended March 31, 2007 was \$538,000, or \$0.05 on a basic and diluted earnings per share. In the three months ended March 31, 2006 we recognized approximately \$159,000 in non-cash compensation expense under SFAS 123R. The change is a result of the fact that more options vested in the current period, and the higher implied volatility of our common stock.

Valuation Assumptions: The fair value of stock options granted during the three months March 31, 2007 and March 31, 2006 was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions:

|                                | Three Months Ended |                |
|--------------------------------|--------------------|----------------|
|                                | March 31, 2007     | March 31, 2006 |
| Fair Market Per Share          | \$ 4.47            | \$ 3.43        |
| <i>Assumptions</i>             |                    |                |
| Risk-free rate of return       | 4.48%              | 3.90%          |
| Volatility                     | 78.32%             | 58.97%         |
| Expected annual dividend yield | 0.00%              | 0.00%          |
| Option Life (years)            | 5                  | 6              |

The employee stock-based compensation expense recognized under FAS123R was determined using the Black-Scholes option valuation model. Option valuation models require the input of subjective assumptions and these assumptions can vary over time. Employee stock-based compensation expense recognized in 2007 was calculated based on awards ultimately expected to vest and has been reduced for estimated forfeitures. FAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. A forfeiture rate of 0% to 25% is applied to the stock-based compensation expense, determined through historical experience of employee stock options.

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

**NOTE D GOODWILL AND INTANGIBLE ASSETS**

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

Accumulated amortization of licensed technology rights was \$1,056,079 as of March 31, 2007 and \$1,009,704 as of December 31, 2006. Amortization expense for licensed technology rights was \$46,375 for the three months ended March 31, 2007. The future estimated amortization expense for licensed technology rights is as follows:

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Estimated Amortization Expense for Licensed Technology Rights

| 2007       | 2008    | 2009    | 2010    | 2011    | Thereafter | Total        |
|------------|---------|---------|---------|---------|------------|--------------|
| \$ 138,750 | 185,500 | 185,500 | 185,500 | 185,500 | 1,773,171  | \$ 2,653,921 |



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

| Commitments                              | 2007                 | 2008              | 2009              | 2010              | 2011              | Thereafter         | Total                 |
|--|----------------------|-------------------|-------------------|-------------------|-------------------|--------------------|-----------------------|
| Operating Leases(1)                      | \$ 183,821           | \$ 119,668        | \$ 122,341        | \$ 118,165        | \$ 79,392         | \$                 | \$ 623,387            |
| Arclight Loan(2)                         |                      | 1                 | 1                 | 1                 | 1                 | 2,846,775          | 2,846,779             |
| Scrubgrass Lease Payments(3)             | 21,682,500           | 29,390,000        | 32,459,000        | 35,944,000        | 39,761,000        | 111,686,000        | 270,922,500           |
| Microgy Construction Commitments(4)      | 382,505              | 3,000,000         |                   |                   |                   |                    | 3,382,505             |
| Scrubgrass Fuel Contracts(5)             | 2,206,899            | 3,033,907         | 3,125,322         | 3,217,262         | 3,313,430         | 3,412,655          | 18,309,475            |
| Separation Agreement Payments(6)         | 500,000              |                   |                   |                   |                   |                    | 500,000               |
| Relocation Costs(7)                      | 600,000              |                   |                   |                   |                   |                    | 600,000               |
| Tax Exempt Bonds(8)                      | 4,200,000            | 4,200,000         | 4,200,000         | 4,200,000         | 4,200,000         | 132,673,200        | 153,573,200           |
| Vehicle Loan and Other Capital Leases(9) | \$ 57,427            | 51,186            | 21,303            | 9,290             |                   |                    | 139,206               |
| <b>TOTAL</b>                             | <b>\$ 29,663,152</b> | <b>39,794,762</b> | <b>39,927,967</b> | <b>43,488,718</b> | <b>47,353,823</b> | <b>250,518,630</b> | <b>\$ 450,397,052</b> |

- (1) We are obligated under various non-cancelable operating leases for office space and automotive vehicles. Rent expense for these operating leases was \$286,501, \$174,334, and \$157,932, in 2006, 2005 and 2004, respectively.
- (2) EPC Corporation is obligated to make at least one payment in any 24-month period to satisfy the terms of the Arclight loan. All distributions from Buzzard will be used to repay these obligations.
- (3) Buzzard is obligated under a facility lease related to the Scrubgrass plant. The estimated remaining lease term is 13.5 years. Our Scrubgrass plant lease expense was \$22,091,063, \$20,829,876, and \$22,065,685 in 2006, 2005 and 2004, respectively. As discussed in Item 1, in addition to scheduled base rent and additional rent payments, the Scrubgrass plant lease expense includes principal, interest and related fees on the Lessor's debt obligations. Since a portion of the Lessor's debt obligations have variable interest rates, we have estimated its future minimum lease payments using average interest rates of 3.27% for the tax-exempt bonds.
- (4) These commitments relate to various purchase agreements, including minimum purchase agreements with SouthTex Treaters for gas treatment equipment, made in connection with our Microgy facilities.
- (5) We have also been assigned various long-term non-cancelable obligations under contractual agreements for fuel handling and excavation, limestone supply, and waste disposal. The contractual terms are generally for 5 to 15 years and provide for renewal options.
- (6) These commitments reflect payments for severance and separation agreements made to Messrs. Cresci, Livingston, and Tejwani and are included in our balance of accrued expenses.
- (7) These costs are comprised mainly of relocation costs associated with the Company's relocation of company headquarters from Portsmouth, NH to White Plains, NY.
- (8) In 2007, Microgy is obligated to make the first scheduled interest payments on the tax exempt bonds. Mandatory redemption of principal amounts begin in 2012.
- (9) We are obligated under various non-cancelable capital leases for automotive vehicles and computer equipment.

**EPC Corporation Debt Obligations** On September 4, 2003, we entered into a Note Purchase Agreement with Crystal Creek Coalpower Funding, LLC, an affiliate of ArcLight Energy Partners Fund I, L.P., referred to as ArcLight, pursuant to which our subsidiary, EPC Corporation, which holds as its sole asset the stock of Buzzard, agreed to issue and sell to ArcLight up to \$5,400,000 original principal amount of its 20.0% Senior Secured Notes due December 31, 2012, consisting of Note A in the original principal amount of \$3,700,000 and Note B in the original principal amount of \$1,700,000. ArcLight purchased Note A on September 4, 2003, as a result of which EPC Corporation received gross proceeds of \$3.7 million. We do not expect ArcLight to purchase Note B. The aggregate minimum principal and interest to be paid by EPC Corporation on Note A over the term of Note A is \$4.8 million. Distributions from Scrubgrass are held by an agent bank, J.P. Morgan. Payments are made first to any outstanding interest, second to fees to the agent bank, third to the management fee to us, and fourth to the outstanding principal. Distributions from Scrubgrass are required to be used to repay Note A. After it is paid in full, we will keep the next \$1.4 million of distributions. Thereafter, future distributions will be shared equally through December 31, 2012. Any unpaid interest that has accrued on the 15<sup>th</sup> of each month is added to the balance of the note.



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We are only required to make payments to the extent that we receive distributions from Scrubgrass with the exception of making at least one payment in any 24 month period. We are prohibited from incurring additional debt at the EPC Corporation subsidiary level. Additionally, we are required to provide ArcLight with financial statements and other related information in a timely manner, for which we are paid an annual management fee of \$75,000. As of March 2007, we are in full compliance with our covenants under our agreements with ArcLight.

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

|  | March 31,<br>2007 | December 31,<br>2006 |
|--|-------------------|----------------------|
| <b>Secured Promissory Notes Payable and Other Borrowings</b>     |                   |                      |
| Sunnyside Project obligations                                    |                   | 583,030              |
| ArcLight Note Payable, net of debt discount and accrued interest | 2,060,032         | 2,060,032            |
| Accrued interest expense, added to principal balance             | 786,745           | 648,987              |
| Vehicle loan & capital leases                                    | 152,618           | 134,070              |
| Tax Exempt Bond Financing  | 60,000,000        | 60,000,000           |
| <b>TOTAL</b>   | <b>62,999,395</b> | <b>62,777,131</b>    |

|   | March 31, 2007   | December 31, 2006 | Interest Rate  |
|---|------------------|-------------------|----------------|
| <b>Buzzard's debt obligations (maturity):</b> |                  |                   |                |
| <u>Working capital loan (2008)</u>            | 5,726,000        | 4,154,000         | LIBOR + 1.250% |
| <b>TOTAL</b>                                  | <b>5,726,000</b> | <b>4,154,000</b>  |                |

*Buzzard Working Capital Loan*-Buzzard may borrow up to \$6 million under a Lessee Working Capital Loan Agreement with the lessor of Scrubgrass for ongoing working capital requirements of this project.

