

POWERSECURE INTERNATIONAL, INC.

Form 10-Q

May 05, 2011

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended March 31, 2011**

**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 1-12014**

**POWERSECURE INTERNATIONAL, INC.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

84-1169358  
(I.R.S. Employer  
Identification No.)

1609 Heritage Commerce Court  
Wake Forest, North Carolina  
(Address of principal executive offices)

27587  
(Zip code)

(919) 556-3056

(Registrant's telephone number, including area code)

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

Large  
accelerated filer ☐  
☐

Accelerated filer ☒

Non-accelerated filer ☐

Smaller reporting company ☐

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ☐ No ☒  
As of May 1, 2011, 18,832,544 shares of the issuer's Common Stock were outstanding.



**POWERSECURE INTERNATIONAL, INC.**  
**FORM 10-Q**  
**For the Quarterly Period Ended March 31, 2011**  
**TABLE OF CONTENTS**

	Page
 <u><b>PART I. FINANCIAL INFORMATION</b></u>	
 <u>Item 1. Financial Statements</u>	
<u>Unaudited Consolidated Balance Sheets - March 31, 2011 and December 31, 2010</u>	3
<u>Unaudited Consolidated Statements of Operations - For the Three Months Ended March 31, 2011 and March 31, 2010</u>	5
<u>Unaudited Consolidated Statements of Cash Flows - For the Three Months Ended March 31, 2011 and March 31, 2010</u>	6
<u>Notes to Unaudited Consolidated Financial Statements</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	25
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	51
<u>Item 4. Controls and Procedures</u>	52
 <u><b>PART II. OTHER INFORMATION</b></u>	
<u>Item 1. Legal Proceedings</u>	53
<u>Item 1A. Risk Factors</u>	53
<u>Item 6. Exhibits</u>	53
<u>Signatures</u>	54
<u>Exhibit 31.1</u>	
<u>Exhibit 31.2</u>	
<u>Exhibit 32.1</u>	
<u>Exhibit 32.2</u>	

**Table of Contents**

**PART I.**  
**FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS (unaudited)**  
**(in thousands, except share data)**

	March 31, 2011	December 31, 2010
<b>Assets</b>		
Current Assets:		
Cash and cash equivalents	\$ 14,890	\$ 8,202
Trade receivables, net of allowance for doubtful accounts of \$256 and \$415, respectively	32,672	29,290
Assets of discontinued operations held for sale		12,183
Inventories	29,863	25,011
Current deferred income taxes	1,731	1,731
Prepaid expenses and other current assets	928	933
 Total current assets	 80,084	 77,350
 Property, plant and equipment:		
Equipment	29,080	24,946
Furniture and fixtures	280	280
Land, building and improvements	5,735	5,720
 Total property, plant and equipment, at cost	 35,095	 30,946
Less accumulated depreciation and amortization	6,481	5,899
 Property, plant and equipment, net	 28,614	 25,047
 Other assets:		
Goodwill	7,970	7,970
Deferred income taxes, net of current portion	1,244	1,244
Restricted annuity contract	2,324	2,306
Intangible rights and capitalized software costs, net of accumulated amortization of \$2,637 and \$2,463, respectively	1,959	1,942
Investment in unconsolidated affiliate	4,732	4,346
Other assets	299	324
 Total other assets	 18,528	 18,132

<b>Total Assets</b>	\$	127,226	\$	120,529
---------------------	----	---------	----	---------

