

ENVIRONMENTAL POWER CORP

Form 10-Q

November 09, 2009

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended September 30, 2009

OR

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

For the transition period from _____ to _____

Commission file number 001-32393

Environmental Power Corporation

(Exact name of registrant as specified in its charter)

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

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

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

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

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

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company
Number of shares of Common Stock outstanding at September 30, 2009: 15,708,591 shares

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

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PART I. FINANCIAL INFORMATION

Cautionary Statement Regarding Forward-Looking Statements

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

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

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

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

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

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

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

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

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

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

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

financing and cash flow requirements and uncertainties,

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

difficulties involved in developing and executing a business plan,

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

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

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

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

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

uncertainties relating to general economic and industry conditions,

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

Table of Contents**Item 1. Financial Statements****ENVIRONMENTAL POWER CORPORATION AND SUBSIDIARIES****Condensed Consolidated Balance Sheets (unaudited) as of September 30, 2009 and December 31, 2008**

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

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

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

See Notes to Consolidated Financial Statements.

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

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

See Notes to Consolidated Financial Statements.

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

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

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Payment of license fees with issuance of 14% convertible note	3,000,000	
Accrued dividend requirement of series A preferred stock	1,000,633	326,634
Capitalized amortization of deferred financing costs	114,304	60,066

See Notes to Consolidated Financial Statements.

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

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

See Notes to Consolidated Financial Statements.

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Notes to Condensed Consolidated Financial Statements

NOTE A BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements of Environmental Power Corporation (we , us , EPC Environmental Power , or the Company) and our subsidiaries have been prepared in accordance with the instructions to Form 10-Q and with Article 10 of Regulation S-X and include all of the information and footnotes required by generally accepted accounting principles for interim financial information. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The results of operations for the three and nine months ended September 30, 2009 are not necessarily indicative of results to be expected for the year ending December 31, 2009. The information in this quarterly report should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and footnotes included in our Annual Report on Form 10-K for the year ended December 31, 2008 (Annual Report).

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

Impairment of Assets

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

Codification of Accounting Standards

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

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

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

Reclassification

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

NOTE B GOING CONCERN

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

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

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Notes to Condensed Consolidated Financial Statements (Continued)

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

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

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

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

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

NOTE C THE COMPANY

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

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

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

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

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

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

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

Discontinued Operations

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

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

NOTE D PROPERTY, PLANT AND EQUIPMENT

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

NOTE E GOODWILL AND INTANGIBLE ASSETS

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

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

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

Estimated Amortization Expense for Licensed Technology Rights

Remaining 2009	2010	2011	2012	2013	Thereafter	Total
\$ 46,375	185,500	185,500	185,500	185,500	1,401,796	\$ 2,190,171

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

NOTE F DEFERRED FINANCING COSTS

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

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

Notes Receivable In 2005, we completed construction of the digester projects at Five Star Dairy, Wild Rose Dairy, and Norswiss Dairy. Each digester had a purchase price of \$1,037,000, of which Microgy agreed to provide 100% seller financing. The notes issued by the purchasers of the digester projects each bear simple interest at 5% per annum, to be paid monthly after the first month that revenues are received under the purchasers' respective biogas supply agreement with Dairyland Power Cooperative. Each maker of these notes is only required to make interest and principal payments from the revenues under the applicable biogas supply agreement with Dairyland Power Cooperative, to the extent that the operation of the facility, which we manage and operate, provides sufficient funds to pay. Each note matures 11 years after the bill of sale for the facility to which it relates has been executed. Because we have limited operating history, we have set up a reserve on these notes in the amount of \$750,000 to allow for any future cash flow deficiencies that would impair the full value of the notes. We also do not expect to record interest income from these notes. As we gain operations and maintenance experience and develop a track record, we will evaluate this allowance and make adjustments accordingly. The following table shows the balance on these notes receivable on September 30, 2009 and December 31, 2008:

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

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

Notes Receivable from Officers and Directors We have outstanding notes receivable from former and current officers and directors for shares purchased in connection with stock option plans that amounted to \$638,219 as of September 30, 2009 and December 31, 2008. These notes, partially secured by the underlying shares of stock purchased thereby, are payable upon demand and bear interest at a floating rate which is payable monthly. In accordance with company policy and applicable law, we no longer make loans to our officers or directors.

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

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

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

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

Contractual Obligations

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

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

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

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

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

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

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

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

Cooperation Agreement

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

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

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

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

California and Texas Bonds

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

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

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executed, is expected to have the following significant terms:

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

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

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

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

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Notes to Condensed Consolidated Financial Statements (Continued)

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

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

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

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

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

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

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

NOTE I ASSET RETIREMENT OBLIGATIONS

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

NOTE J PREFERRED STOCK AND SHAREHOLDERS EQUITY

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

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

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

NOTE K FAIR VALUE OF FINANCIAL INSTRUMENTS

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

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

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

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

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

NOTE L STOCK-BASED COMPENSATION

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

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

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

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

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Notes to Condensed Consolidated Financial Statements (Continued)

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

NOTE M IMPAIRMENT OF ASSETS

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

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

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

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

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

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

NOTE N INCOME TAXES

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

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

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

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

future examinations by relevant tax authorities.

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

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

NOTE P RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

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

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

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

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

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

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

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

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

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

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

Overview

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

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

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

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

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

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

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

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

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

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

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

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

Discontinued Operations

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

Going Concern

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

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

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

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

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

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

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

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

RESULTS OF OPERATIONS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Liquidity and Capital Resources

Certain Balance Sheet Items

September 30, 2009 compared to December 31, 2008

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

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

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

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

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

Operating Activities

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

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

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

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

Investing Activities

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

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

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

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

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

Financing Activities

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

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

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

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

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2009 Outlook

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

Current Operations

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

Our previously reported comprehensive upgrades to process-instrumentation and controls, the gas conditioning system, and the gas-collection system at Huckabay Ridge continue to deliver improved online reliability. Indeed, during the period from July through September, we were producing product between 90% and 96% of the time versus a targeted level of 90%. During the last half of October, the Huckabay Ridge facility produced RNG[®] product 98% of the time. After an outage in early October to repair and modify elements in the gas processing system, the Huckabay Ridge facility produced RNG[®] product 97% of the time with production averaging 87% of target for the period. RNG[®] production for the last 11 days of the month averaged 95% of target as the system stabilized. We achieved this level of performance while meeting or exceeding pipeline-quality standards for the removal of CO₂, H₂S and HO. These results confirm our confidence in our operating model and give us added confidence in our ability to manage the biogas-generation process as we look forward to our next generation of operating units.

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

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

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

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

Projects in Development

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

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

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

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

Table of Contents*Cash Flow Outlook for 2009*

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

Capacity Update

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

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