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

*Scrubgrass Debt Obligations* Buzzard and the lessor have various debt obligations related to Scrubgrass. Under the terms of the Scrubgrass lease, Buzzard is required to pay the principal, interest and fees for the lessor's debt obligations as a base lease payment. As such, Buzzard is committed to pay all of the Scrubgrass debt obligations as either a debt or lease obligation. Scrubgrass had the following debt obligations as of March 31, 2007 and December 31, 2006:

|  | March 31, 2007     | December 31, 2006  | Interest Rate     |
|--|--------------------|--------------------|-------------------|
| <b>Buzzard's lease obligations (maturity):</b> |                    |                    |                   |
| Tax-exempt bonds (2012)                        | 119,252,000        | 120,232,000        | Quoted Bond Rates |
| <b>TOTAL</b>                                   | <b>119,252,000</b> | <b>120,232,000</b> |                   |

Because we are not required to fund Buzzard's operating losses, including payments on lease obligations, or otherwise invest further from sources outside of the Scrubgrass plant, Buzzard's lease obligations for the lessor's debt are not reported in our consolidated financial statements. As these debt obligations mature, they will be billed by the lessor to Buzzard and reported as a lease expense in our consolidated financial statements.

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*Notes Receivable from Officers and Directors* We have outstanding notes receivable from officers and directors for shares purchased in connection with stock option plans that amounted to \$638,219 as of March 31, 2007 and December 31, 2006. These notes, secured by the underlying shares of stock, are payable upon demand and bear interest at a floating rate which is payable monthly. In accordance with company policy and applicable law, we no longer make loans to our officers or directors.

### **NOTE G NOTES RECEIVABLE**

In 2005, we completed construction of the digesters at Five Star Dairy, Wild Rose Dairy, and Norswiss Dairy. Each digester had a purchase price of \$1,037,000, of which EPC agreed to provide 100% seller financing. The notes issued to the purchasers of the digesters each bear simple interest at 5% per annum, to be paid monthly after the first month that revenues

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are received under the purchasers' respective biogas supply agreement with Dairyland Power Cooperative. Each maker of these notes is only required to make interest and principal payments from the revenues under the applicable Biogas Supply Agreement with Dairyland Power Cooperative, to the extent that the operation of the facility, which we manage and operate, provides sufficient funds to pay. Each note matures 11 years after the bill of sale for the facility to which it relates has been executed. Because we have limited operating history, we have set up a reserve on these notes in the amount of \$750,000 to allow for any future cash flow deficiencies that would impair the full value of the notes. We also do not expect to record interest income from these notes. As we gain operations and maintenance experience and develop a track record, we will evaluate this allowance and make adjustments accordingly. The following table shows the balance on these Notes receivable on March 31, 2007 and December 31, 2006.

|                         | March 31, 2007 | December 31, 2006 |
|-------------------------|----------------|-------------------|
| <b>Notes Receivable</b> |                |                   |
| Notes receivable        | \$ 2,667,704   | \$ 2,667,704      |
| Bad debt reserve        | (750,000)      | (750,000)         |
| Notes receivable, net   | \$ 1,917,704   | \$ 1,917,704      |

**NOTE H INCOME TAXES**

We adopted the provisions of Financial Standards Accounting Board Interpretation No. 48 Accounting for Uncertainty in Income Taxes ( FIN 48 ) an interpretation of FASB Statement No. 109 ( SFAS 109 ) on January 1, 2007. As a result of the implementation of FIN 48, we recognized no material adjustment in the valuation allowance or deferred tax assets. At the adoption date of January 1, 2007, we had \$10,462,459 of unrecognized tax benefits, all of which would affect our effective tax rate if recognized. At March 31, 2007, we have \$10,406,092 of unrecognized tax benefits.

It is our policy to recognize interest and penalties related to uncertain tax positions in income tax expense. As of March 31, 2007, we did not have any accrued interest or penalties related to uncertain tax positions.

The tax years 2003-2006 remain open to examination by the major taxing jurisdictions to which we are subject.

**NOTE I SEGMENT INFORMATION**

We manage and evaluate our operations in two reportable business segments: the Scrubgrass project (Buzzard) and Microgy. All Other Segments is comprised of corporate items that are not directly tied to either operating entity. These segments have been classified separately because of the different technologies used in the generation of energy and the future growth prospects of the businesses. Financial data for reportable business segments is as follows:

| SEGMENT INFORMATION (UNAUDITED)          | Buzzard    | Microgy     | All Other Segments | Consolidated |
|--|------------|-------------|--------------------|--------------|
| <b>Three Months Ended March 31, 2007</b> |            |             |                    |              |
| Revenues                                 | 13,945,858 | 215,273     |                    | 14,161,131   |
| Interest income                          | 24,742     | 3,975       | 154,562            | 183,279      |
| Interest expense                         | 70,094     | 2,866       | 140,035            | 212,995      |
| Depreciation and amortization            | 41,148     | 55,263      | 15,599             | 112,010      |
| Amortization of deferred gain            |            |             | 77,103             | 77,103       |
| Construction in Progress                 |            | 3,684,632   |                    | 3,684,632    |
| Capital expenditures                     |            | 44,510      | 8,127              | 52,637       |
| Pre-tax income (loss)                    | 396,428    | (1,449,725) | (292,786)          | (1,346,083)  |
| Identifiable assets                      | 92,142,329 | 82,946,505  | 10,359,547         | 185,448,381  |
| <b>Three Months Ended March 31, 2006</b> |            |             |                    |              |
| Revenues                                 | 13,480,803 | 883,406     |                    | 14,364,209   |
| Interest income                          | 17,577     |             | 100,564            | 118,141      |
| Interest expense                         | 37,777     | 319         | 116,445            | 154,541      |

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|                               |            |             |            |             |
|-------------------------------|------------|-------------|------------|-------------|
| Depreciation and amortization | 59,247     | 54,095      | 14,059     | 127,401     |
| Amortization of deferred gain |            |             | 77,103     | 77,103      |
| Construction in Progress      |            | 732,042     |            | 732,042     |
| Capital expenditures          |            | 17,948      | 4,016      | 21,964      |
| Pre-tax income (loss)         | 307,708    | (1,283,201) | (441,947)  | (1,417,440) |
| Identifiable assets           | 96,568,170 | 11,689,102  | 14,593,542 | 122,850,814 |

**NOTE J RECENT ACCOUNTING PRONOUNCEMENTS**

In September 2006 the FASB issued FASB Statement No. 157, Fair Value Measurements, or SFAS 157. The standard provides guidance for using fair value to measure assets and liabilities. The standard also responds to investors' requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. The standard applies whenever other standards

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require or permit assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances. SFAS 157 must be adopted prospectively as of the beginning of the year it is initially applied. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company does not believe the adoption of this standard will have a material impact on its financial position or results of operations.

In October 2006, the FASB issued proposed Staff Position (FSP) FAS 141-b, 142-e, and 144-b, Fair Value Measurements in Business Combinations and Impairment Tests. This position provides a consistent definition of fair value measurement under SFAS 141, 142 and 144. It is not expected to have a material impact on our consolidated financial position or results of operations.

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

### **NOTE K OTHER INCOME**

We had contingent obligations of \$1.2 million on our consolidated balance sheet as of December 31, 2000. The contingent obligations were principally expenses for the sale of our Sunnyside project which were payable upon collection of certain obligations from the purchasers of Sunnyside. On April 10, 2001, we received aggregate proceeds of \$1.5 million from the purchasers of Sunnyside and resolved litigation by executing a binding settlement agreement. In this agreement, we were formally released from contingent obligations of \$178,000. We have also been released by the statute of limitations or the terms of the underlying agreements from additional contingent obligations of \$457,000. We reported the settlement proceeds of \$1.5 million and the released liabilities of \$635,000 as other income in our consolidated financial statements for 2001.

On January 1, 2007, there were remaining contingent obligations of \$583,000 related to the Sunnyside project. The statute of limitations for any legal action relating thereto ran out in March 2007, and we recognized the \$583,000 in other income.

### **NOTE L SUBSEQUENT EVENTS**

#### **Costs Associated With Relocation Activities**

On April 3, 2007, we committed to a plan to close our Portsmouth, New Hampshire office and move the operations to White Plains, New York. We expect to complete the Portsmouth office closure by the end of the third quarter of 2007. The move will facilitate the consolidation of the Company's executive offices and bring them closer to major financial markets and transportation hubs. It will also allow us to draw from significantly larger labor markets as we grow our organization.

We estimate total cash costs and expenses associated with the closure of the Portsmouth office to be approximately \$600,000, comprised of (1) approximately \$575,000 of one-time termination benefits and relocation costs; (2) and approximately \$25,000 of other labor related costs including training and temporary living expenses.

As of March 31, 2007, there were no costs recorded for the office closure. In the second and third quarters of 2007, we anticipate recording a charge in connection with the office closure of \$600,000. These costs will be recorded on the income statement as general and administrative expenses. We expect cash outlays to be about \$300,000 in 2007 and \$300,000 in 2008.

#### **Lease Agreement Default**

Due to projected shortfalls in revenues available to make certain rental payments, Buzzard and Scrubgrass Generating Company (SGC), entered into a forbearance agreement on December 11, 2006 (the Forbearance Agreement). Under the Forbearance Agreement, SGC agrees that it will forbear from exercising its rights and remedies under the lease agreement relating to Buzzard's Scrubgrass facility (the Lease Agreement) with respect to certain missed rental payments. The Forbearance Agreement runs through July 1, 2007.