*See accompanying notes to consolidated financial statements.*

**Table of Contents**

**POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS (unaudited)**  
(in thousands, except share data)

	<b>March 31, 2011</b>	<b>December 31, 2010</b>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$ 9,392	\$ 8,438
Accrued and other liabilities	13,260	10,986
Liabilities of discontinued operations held for sale		1,411
Current income taxes payable	139	251
Current unrecognized tax benefit	954	954
Current portion of capital lease obligations	807	796
 Total current liabilities	 24,552	 22,836
 Long-term liabilities:		
Revolving line of credit	5,000	5,000
Capital lease obligations, net of current portion	3,441	3,647
Unrecognized tax benefit	749	749
Deferred compensation	1,136	1,053
 Total long-term liabilities	 10,326	 10,449
 Commitments and contingencies (Notes 7 and 9)		
 Stockholders' Equity:		
PowerSecure International stockholders' equity:		
Preferred stock—undesignated, \$.01 par value; 2,000,000 shares authorized; none issued and outstanding		
Preferred stock—Series C, \$.01 par value; 500,000 shares authorized; none issued and outstanding		
Common stock, \$.01 par value; 25,000,000 shares authorized; 18,807,044 and 18,701,614 shares issued and outstanding, respectively	188	187
Additional paid-in-capital	115,342	114,791
Accumulated deficit	(24,753)	(29,489)
 Total PowerSecure International, Inc. stockholders' equity	 90,777	 85,489
Noncontrolling interest	1,571	1,755
 Total stockholders' equity	 92,348	 87,244

<b>Total Liabilities and Stockholders' Equity</b>	\$ 127,226	\$ 120,529
---	------------	------------

*See accompanying notes to consolidated financial statements.*

**Table of Contents**

**POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share data)

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Revenues	\$ 23,713	\$ 20,460
Cost of sales	16,054	12,351
Gross profit	7,659	8,109
Operating expenses:		
General and administrative	7,919	6,462
Selling, marketing and service	1,158	1,046
Depreciation and amortization	806	584
Total operating expenses	9,883	8,092
Operating income (loss)	(2,224)	17
Other income and (expenses):		
Equity income from unconsolidated affiliate	1,011	1,030
Management fees	168	154
Interest income and other income	20	30
Interest expense	(142)	(141)
Income (loss) before income taxes	(1,167)	1,090
Income tax benefit (provision)	83	(205)
Income (loss) from continuing operations	(1,084)	885
Discontinued operations (Note 5):		
Income from operations, net of tax		519
Gain on disposal, net of tax	5,636	
Income from discontinued operations, net of tax	5,636	519
Net income	4,552	1,404
Less: Net (income) loss attributable to noncontrolling interest	184	(187)

Net income attributable to PowerSecure International, Inc.	\$	4,736	\$	1,217
Amounts attributable to PowerSecure International, Inc. common stockholders:				
Income (loss) from continuing operations, net of tax	\$	(900)	\$	698
Income from discontinued operations, net of tax		5,636		519
Net income	\$	4,736	\$	1,217
Basic earnings per share attributable to PowerSecure International, Inc. common stockholders:				
Income (loss) from continuing operations	\$	(0.05)	\$	0.04
Income from discontinued operations		0.30		0.03
Net income attributable to PowerSecure International, Inc. common stockholders	\$	0.25	\$	0.07
Diluted earnings per share attributable to PowerSecure International, Inc. common stockholders:				
Income (loss) from continuing operations	\$	(0.05)	\$	0.04
Income from discontinued operations		0.30		0.03
Net income attributable to PowerSecure International, Inc. common stockholders	\$	0.25	\$	0.07

*See accompanying notes to consolidated financial statements.*

**Table of Contents**

**POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)**  
(in thousands)

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 4,552	\$ 1,404
Adjustments to reconcile net income to net cash used in operating activities:		
Income from discontinued operations	(5,636)	(519)
Depreciation and amortization	806	584
Stock compensation expense	480	494
Distributions to noncontrolling shareholder		(598)
Equity in income of unconsolidated affiliate	(1,011)	(1,030)
Distributions from unconsolidated affiliate	607	809
Changes in operating assets and liabilities, net of effect of aquisitons:		
Trade receivables, net	(3,382)	(1,222)
Inventories	(4,852)	(4,375)
Other current assets and liabilities	(106)	357
Other noncurrent assets	25	35
Accounts payable	954	5,304
Restructuring charges		(248)
Accrued and other liabilities	2,166	(3,453)
Deferred compensation obligation	83	83
Restricted annuity contract	(18)	(22)
Net cash used by continuing operations	(5,332)	(2,397)
Net cash provided by discontinued operations		592
Net cash used in operating activities	(5,332)	(1,805)
<b>Cash flows from investing activities:</b>		
Purchases of property, plant and equipment	(4,180)	(1,102)
Additions to intangible rights and software development	(192)	(286)
Proceeds from sale of property, plant and equipment		5
Proceeds from sale of discontinued operations	16,515	
Discontinued operations investing activities		(21)
Net cash provided by (used in) investing activities	12,143	(1,404)
<b>Cash flows from financing activities:</b>		
Borrowings (payments) on revolving line of credit		
Payments on capital lease obligations	(195)	(185)
Proceeds from stock option and warrant exercises, net of shares tendered	72	(162)