On April 12, 2007, the Company and Buzzard received written notice from SGC of an event of default under the Lease Agreement related to a missed rental payment on April 2, 2007 (the Default Notice). SGC specified in the Default Notice





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that such missed rental payment was covered by the Forbearance Agreement, and that SGC would forbear from exercising its rights and remedies under the Lease Agreement with respect to such event of default as provided in the Forbearance Agreement.

Discussions among the interested parties are ongoing. Possible remedies include the restructuring of the lease, the sale of Buzzard, or the termination of the Lease Agreement. Buzzard's obligations under the Lease Agreement remain without recourse to the Company.

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

*You should read the following discussion together with our financial statements and accompanying notes included in this quarterly report and our audited financial statements included in our annual report on Form 10-K for the year ended December 31, 2006, which is on file with the Securities and Exchange Commission. In addition to historical information, the following discussion contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results could differ materially from those anticipated by the forward-looking statements due to important factors and risks including, but not limited to, those set forth in Part II, Item 1A – Risk Factors of this Quarterly Report on Form 10-Q and other filings we make with the Securities and Exchange Commission.*

**Overview**

We are a developer, owner, and operator of renewable energy production facilities. Our goal is to produce energy that is Beyond Renewable, which we define as energy that not only uses waste materials instead of precious resources, but energy that is also clean, reliable, and cost-effective. Since inception, we have been an independent developer and owner of non-commodity, renewable and alternative energy facilities that produce biofuels or electricity by utilizing fuel derived from our waste management processes or alternative fuel sources such as waste coal. Such fuel sources generally are not subject to the pricing and market fluctuations of commodity fuels and, in some instances, are considered renewable energy fuels. We have developed three anaerobic digesters, seven hydroelectric plants, two municipal waste projects, and three waste coal-fired generating facilities. We sold or transferred all of these projects either in development or after completion. We currently have two principal business units, Buzzard Power Corporation and Microgy, Inc., which are described below. We believe that Microgy represents a substantial portion of the future potential growth of Environmental Power Corporation and, as such, we are investing substantially all of our available resources, in terms of both financial and human capital, to take advantage of Microgy's opportunities.

**Buzzard Power Corporation**

Buzzard Power Corporation, referred to as Buzzard, is a subsidiary of our wholly owned subsidiary, EPC Corporation. Buzzard leases its generating facility from Scrubgrass Generating Company, L.P. The Scrubgrass plant, referred to as Scrubgrass, located on a 600-acre site in Venango County, Pennsylvania, is an approximate 83 megawatt waste coal-fired electric generating station.

**Microgy, Inc.**

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

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

We believe that a number of factors, including high energy prices, increasing desire for renewable energy sources and more stringent environmental and waste management requirements, will continue to provide a favorable market environment for our business.

Microgy Holdings, LLC was formed in 2006 as a subsidiary of Environmental Power Corporation in connection with the \$60 million tax-exempt debt financing we completed in November 2006 relating to the construction and operations of four RNG facilities in Texas. This entity and its subsidiaries are included in the Microgy segment.

The following Management's Discussion and Analysis of Financial Condition and Results of Operations compares the results of operations for the three months ended March 31, 2007 with the results of operations for the three months ended March 31, 2006. Unless otherwise indicated, all references to 2007 pertain to the three months ended March 31, 2007 and all references to 2006 pertain to the three months ended March 31, 2006. Historical results and trends that might appear should not be taken as indicative of future operations.



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**CRITICAL ACCOUNTING POLICIES**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, the reported amounts of revenues and expenses during the reporting period, and the disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates. Management believes the critical accounting policies discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations appearing in our Annual Report on Form 10-K for the year ended December 31, 2006, which is on file with the Securities and Exchange Commission (the 2006 10-K), as well as Note B to our consolidated financial statements included in the 2006 10-K, involve more significant judgments and estimates used in the preparation of our consolidated financial statements. The financial disclosures set forth in this Quarterly Report on Form 10-Q should be read in conjunction with the discussion of these critical accounting policies set forth in the 2006 10-K.

**RESULTS OF OPERATIONS**

**Three months ended March 31, 2007 compared to three months ended March 31, 2006.**

For the three months ended March 31, 2007, we had a net loss of \$1.3 million, or \$0.17 per common share, compared to a loss of \$1.4 million, or \$0.15 per common share, for the three months ended March 31, 2006. The decrease in loss was due to a \$583,000 increase in other income as a result of the release of the Sunnyside contingent liability, which was partially offset by a \$200,000 decrease in revenue and a \$359,000 increase in non-cash compensation.

Revenues remained steady at \$14.2 million for the three months ended March 30, 2007, as compared to \$14.4 million from the same period in 2006. Buzzard revenues increased by \$465,000 due to an increase in operating capacity. Buzzard's operating capacity for the three months ended March 31, 2007 was 100.6%, as compared to 99.1% for the three months ended March 31, 2006. Billed power generation revenues for the three months ended March 31, 2007 increased by \$1.2 million as compared to the three months ended March 31, 2006. Accrued power generation revenues, discussed in further detail below, decreased by \$722,000. Revenues at Microgy fell by \$668,000 to \$215,000 for the three months ended March 31, 2007 compared to \$883,000 for the three months ended March 31, 2006. This decrease is primarily a result of a change in business model at Microgy from a sell-and-operate model to an own-and-operate model.

Costs and expenses increased by \$325,000 to \$16.1 million for the three months ending March 30, 2007 from \$15.8 million for the same period in 2006. The increase was primarily attributable to a \$446,000 increase in general and administrative expenses and a \$390,000 increase in operating expenses at Buzzard. These increases were partially offset by a \$556,000 decrease in costs of goods sold at Microgy.

The reasons for the foregoing changes are discussed in more detail below.

**Buzzard**

Buzzard had pre-tax income of \$396,000 for the three months ended March 30, 2007, compared to pre-tax income of \$308,000 for the three months ended March 30, 2006.

Billed power revenues at Buzzard, which consist of power generation revenues, increased to \$15.7 million for the three months ended March 30, 2007, compared to \$14.5 million for the same period in 2006. Buzzard operated at 100.6% of capacity for this period, compared to 99.1% of capacity for the same period in 2006. Billed power rates also increased by 7% as compared to the prior year period. Accrued power generation revenues were a \$1.8 million offset to Buzzard revenue, compared to a \$1.1 million offset in the previous year. The accrued power generation revenues result from the FASB 13 accounting treatment of the Scrubgrass lease. In accordance with generally accepted accounting principles in the United States, we are required to treat our power sales agreement with Penelec as a lease, aggregate the minimum lease payments expected to be received over its life, and recognize it on a straight-line basis over the 22-year lease term. However, we have limited the recognition of accrued power revenues to the recognition of the deemed minimum payments of the facility lease so that we do not recognize any profits early related to executory costs or payment for goods and services other than solely for the right to use the facility. This minimum lease payment component is higher in the early years, decreases in the subsequent years, and reverses itself in the later years of the power purchase agreement. This adjustment has no effect on pre-tax income because it is completely offset by an accrued lease expense.

Total operating expenses at Buzzard for the three months ended March 30, 2007 increased by \$390,000 to \$7.3 million, as compared to \$6.9 million for the same period in 2006 due to a \$190,000 increase in fuel costs and an increase of \$129,000 in limestone costs as compared to the same period in the prior year.



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Lease expenses at Buzzard for the three months ended March 31, 2007 remained flat at \$5.6 million, compared to \$5.6 million for the same period in 2006. General and administrative expenses decreased to \$562,000 in the three months ended March 31, 2007, compared to \$643,000 in the same period in the prior year, due primarily to a \$188,000 decrease in general overhead fees, partially offset by a \$76,000 increase in salary expenses.

### **Microgy**

Pre-tax losses at Microgy increased to \$1.5 million for the three months ended March 31, 2007, from \$1.3 million for the three months ended March 31, 2006. This increase resulted primarily from a decrease in revenues of \$668,000 to \$215,000 as compared to \$883,000 in the same period in the prior year, as discussed in more detail below. This decrease in revenue was partially offset by a decrease in costs of goods sold to \$217,000 in the three months ended March 31, 2007, compared to \$773,000 in the three months ended March 31, 2006. Additionally, business development costs increased by approximately \$126,000 to \$132,000 as we expanded our business development efforts.

Microgy recognized revenues of \$215,000 for the three months ended March 31, 2007, down from \$883,000 for the same period in 2006. This decrease in revenue is due mainly to the change in business model from a model where facilities are sold, to the current ownership model, where we build and operate facilities for our own account. Revenues from the operation and maintenance of facilities remained relatively steady at \$215,000 for the three months ended March 31, 2007, compared to \$242,000 for the same period in the prior year. In the three months ended March 31, 2006, we recognized \$641,000 associated with the construction of projects under our relationship with Dairyland using the percentage of completion method. In the current period, we did not recognize any revenue related to the construction of facilities due to the aforementioned change in business model and the completion of facilities sold under the previous business model.

Cost of goods sold at Microgy decreased to \$217,000 for the three months ended March 31, 2007, as compared to \$773,000 for the same period in 2006. This decrease is due primarily to an absence of construction costs, as Microgy now build facilities for its account and these costs are capitalized.

General and administrative expenses at Microgy remained flat at \$1.4 million for the three months ended March 31, 2007, compared to \$1.3 for the three months ended March 31, 2006. A \$126,000 increase in sales expense and a \$148,000 increase in general overhead were offset by a \$190,000 decrease in salary expenses.

### **All Other Segments**

All other segments are comprised of corporate expenses and non-current business segments. We did not have any revenues in these segments for the three months ended March 31, 2007. We had pre-tax loss in this segment of \$293,000 for the three months ended March 31, 2007, compared to a pre-tax loss of \$442,000 for the three months ended March 31, 2006. This decrease in loss is primarily attributable to a \$583,000 increase in other income as the result of the release of contingent obligations in connection with the expiration of the statute of limitations relating to certain liabilities associated with the Sunnyside project, as discussed in more detail in Notes F and K to the consolidated financial statements included in this report. The increase in other income was partially offset by a \$374,000 increase in non-cash compensation.

The accounting for non-cash compensation expense, in accordance with FAS 123R resulted in a non-cash compensation expense of \$538,000 for the three months ended March 31, 2007. Please see Note C to the consolidated financial statements included in this report for more information.

We had total other income in this segment of \$675,000 for the three months ended March 31, 2007, compared to income of \$61,000 for the same period in 2006. The increase in other income is primarily due to the expiration of the statute of limitations regarding the Sunnyside project liability, as discussed above, which provided \$583,000 in other income.

## **LIQUIDITY AND CAPITAL RESOURCES**

### ***Operating Activities***

Our cash used in operating activities was \$4.0 million for the three months ended March 31, 2007, compared to cash used in operating activities of \$5.9 million for the same period in 2006. We reported a net loss of \$1.3 million during the three months ended March 31, 2007. The following adjustments, which did not impact our cash flows, need to be considered in order to reconcile our net loss in the first quarter of 2007 to our net cash used in operating activities:

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*Depreciation and amortization* During the three months ended March 31, 2007, we recognized depreciation and amortization expense for lease rights of \$37,251, licensed technology rights of \$46,375, and property plant and equipment of \$35,798.

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*Deferred gain, net* Our deferred gain, net, decreased by \$77,000 over the three months ended March 31, 2007 from \$2.9 million as of December 31, 2006. The decrease is due to the amortization of the deferred gain related to Scrubgrass, which is being amortized on a straight-line basis over 22 years.

*Interest expense, accrued and added to the balance of borrowing* During the three months ended March 31, 2007, we had \$138,000 of interest expense that was added to the outstanding principal balance of the ArcLight loan.

*Stock-based compensation* The accounting for options issued to employees resulted in non-cash compensation expenses of \$538,000 for the three months ended March 31, 2007.

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

*Receivables* Microgy receivables increased to \$115,000 on March 31, 2007 from \$110,000 on December 31, 2006. Receivables at Buzzard increased to \$15.7 million on March 31, 2007 from \$12.9 million on December 31, 2006 due to increased power generation revenues in the first quarter of 2007 compared to power generation revenues in the fourth quarter of 2006.

*Fuel Inventory* Fuel inventory at Buzzard remained relatively flat at \$1.1 million on March 31, 2007, compared to \$1.2 million on December 31, 2006.

*Accounts payable and accrued expenses* Our accounts payable and accrued expenses not related to accrued preferred dividends remained relatively flat at \$13.7 million on March 31, 2007 from \$13.3 million on December 31, 2006.

### ***Investing Activities***

Our cash used for investing activities was \$2.7 million for the three months ended March 31, 2007, as compared to \$793,000 in the same period in 2006. Our investing activities were concentrated primarily in the following areas:

*Restricted cash* We are required to hold cash associated with our tax-exempt bond financing with a third party disbursement agent. On March 31, 2007, the disbursement agent was holding a balance of \$51.4 million in bond proceeds, compared to \$52.2 million on December 31, 2006. Additionally, we are contractually required to make scheduled deposits to a restricted maintenance fund for Scrubgrass to ensure that funds are available in the future for scheduled major equipment overhauls. We are allowed to use cash from this restricted maintenance fund for major equipment overhauls at Scrubgrass, subject to certain restrictions. Our restricted cash balance was \$2.5 million on March 31, 2007, compared to \$3.2 million on December 31, 2006. These funds will be used to pay for future major maintenance expenses.

*Construction on projects* Construction continued on the Huckabay Ridge facility. Expenditures on this facility were \$3.7 million for the three months ended March 31, 2007.

*Property, plant and equipment* Property, plant and equipment expenditures were \$52,000 for the three months ended March 31, 2007, compared to expenditures of \$22,000 for the same period in 2006.

### ***Financing Activities***

Our cash provided by financing activities was \$2.4 million in the three months ended March 31, 2007, compared to cash provided by financing activities of \$4.6 million in the three months ended March 31, 2006. We offer the following information concerning the financing activities for our business:

*Dividend payments to preferred stock of subsidiary* Buzzard paid dividends of \$1,250 to its preferred stockholder during the three months ended March 31, 2007.

*Exercise of Stock Options and Warrants* We received \$796,000 of gross proceeds from the exercise of stock options and warrants in the three months ended March 31, 2007.





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*Working Capital Loan and Current Notes Payable for Scrubgrass* Buzzard may borrow up to \$6 million under a Lessee Working Capital Loan Agreement with the lessor of Scrubgrass for ongoing working capital requirements of this project. The outstanding borrowings under this loan were \$5.7 million as of March 31, 2007.

### **2007 Outlook**

#### ***Operations***

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

#### **Buzzard**

Power generation revenues are expected to remain relatively flat in 2007 as a result of the straight-line accounting treatment of revenue under the power sales agreement. Billed revenues are expected to increase by 4% due to increased power rates. This increase will be offset by a decrease in the accrued power generation revenues. We also expect the facility to run at a lower capacity due a required maintenance shut-down in the second quarter.

Operating expenses are expected to increase slightly in 2007 primarily due to increases the planned outage expenses and other maintenance expenses.

Lease expenses are expected to increase slightly in 2007 due to increases in scheduled principal and equity payments. These increases will be partially offset by decreases in the accrued lease expenses related to the straight-line accounting treatment of the lease.

Due to projected shortfalls in revenues available to make certain rental payments, Buzzard and SGC have entered into a forbearance agreement on December 11, 2006. Under the Forbearance Agreement, SGC agrees that it will forbear from exercising its rights and remedies under the Lease Agreement with respect to certain missed rental payments. This agreement runs through July 1, 2007.

On April 12, 2007, the Company and Buzzard received written notice from SGC of an event of default under the Lease Agreement related to a missed rental payment on April 2, 2007 (the Default Notice ). SGC specified in the Default Notice that such missed rental payment was covered by the Forbearance Agreement, and that SGC would forbear from exercising its rights and remedies under the Lease Agreement with respect to such event of default as provided in the Forbearance Agreement.

Discussions among the interested parties are ongoing. Possible remedies include the restructuring of the lease, the sale of Buzzard, or the termination of the lease agreement. Buzzard's obligations under the Lease Agreement remain without recourse to the Company.

#### **Microgy**

We expect increased revenues from Microgy in 2007, as we expect to generate revenues from our Huckabay Ridge project in Texas. Our revenues related to the operations and maintenance of the Wisconsin facilities are expected to increase slightly. We also expect to generate revenues from the sale of certain credits related to the operation of facilities.

Although we do not expect to record any costs of goods sold related to the construction of facilities that we sold under our old business model, our operating expenses will increase slightly. The operating expenses will be related to the operations of our RNG facilities and to the management of the Wisconsin facilities.

General and administrative expenses are expected to remain relatively flat. We will continue to incur substantial costs associated with the development and growth of the business.

#### **All Other Segments**

We do not expect significant changes in general and administrative expenses related to All Other Segments.

#### ***Cash Flow Outlook***

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During 2007, we expect to fund our business activities principally from available cash balances, investment earnings, raising additional funds through debt and or equity financings by Environmental Power or Microgy and project-specific financing, to the extent available. The requirement for additional financing will be in direct proportion to the number of projects on which we begin construction over the next twelve months. We do not expect to receive cash from the operations of Buzzard, insofar as any available cash will be used to repay interest and principal on the ArcLight loan.

On March 31, 2007, our unrestricted cash balance was \$9.5 million, as compared to \$14.8 million as of December 31, 2005. In addition, our restricted cash balances were \$53.8 million and \$55.5 million at March 31, 2007 and December 31, 2006, respectively. As discussed further under investing activities, we are allowed to spend restricted cash contributed to the Scrubgrass maintenance fund to fund the cost of major equipment overhauls at Scrubgrass, subject to certain restrictions, and to use restricted cash representing the remaining proceeds of our \$60 million tax-exempt bond financing to construct up to four planned RNG facilities in Texas, subject to certain restrictions.