Edgar Filing: POWERSECURE INTERNATIONAL, INC. - Form 10-Q

Net cash used in financing activities	(123)	(347)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	6,688	(3,556)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	8,202	20,169
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 14,890	\$ 16,613

*See accompanying notes to consolidated financial statements.*

**Table of Contents**

**POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES**

**Notes to Unaudited Consolidated Financial Statements**

As of March 31, 2011 and December 31, 2010 and

For the Three Month Periods Ended March 31, 2011 and 2010

(in thousands, except per share data)

**1. Description of Business and Basis of Presentation**

**Description of Business**

PowerSecure International, Inc., headquartered in Wake Forest, North Carolina, is a leading provider of Energy and Smart Grid Solutions to electric utilities, their commercial, institutional and industrial customers, and of Energy Services to oil and natural gas producers.

Our core business is our Energy and Smart Grid Solutions segment, operated through our largest wholly-owned subsidiary PowerSecure, Inc., which we refer to as our PowerSecure subsidiary. This segment includes our three core strategic business areas: Interactive Distributed Generation, Utility Infrastructure and Energy Efficiency. These three areas are focused on providing utilities and their commercial, institutional and industrial customers with products and services to help them generate, deliver, and utilize electricity more efficiently and are intended to deliver strong returns on investment. They share common or complementary utility relationships and customer types, common sales and overhead resources, and facilities. However, each business area in this segment possesses distinct technical disciplines and specific capabilities that are designed to provide a competitive advantage in the marketplace for its specific products and services, including personnel, technology, engineering, and intellectual capital. This segment operates primarily out of our Wake Forest, North Carolina headquarters office, and its operations also include several satellite offices and manufacturing facilities, the largest of which are in Raleigh, North Carolina, Randleman, North Carolina, McDonough, Georgia, and Anderson, South Carolina. The locations of our sales organization for this segment are generally in close proximity to the utilities and commercial, industrial, and institutional customers they serve.

Until recently, our Energy Services segment operated through our two other principal operating subsidiaries, Southern Flow Companies, Inc., which we refer to as Southern Flow, and WaterSecure Holdings, Inc., which we refer to as WaterSecure. WaterSecure holds an investment of 40% of the equity interests in an unconsolidated business, Marcum Midstream 1995-2 Business Trust, which we refer to as MM 1995-2 or as our WaterSecure operations. Our WaterSecure operations provide water processing, recycling, and disposal services for oil and natural gas producers in northeastern Colorado utilizing environmentally responsible technologies and processes. Our Southern Flow business, which was sold in 2011 pursuant to a purchase agreement executed in December 2010, provides oil and natural gas measurement services to customers involved in oil and natural gas production, transportation, and processing, with a focus on the natural gas market. Due to its sale, Southern Flow's operations are now reflected as discontinued operations in the accompanying consolidated financial statements. See Note 4 for more information regarding the sale of Southern Flow.

See Note 11 for more information concerning our reportable segments.