We believe that our current cash balance will be sufficient to fund our minimum lease, debt obligations, current construction commitments, and our corporate overhead requirements. However, our current cash balance and our cash flows from operations will not be sufficient to fund the construction of currently planned facilities in the absence of obtaining additional financing.

Our present business strategy generally anticipates direct or indirect participation in the ownership of all facilities. We anticipate that project or corporate financing may be obtained in the form of a credit facility with one or more lenders, the sale of tax exempt or taxable bonds to investors, equity, other financing, or a combination of the foregoing. However, we cannot assure you that Microgy or any other prospective facility owner will be able to secure project or other financing in the amount required to fulfill any development or construction requirements, that financing will be obtained in time to meet such requirements, or that any such proposed financing, if obtained, will be on terms favorable to Microgy or any other prospective project owner. Furthermore, to the extent Microgy or an affiliate is a direct or indirect owner of facilities, Microgy will need to obtain substantial additional financing to allow it to develop and construct such facilities. While we may also seek debt or equity financing at the parent company level in order to fund Microgy's operations, we cannot assure you that we will be successful in obtaining such financing or that, if obtained, such financing will be on terms favorable to us.

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

Our most significant market risk exposure is changing interest rates, which may affect our short-term investments, debt and certain of our lease expenses. In addition, we expect to become increasingly exposed to commodity price risk relating to our gas production. We offer the following information about these market risks:

#### ***Short-term investments***

We invest cash balances that are in excess of our normal operating requirements in short term investments generally with maturities of three months or less. Because of the short duration of these investments, we do not believe our short-term investments are subject to material market risk.

#### ***Debt***

We have borrowings that bear interest at variable rates that are based on LIBOR. We monitor market conditions for interest rates and, from time to time, enter into interest rate swaps to manage our interest payments. The interest rate swaps have the effect of converting the variable rate borrowings to fixed rate borrowings for specified time periods.

#### ***Lease Expense***

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

As of March 31, 2007, the aggregate outstanding balance of the lessor's variable rate debt obligations, which are passed along to us as a lease expense, was \$119,252,000. Based on these balances, an immediate change of one percent for the variable interest rates would cause a change in lease expense of \$1,192,520. Our objective in maintaining these variable rate borrowings is to achieve a lower overall cost when compared to fixed-rate borrowings. We believe the lessor has the same objective for maintaining its variable rate borrowings.

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

As Microgy begins to focus a significant portion of its development efforts on multi-digester projects for the production of gas for sale as a commodity, we will become increasingly exposed to market risk with respect to the commodity pricing applicable to our gas production. Realized commodity prices received for such production are expected to be primarily driven by spot prices applicable to natural gas. Historically, natural gas prices have been volatile, and we expect such volatility to continue. Fluctuations in the commodity price of natural gas may have a materially adverse impact on the profitability of some of our facilities, particularly where we do not have a long-term contract for the sale of the facility's output at a fixed or predictable price. At such time as Microgy's facilities begin to produce commercial quantities of gas for sale as a commodity, we intend to explore various strategies, including hedging transactions and the like, in order to mitigate the associated commodity price risk. In connection with our Texas bond financing, we are required to maintain certain gas price protection arrangements for the gas output of our Texas facilities. In connection with this obligation, Microgy Holdings LLC has entered into an agreement to sell up to 2,000 MMBTUs per day of the output of our Huckabay Ridge facility to a counterparty under a collared product pricing arrangement for a term of 18 months beginning April 2007 and ending in October 2008. In addition, as previously announced, Microgy, Inc. has also entered into a long-term fixed price arrangement with PG&E to purchase the gas produced from our planned California facilities in an amount up to 8,000 MMBTUs per day.

***Substrate Costs***

We are reliant on substrate for the operation of our digesters. We are currently unable to forecast the prices or supply of substrate, and are exposed to market risk relating to the cost and availability of these materials. Substrate costs are driven by industry supply and demand, including competition by other users and recyclers of these materials, transportation costs, weather, and many other factors. Fluctuations in the availability or cost of substrate are expected and could have a materially adverse effect on the profitability of our investments. In the absence of useable substrate or substrate of sufficient quality, our anaerobic digester facilities would operate less efficiently, which would materially and adversely affect our overall profitability.

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

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of March 31, 2007. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by the company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. While our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only such reasonable assurance, and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of March 31, 2007, our chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the fiscal quarter ended March 31, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II. OTHER INFORMATION**

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

We are not a party to any material legal proceedings.

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

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

#### **Risks Relating to Microgy**

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

Microgy was formed in 1999 and remains in the early stages of its development. Microgy is developing facilities that use environmentally friendly anaerobic digestion and other technologies to produce biogas from animal and organic wastes. However, none of the facilities to be owned by Microgy has yet been completed. Although Microgy has developed and is operating three single digester facilities in Wisconsin, Microgy has limited experience in the construction and operation of multiple digester facilities such as those Microgy is currently constructing or intends to construct, and limited experience in gas conditioning or the sale of gas as a commodity. Because of this limited experience, Microgy may never be profitable.

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

Microgy has a history of losses. For the three months ended March 31, 2007, we incurred a net loss of \$1.5 million. For the years ended December 31, 2006, 2005 and 2004, we incurred net losses of \$6.8 million, \$11.4 million and \$4.0 million, respectively. We expect our Microgy subsidiary to continue to incur losses, reduce our earnings or, as the case may be, add to our earnings deficit as we seek to further develop its business. These ongoing losses will adversely affect our financial condition into at least 2008. As a result of these losses, we anticipate that we will, in all likelihood, have to rely on external financing for most of our capital requirements. Future losses are likely to continue unless we successfully implement



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our business plan. If we are not successful in reaching and maintaining profitable operations, we may not be able to attract sufficient capital to continue our operations. Our inability to obtain adequate financing would likely result in the need to curtail or cease our business operations and, consequently, a much lower stock price.

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

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

Site agreements;

Supply contracts;

Design/build or other construction-related agreements;

Off-take agreements for gas produced;

Power sales contracts;

Various co-product sales agreements;

Waste disposal agreements;

Licenses;

Environmental and other permits;

Local government approvals; and

Financing commitments required for the successful completion of facilities under consideration.

Microgy's failure to accomplish any of these objectives could materially increase the cost, or prevent the successful completion of, development or operation of facilities and incur the loss of any investment made. Many of these objectives are dependent upon decisions by third parties. Delays in such parties' decision-making process are outside of our control and may have a negative impact on our development costs, cost of operations, receipt of revenue and sales projections. We expect that, in some cases, it may take a year or more to obtain decisions on permits and approvals and to negotiate and close these complex agreements. Such delays could harm our operating results and financial condition.

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

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

Because we have not yet generated sufficient positive cash flow, and do not expect to do so until at least 2008, we do not have adequate funds on hand to complete construction of the facilities we currently have planned. We are seeking and will require corporate, project or group financing to fund the cost of any development we may decide to pursue for Microgy's facilities. This financing may be difficult or impossible for us to obtain. If we are unable to obtain such financing, the value of our Microgy investment may be reduced significantly, and we may be required to substantially curtail our business or completely cease construction or operation of any facilities. This financing will depend on prospective lenders' or investors' review of our financial capabilities as well as specific facilities and other factors, including assessment of our ability to construct and manage each facility successfully. If we are unable to obtain the required financing, your investment in our securities will be materially adversely affected.



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

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

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

Microgy is expected to derive a significant portion of its revenues from the sale of renewable natural gas as a commodity. As a result, Microgy will be exposed to market risk with respect to the commodity pricing applicable to its gas production. Realized commodity prices received for such production are expected to be primarily driven by spot prices applicable to natural gas. Historically, natural gas prices have been volatile, with recent significant price declines, and Microgy expects such volatility to continue. Furthermore, future supply of and demand for natural gas is unpredictable. There are many players in the markets for natural gas and other energy commodities that natural gas tends to track, including large energy companies and foreign cartels, that are of far greater size than Microgy and which can often cause significant movement in the short- and long-term supply and prices of natural gas. Fluctuations in the commodity price of natural gas may have a materially adverse impact on the profitability of some of Microgy's facilities, particularly where the facility does not have a long-term contract for the sale of its output at a fixed or predictable price. At such time as Microgy's facilities begin to produce commercial quantities of gas for sale as a commodity, it intends to explore various strategies, including hedging transactions and long-term sale agreements, in order to mitigate the associated commodity price risk. Furthermore, Microgy Holdings is required by the terms of its tax-exempt bonds to maintain certain gas price protection arrangements for specified periods of time. However, we cannot assure you that any such risk management vehicles will be available or successful. As a result, any such facility, and Microgy as a whole, may become unprofitable.

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

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

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

We have invested, and expect to invest, substantial funds and resources in the development of four multi-digester, renewable natural gas facilities in Texas modeled on the facility located in Stephenville, Texas, commonly known as the Huckabay Ridge facility. We have pledged all of our interest in these facilities as collateral security for the loan to our subsidiary, Microgy Holdings, from the Gulf Coast Industrial Development Authority of Texas relating to the \$60 million tax-exempt bond financing we completed in November 2006. While the loan is not recourse to Environmental Power, Environmental Power is required to provide at least 20% of the construction costs of these facilities, as well as to cover any cost overruns in construction, which represents a substantial investment of corporate resources. If Microgy Holdings were to default on this loan, we would lose some or all of our investment in the Texas facilities, which would have a material adverse effect on our business, financial condition and results of operations.



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

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

Microgy also faces many forms of competition with respect to the resources required to operate its facilities. Such competition includes other providers of pollution control, including environmental engineers, providers of pollution control systems, private companies, public companies, associations, cooperatives, government programs, such as AgStar, foreign companies, and educational pilot programs. Furthermore, there are many companies that offer anaerobic digester systems. We believe that at least 60 companies offer complete systems or components to these systems in the U.S. market. A number of competitors have more mature businesses and have successfully installed anaerobic digester systems in the United States. Microgy may be forced to compete with any of these competitors for access to equipment, construction supplies, skilled labor for the construction and operation of its facilities and the supplies of manure and substrate required to operate its facilities. In addition, Microgy may also have to compete for access to substances that make desirable substrates with other users of these substances, such as recyclers of waste grease and producers of biodiesel and other biofuels. The effect of such competition could be reflected in higher costs associated with obtaining access to these resources, as well as an insufficient supply of these resources for the profitable operation of Microgy's facilities. If Microgy cannot obtain and maintain these supplies, or cannot obtain or maintain them at reasonable costs, the profitability of Microgy's business will be adversely affected.

### ***Microgy is a small company, and the entrance of large companies into the alternative fuels and renewable energy business will likely harm its business.***

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

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

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

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

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

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



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

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

Microgy licenses its anaerobic digester technology from Danish Biogas Technology, A.S., referred to as DBT, a Danish company. The license agreement grants to Microgy a perpetual, exclusive license to develop facilities based on this technology in North America. Pursuant to the license agreement, Microgy is required to pay a one-time licensing fee per facility and engineering and design fees to DBT in connection with the development of facilities. Microgy relies upon DBT for technical advice and engineering assistance. Therefore, if DBT were to cease doing business, our Microgy business may be negatively impacted.

*Because all of the cash flow we receive from Buzzard is currently dedicated to the repayment of loan obligations, we are entirely dependent upon the capital we raise and Microgy's cash flow to fund the continuing development of Microgy.*

We do not expect to receive cash from the operations of Buzzard, because such cash, if any, will be used to repay interest and principal on our loan from an affiliate of ArcLight Energy Partners Fund I, L.P., referred to as ArcLight. As a result, if we are not able to raise additional capital to fund Microgy's operations and our corporate expenses until Microgy's operations begin to generate positive cash flow, we will not be able to continue to fund Microgy's operations at their current levels, and our business will be materially and adversely affected.

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

We expect that Microgy's facilities are likely to be subject to various local, state and federal government regulations, including regulations covering air and water quality, solid waste disposal and related pollution issues. These regulations are mandated by the United States Environmental Protection Agency, or EPA, and state and local governments and are usually implemented through a permitting process, with ongoing compliance requirements thereafter. In addition, our activities will fall under a number of health and safety regulations and laws and regulations relating to farming and zoning. Compliance with these regulations and permitting requirements could delay the development of facilities and could be costly and harm our financial condition.

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

Microgy's facilities produce and emit into the atmosphere carbon dioxide as a result of the anaerobic digestion process that they employ. While such facilities capture a significantly greater amount of carbon, in the form of methane, than they produce in the form of carbon dioxide, Microgy's facilities may still be subject to future federal or state legislation or regulation, or the implementation of international treaties, which seek to limit or impose a cost on carbon emissions. If any such legislation, regulations or treaties were implemented, Microgy's may be required to expend resources to capture the carbon dioxide it produces, pay a tax on its carbon emissions, purchase carbon emissions credits or take similar actions. Any of the foregoing could harm the profitability of Microgy's facilities.

### **Risks Relating to Buzzard**

*Cash distributions resulting from the Scrubgrass operations have been dedicated to the repayment of the ArcLight loan.*

We will not receive any distributions from Buzzard until the loan from ArcLight is repaid. Thereafter, we will receive the next \$1,400,000 of distributions, after which we will share distributions equally with ArcLight through December 31, 2012. As a result, we cannot rely on cash flows from Buzzard to fund our other operations.

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***If our subsidiary EPC Corporation defaults on its obligations under the loan agreement with ArcLight, we may lose ownership of EPC Corporation and, thereby, the leasehold interest in the Scrubgrass facility.***

EPC Corporation's loan from ArcLight is secured by a pledge of all of the outstanding stock of EPC Corporation, which in turn holds Buzzard Power Corporation as its sole asset, the entity that maintains the Scrubgrass facility. If EPC Corporation were to default on its obligations under the agreement with ArcLight, ArcLight would have the right to foreclose on this pledge and take ownership of EPC Corporation. As a result, we would lose our interest in the Scrubgrass facility. The events of default under the agreements with ArcLight are narrowly defined. The most significant default is related to non-payment. EPC Corporation is only required to make payments when there is a distribution from Scrubgrass. Nevertheless, if EPC Corporation does not make any payments in a 24-month period, a default under the agreements with ArcLight would be triggered.

***We do not control the management of the Scrubgrass facility, our primary revenue-generating asset.***

Buzzard has a management services agreement with Cogentrix, formerly PG&E National Energy Group, to manage the Scrubgrass facility and a 15-year operation and maintenance agreement with PG&E Operating Services to operate the facility. These agreements contain provisions that limit Buzzard's participation in the management and operation of the Scrubgrass facility. Because Buzzard does not exercise control over the operation or management of the Scrubgrass facility, decisions may be made, notwithstanding our opposition, which may have an adverse effect on our business.

***Buzzard's current power generation revenue is derived from only one customer***

The Scrubgrass facility power generation revenue is earned under a long-term power purchase agreement for all output with one customer, Pennsylvania Electric Company, or Penelec, a subsidiary of FirstEnergy Corporation. This concentration of Buzzard's revenue with this customer will continue for the foreseeable future. If this customer goes out of business or defaults on its payments to Buzzard, its operating results will be adversely affected. Furthermore, the Scrubgrass facility operates as a qualifying facility, or QF, under the Public Utility Regulatory Policy Act of 1975, or PURPA. The loss of QF status could trigger defaults in the project's power sales agreement, or PSA, with Penelec. Therefore, Buzzard would most likely have to sell power at prevailing market rates that are much lower than the rate outlined in the PSA.

***A large increase in interest rates may adversely affect Buzzard's and EPC Corporation's operating results.***

Our Buzzard and EPC Corporation subsidiaries are leveraged with variable rate and fixed rate debt obligations. Additionally, Buzzard has lease expenses that are based on the principal, interest and fees of the debt obligations of the lessor of the Scrubgrass facility, most of which carries variable rate interest. Over 90% of the debt obligations and lease obligations with respect to Buzzard and EPC Corporation have variable interest rates. Therefore, significant increases in market interest rates will adversely affect operating results since Buzzard is required to pay the Scrubgrass lessor's debt obligations as a base lease expense. For example, as of March 31, 2007, a one percent increase in the London Interbank Offering Rate, referred to as LIBOR, and our quoted bond rates would result in a \$1,192,520 increase in Buzzard's lease expense.

***Poor quality fuel and other materials may expose us to environmental liability and reduce Buzzard's operating results.***

Buzzard obtains waste coal for its Scrubgrass facility primarily from coal mining companies on a long-term basis because waste coal is plentiful and generally creates environmental hazards, such as acid drainage, when not disposed of properly. The waste coal is burned in the Scrubgrass facility using a circulating fluidized bed combustion system. During the circulating fluidized bed combustion process, the waste coal is treated with other substances such as limestone. Depending on the quality of the waste coal and the limestone, the facility operator may need to add additional waste coal or other substances to create the appropriate balance of substances in order to produce the best fuel or sorbent consistency for power generation and compliance with air quality standards. Therefore, the cost of generating power is directly impacted by the quality of the

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waste coal, which supplies the Scrubgrass power generation facility. Certain conditions, such as poor weather, can create situations where the facility operator has less control over the quality of the waste coal. Poor fuel quality may impact Buzzard's future operating results.

*If Buzzard violates performance guarantees granted to Penelec, Buzzard will be required to provide Penelec with an incentive payment.*

Buzzard's agreement for the sale of power to Penelec contains a provision that requires the Scrubgrass facility to provide Penelec with a minimum output of 85% of capacity based on a rolling 3-year average. If Buzzard does not comply with this performance guarantee, it will be required to compensate Penelec with an incentive payment. The payment of an incentive payment would have an adverse effect on Buzzard's operating results.

*Buzzard's power producing activities could be subject to costly regulations and tariffs.*

Buzzard's Scrubgrass facility produces power for sale to the local electrical grid. The sale of this power may come under the regulations of the Pennsylvania Public Utilities Commission and the Federal Energy Regulatory Commission or FERC, although such sales are currently exempt. These commissions set the price tariffs under which energy can be sold or purchased, they regulate the sale of some generation assets and they set the design standards for the interconnection of power producing equipment with the electrical power grid. Any facility that sells electricity to the grid may come under regulation by these commissions, which may impair or delay Buzzard's ability to sell the energy generated. Substantial delays may materially affect Buzzard's financial condition.

Furthermore, there are from time to time various legislative proposals that would amend or comprehensively restructure PURPA and the electric utility industry. Most recently, these proposals resulted in the enactment of the Energy Policy Act of 2005, which eliminates the PURPA obligation of electric utilities to enter into new contracts with qualifying facilities, or QFs. While the Energy Policy Act does not affect existing contracts, if PURPA is amended again or repealed in the future, the statutory requirement that electric utilities purchase electricity at full-avoided cost from QFs could be repealed or modified. While we expect that existing contracts would continue to be honored, the repeal or modification of these statutory purchase requirements under PURPA in the future could, among other things, increase pressure from electric utilities to renegotiate existing contracts. Should there be changes in statutory purchase requirements under PURPA, and should these changes result in amendments to the current power purchase agreement with Penelec for the Scrubgrass facility that reduce the contract rates, Buzzard's operating results could be negatively impacted.

### **Risks Relating to Both Microgy and Buzzard**

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

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

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

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

the success or failure of the facilities currently underway;

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

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

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other unforeseen activities or issues.

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

***Our facilities may be subject to numerous governmental regulations.***

We expect that our facilities will be subject to various government regulations, including regulations covering air and water quality, solid waste disposal and related pollution issues. These regulations are mandated by the United States Environmental Protection Agency, or EPA, and various state and local governments and are usually implemented through a permitting process, with ongoing compliance requirements thereafter. In addition, our activities will fall under a number of health and safety regulations and laws and regulations relating to farms and zoning. Compliance with these regulations and permitting requirements could delay the development of facilities, increase the construction and operating costs of our facilities and harm our financial condition.



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

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

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

A significant portion of our outstanding shares of common stock had been restricted from immediate resale, but are now available for sale in the market pursuant to Rule 144 under the Securities Act of 1933. As of March 31, 2007, we had approximately 2,134,067 shares of restricted common stock outstanding, all of which shares are eligible for resale without volume and manner of sale restrictions in accordance with Rule 144(k).

Furthermore, we currently have on file with the Securities and Exchange Commission an effective registration statement that permits the resale by certain of our stockholders of up to 1,677,688 shares of our restricted common stock, of which 1,066,928 shares are currently issued and outstanding and 610,760 shares are subject to outstanding warrants that are currently exercisable at a price of \$6.60 per share. We also currently have on file with the Securities and Exchange Commission an effective registration statement that permits the resale of up to 100,000 shares of our common stock subject to warrants exercisable at a price of \$6.33 per share by the holders of such warrants. In addition, in connection with our sale of shares of our series A preferred stock and common stock warrants on November 9, 2006, we filed a registration statement to permit the resale of up to 4,387,360 shares of common stock issuable upon conversion of such shares of series A preferred stock and exercise of such warrants. The shares of series A preferred stock are convertible at a conversion price of \$5.271 per share, and the common stock warrants are exercisable at a price of \$5.522 per share as to 1,406,205 of the warrants, and \$5.271 per share as to 168,745 of the warrants.

As of March 31, 2007, we had outstanding options to acquire up to approximately 2,967,820 shares of our common stock at prices ranging from \$1.75 to \$10.50 per share. The shares of common stock issuable upon exercise of these options will be freely transferable without restriction, except to the extent that they are held by our affiliates. Any shares held by our affiliates may only be sold in compliance with the volume limitations of Rule 144. These volume limitations restrict the number of shares that may be sold by an affiliate in any three-month period to the greater of 1% of the number of shares then outstanding, which equals approximately 98,000 shares as of March 31, 2007, or the average weekly trading volume of our common stock during the four calendar weeks preceding the filing of a notice on Form 144 with respect to the sale.

In addition, pursuant to our business development agreement with Cargill, Incorporated, we may issue warrants to Cargill from time to time to acquire up to an aggregate of 4.99% of our outstanding common stock on a fully diluted basis, at an exercise price equal to 75% of the closing price of our common stock on the date on which such warrants are issued.

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

*The issuance of preferred stock may adversely affect the price of our common stock.*

We are authorized to issue up to 2,000,000 shares of preferred stock, of which 281,241 shares have been designated as series A 9% cumulative convertible preferred stock, referred to as the series A preferred stock, and which are currently issued and outstanding. The preferred stock not already designated and issued may be issued in series from time to time with such designations, rights, preferences and limitations as our board of directors may determine by resolution without stockholder approval. While the terms of the series A preferred stock do not currently allow for the issuance of preferred stock having dividend and liquidation preferences greater than or senior to the series A preferred stock, any future issuances of preferred stock may enjoy dividend and liquidation preferences over our common stock, thereby diminishing the value of our common stock.

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

As of March 31, 2007, management and directors, including Richard E. Kessel, Joseph E. Cresci, Kamlesh R. Tejwani, Robert I. Weisberg, John R. Cooper, August Schumacher, Jr., Lon Hatamiya, Steven Kessner, Dennis Haines and John F. O'Neill, beneficially owned approximately 21.8% of our outstanding common stock. In addition, the three holders of our



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series A preferred stock, two of which are affiliated with each other, control approximately 22.6% of the total number of votes currently entitled to be cast at any meeting of our stockholders. While there are no voting agreements among them, such persons, as a group, may be able to exercise some level of control over the outcome of matters submitted for stockholder action, including the election of members to our board of directors and the approval of significant change in control transactions. This may have the effect of delaying or preventing a change in control of our company and, therefore, your opportunity to sell your shares in such a transaction. Furthermore, the holders of our series A preferred stock have special approval rights with respect to certain changes to our certificate of incorporation and certain other corporate actions.

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

While our common stock is currently listed for trading on the American Stock Exchange, trading activity in our common stock has fluctuated and has at times been limited. For example, for the one-month period from March 1, 2007 to March 31, 2007, our daily trading volume ranged from a low of 12,000 shares to a high of 82,400 shares, and averaged 36,736 shares. We cannot guarantee that a consistently active trading market will develop in the future. As a result, a holder of our common stock may find it difficult to dispose of our common stock.

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

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

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

We have historically needed to raise capital to fund our operating losses. We expect to continue to incur operation losses into at least 2008. Although we recently completed a tax-exempt bond financing in Texas to finance a portion of the construction costs of our Texas facilities, as well as a \$15 million private placement of our series A preferred stock and common stock warrants, we will require and will continue to seek corporate and project financing to fund our ongoing operations and growth plans as well as and the cost of any development we may decide to pursue for our facilities. We cannot assure you that such capital will be available in sufficient amounts or on terms acceptable to us, if at all. Any such financing could be in the form of debt or equity instruments or a combination of debt and equity instruments. To the extent any such financing involves equity convertible debt, we may issue a significant number of shares of our common stock or preferred stock, which will dilute your investment in our common stock, and we may issue such shares at prices that may be lower than the price you paid for our common stock. In addition, if we issue shares of preferred stock, such preferred stock may have rights and preferences that are superior to those of our common stock. Indeed, the shares of series A preferred stock issued in our November 2006 private placement have rights and preferences that are superior to those of our common stock. Because we are authorized to issue shares of additional series of preferred stock, as designated by our board of directors, subject to certain limitations included in the terms of our series A preferred stock, we may issue more shares of preferred stock in the future.

Issuances of common stock or securities convertible into common stock in the future could dilute existing stockholders and adversely affect the market price of our common stock. We have the authority to issue up to 21,400,000 shares of common stock, of which 9,787,384 are issued and outstanding and 5,198,888 have been reserved for issuance upon the exercise of options and warrants outstanding as of March 31, 2007. An additional 2,812,410 shares have been reserved for issuance in connection with the conversion of shares of our series A preferred stock issued in our November 2006 private placement. We may also issue warrants to purchase up to 5% of our common stock, on a fully diluted basis, to Cargill, Incorporated pursuant to the terms of our business development agreement. We also have the authority to issue preferred stock as previously described, debt securities convertible into common stock, and options and warrants to purchase shares of our common stock. We may issue shares of common stock or securities convertible into common stock at values below our market price up to a maximum of 19.9% of our outstanding common stock without stockholder approval, which values may be substantially below the price paid for our common stock by our stockholders. We also do not need stockholder approval to issue an unlimited number of shares of common stock or securities convertible into common stock (provided sufficient shares of common stock are authorized and unreserved) at or above our market price pursuant to certain American Stock Exchange requirements. Any such issuances could be at values below the price paid for our common stock by our stockholders.

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

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

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

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

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

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

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

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

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

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

Not applicable.

### **Item 3. Defaults Upon Senior Securities**

Not applicable.



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

Not applicable.

**Item 5. Other Information**

*Shareholder Proposals for 2007 Annual Meeting of Stockholders*

Our 2006 Annual Meeting of Stockholders was held on May 3, 2006. The date of our 2007 Annual Meeting of Stockholders has not yet been determined, but is likely to be later than June 2, 2007, which is more than 30 calendar days after the date on which our Annual Meeting was held last year. Consequently, the deadline for the receipt of shareholder proposals for inclusion in our proxy materials for the 2007 Annual Meeting of Stockholders will be a reasonable time before we begin to print and send our proxy materials for the 2007 Annual Meeting of Stockholders. We have not yet determined the date on which we will print and send such proxy materials or on which the 2007 Annual Meeting of Stockholders will be held.

*Appointment of Michael E. Thomas as Senior Vice President and Chief Financial Officer*

On May 10, 2007, Michael E. Thomas accepted the Company's offer of employment as the Company's Senior Vice President and Chief Financial Officer by executing and returning to the Company an offer letter (the "Thomas Offer Letter"). Mr. Thomas is expected to commence employment with the Company on May 21, 2007.

Mr. Thomas has been the principal of MET Consulting, LLC, a business and financial services consulting firm, from January 2007 to the present. From January 1999 to December 2006, Mr. Thomas was Vice President, Chief Financial Officer for Maine Yankee Atomic Power Company, and also served from October 2004 to December 2006 as Vice President and Chief Financial Officer for Connecticut Yankee Atomic Power Company, and from December 2004 to December 2006 as Vice President and Chief Financial Officer for Yankee Atomic Electric Company. In these capacities, Mr. Thomas had responsibility for financial reporting, investment management, risk management and treasury functions, as well as human resources responsibilities for these three utilities, which had combined assets of over \$1 billion and substantially completed decommissioning programs for the three nuclear power plants owned by them during Mr. Thomas' tenure. From 1991 to 1999, Mr. Thomas held various other finance positions with Maine Yankee Atomic Power Company, including Manager of Financial Services and Vice President and Treasurer. From 1984 to 1989, Mr. Thomas held various finance positions with Central Maine Power Company, including Senior Financial Analyst and Director of Treasury Operations. Mr. Thomas holds a bachelor's degree with a major in economics from Bowdoin College and an MBA from the University of Southern Maine.

There are no family relationships between Mr. Thomas and any other executive officer or any director of the Company. There have not been any transactions between the Company and Mr. Thomas which would require disclosure pursuant to Item 404 of Regulation S-K.

The Thomas Offer Letter provides for Mr. Thomas' employment with the Company on the following principal terms:

An annual salary of \$220,000.

Effective on his first date of employment (the "Grant Date"), the grant of a stock appreciation right ("SAR") under the Company's 2005 Stock Incentive Plan or 2006 Equity Incentive Plan, or a combination thereof (the "Plans"), pursuant to which he will be entitled to receive, after vesting and upon exercise, a payment in cash or in shares of the Company's common stock, or a combination of the foregoing (the form and composition of such payment to be at the election of the Company) equal to the increase, if any, in the fair market value of up to 100,000 shares of common stock (the "Measuring Shares") over the fair market value of the Measuring Shares at the close of business on the Grant Date, vesting as follows:

| Number of Measuring Shares | Vest                               |
|----------------------------|------------------------------------|
| 25,000                     | 12 months following the Grant Date |

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|        |  |
|--------|--|
| 25,000 | 24 months following the Grant Date   |
| 25,000 | 24 months following the Grant Date, so long as the closing price of a share of the Company's common stock equals or exceeds \$11 on or before that date. |
| 25,000 | On the Company's achieving a certain equity and debt financing objectives.   |

The SAR will not represent the right to purchase the underlying Measuring Shares, and in no event may the number of shares of the Company's common stock issued by the Company pursuant to the SAR exceed the number of shares then available for issuance under the Plans. The vesting of the SAR will accelerate in full upon a change in control, as defined in the Thomas Offer Letter.

Eligibility to participate at the same level as other executives reporting directly to the Chief Executive Officer of the Company in any bonus plan adopted by the Company from time to time, subject to the terms of any such plan, with an annual bonus target of 35% of base salary, based on annual performance and financial targets developed by the Company's Chief Executive Officer.

The following benefits, as well as such other medical, dental, retirement and other benefits as are made available from time to time to other senior executives of the Company:

- o An automobile allowance not to exceed \$750.00 per month;
- o Reimbursement for long-term disability and term life insurance coverage premiums paid by Mr. Thomas, in an amount not to exceed \$3,500.00 per year;
- o Four weeks' paid vacation per year;
- o Reimbursement for expenses of relocation, including the expenses of selling his existing residence, purchasing a new residence and moving, as well as temporary housing expenses of up to \$1,500 per month for a period of six months.

The Thomas Offer Letter further provides that, notwithstanding the fact that Mr. Thomas will be an employee-at-will, he will be entitled to severance equal to 12 months of his then current base salary if he is terminated as a result of job elimination or termination without cause, as defined in the Thomas Offer Letter, and not as a result of discharge for cause, retirement, disability, death or voluntary resignation, with such severance payable in a lump sum upon termination. In addition to severance, Mr. Thomas will also be entitled to 12 months of continued medical benefits coverage.

### ***Separation Agreement with John F. O'Neill***

On May 9, 2007, the Company entered into a Release and Severance Agreement (the "Severance Agreement") with John F. O'Neill, its Chief Financial Officer and Treasurer, in connection with Mr. O'Neill's planned departure from employment with the Company. The Severance Agreement provides for the following principal terms:

The continued employment of Mr. O'Neill on a transition basis through July 31, 2007 on the terms set forth in his offer letter, dated June 29, 2005, subject to earlier termination by the Company or Mr. O'Neill on not less than 30 days' prior written notice, with the last day of Mr. O'Neill's employment referred to as the termination date;

A complete release by Mr. O'Neill of all claims against the Company through the date of the Severance Agreement, with another such release to be executed upon the termination date;

Subject to the foregoing releases not having been revoked during the applicable time periods, and provided that the Company does not terminate Mr. O'Neill's employment with the Company for cause:

- o The Company will make a lump sum payment of \$10,000 to Mr. O Neill upon the termination date. This payment will be in full and complete satisfaction for all expenses incurred by Mr. O Neill in connection with his employment and exit from the Company, including legal fees, costs of travel, job-search assistance, professional fees, association dues, and phone- and other connection-charges.
- o The Company will make an aggregate of \$200,000 in severance payments, payable in semi-monthly installments in accordance with the Company's normal payroll schedule and practices until such amount is paid in full.
- o The Company will continue to pay the premiums of, and permit Mr. O Neill to participate in, the medical, dental and life insurance plans as offered by the Company from time to time to its employees for a period of one year following the termination date, provided that said payments and participation shall cease on the 60th day following Mr. O Neill's commencement of full-time employment with a new employer, and further provided, that Mr. O Neill will be required to contribute toward premiums (via the Company's withholding from severance payments) and make co-payments to the same extent that active employees are required to contribute or pay.
- o Provisions in Mr. O Neill's option agreement that would require him to exercise the options within one year of the termination date shall be deemed to be amended to allow exercise any time prior to the second anniversary of his termination date, and any such options which are not yet vested shall continue to vest during such period as though no termination of employment had occurred. In addition, such options shall be exercisable only on a net share basis, meaning that, upon exercise of such options, Mr. O Neill would receive shares of the Company's common stock equal to the difference between the market value of the shares subject to the option and their exercise price, less required withholding for taxes.

On May 14, 2007, Mr. O Neill and the Company entered into a letter agreement, supplemental to the Severance Agreement, whereby Mr. O Neill resigned as the Company's Chief Financial Officer and Treasurer, effective May 18, 2007 and agreed that his employment with the Company would continue on a transition basis through June 1, 2007, which would become his termination date for purposes of the Severance Agreement.

**Item 6. Exhibits**

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



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**SIGNATURES**

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

**ENVIRONMENTAL POWER CORPORATION**

By: /s/ John F. O Neill  
John F. O Neill  
Chief Financial Officer and Treasurer  
(principal financial and accounting officer and  
authorized officer)

May 15, 2007

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**Exhibit Index**

- 3.1 Restated Certificate of Incorporation of the Registrant (Incorporated by reference to Exhibit 3.01 to the Registrant's Current Report on Form 8-K dated November 30, 2004, as filed with the SEC on December 2, 2004 (SEC File No. 000-15472))
- 3.2 Restated Bylaws of the Registrant (Incorporated by reference to Exhibit 3.02 to the Registrant's Current Report on Form 8-K/A dated June 2, 2003, as filed on June 10, 2003 (SEC File No. 000-15472))
- 3.3 Certificate of Designations, Preferences and Rights of the Registrant's Series A 9% Cumulative Convertible Preferred Stock (Incorporated by reference to exhibit 3.1 to the Registrant's Current Report on Form 8-K dated November 9, 2006, as filed with the SEC on November 14, 2006 (SEC File No. 001-32393))
- 31.1 Rule 13a-14(a)/15d-14(a) Certifications of the Registrant's Chief Executive Officer.
- 31.2 Rule 13a-14(a)/15d-14(a) Certifications of the Registrant's Chief Financial Officer.
- 32.1 Section 1350 Certifications of the Registrant's Chief Executive Officer.
- 32.2 Section 1350 Certifications of the Registrant's Chief Financial Officer.