**Table of Contents****Basis of Presentation**

**Organization** The accompanying consolidated financial statements include the accounts of PowerSecure International, Inc. and its subsidiaries, primarily, PowerSecure, Inc. ( our PowerSecure subsidiary ) (and its majority-owned and wholly-owned subsidiaries, UtilityEngineering, Inc., PowerServices, Inc., EnergyLite, Inc., EfficientLights, LLC, Innovative Electronic Solutions Lighting, LLC ( IES ), Reid 's Trailer, Inc. and PowerPackages, LLC), Southern Flow Companies, Inc. ( Southern Flow ), WaterSecure Holdings, Inc. ( WaterSecure ), and Marcum Gas Metering, Inc. (fka Metretek International, Inc. and Metretek, Incorporated) ( Metretek Florida ), collectively referred to as the Company or we or us or our .

These consolidated financial statements have been prepared pursuant to rules and regulations of the Securities and Exchange Commission. The accompanying consolidated financial statements and notes thereto should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2010.

In management 's opinion, all adjustments (all of which are normal and recurring) have been made which are necessary for a fair presentation of the consolidated financial position of us and our subsidiaries as of March 31, 2011 and the consolidated results of our operations and cash flows for the three months ended March 31, 2011 and March 31, 2010.

**Principles of Consolidation** The consolidated financial statements include the accounts of PowerSecure International, Inc. and its subsidiaries after elimination of intercompany accounts and transactions. We use the equity method to account for our investment in our unconsolidated affiliate.

**Noncontrolling Interest** The noncontrolling ownership interests in the income or losses of our majority-owned subsidiaries is included in our consolidated statements of operations as a reduction or addition to net income to derive income attributable to PowerSecure International stockholders. Similarly, the noncontrolling ownership interest in the undistributed equity of our majority-owned subsidiaries is shown as a separate component of stockholders ' equity in our consolidated balance sheet.

Until April 30, 2010, our PowerSecure subsidiary held a 67% controlling ownership interest in EfficientLights which is consolidated in our financial statements. On April 30, 2010, we acquired the 33% noncontrolling ownership interest in EfficientLights at which time EfficientLights became a wholly-owned subsidiary of our PowerSecure subsidiary. Also, on April 1, 2010, our PowerSecure subsidiary acquired a 67% controlling ownership interest in IES.

Accordingly, our noncontrolling interest for the three months ended March 31, 2011, consists solely of the results of IES. Similarly, our noncontrolling interest for the three month ended March 31, 2010 consists solely of the results of EfficientLights. As a result, period-to-period comparisons of the aggregate amount of noncontrolling interests are not necessarily comparable.

The following is a reconciliation of the amounts attributable to the noncontrolling interest for the three months ended March 31, 2011:

	Noncontrolling Interest		
	EfficientLights	IES	Total
Balance, December 31, 2010	\$	\$ 1,755	\$ 1,755
Income (loss)		(184)	(184)
Distributions			
Balance, March 31, 2011	\$	\$ 1,571	\$ 1,571

**Table of Contents**

The following is a reconciliation of the amounts attributable to the noncontrolling interest for the three months ended March 31, 2010:

	Noncontrolling Interest		
	EfficientLights	IES	Total
Balance, December 31, 2009	\$ 1,107	\$	\$ 1,107
Income (loss)	187		187
Distributions	(598)		(598)
Balance, March 31, 2010	\$ 696	\$	\$ 696

**Use of Estimates** The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires that our management make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates include percentage-of-completion estimates for revenue and cost of sales recognition, incentive compensation and commissions, allowance for doubtful accounts receivable, inventory valuation reserves, warranty reserves and our deferred tax valuation allowance.

**Reclassifications** During the fourth quarter of 2010, our board of directors approved a plan to sell our Southern Flow business (see Note 4). The operations of Southern Flow have been reclassified to discontinued operations for all periods presented in the accompanying consolidated financial statements. In addition, certain 2010 amounts have been reclassified to conform to current year presentation. Such reclassifications had no effect on net income or stockholders equity.

## **2. Summary of Significant Accounting Policies and Recent Accounting Standards**

**Revenue Recognition** For our distributed generation turn-key project-based sales and our utility infrastructure projects, we recognize revenue and profit as work progresses using the percentage-of-completion method, which relies on various estimates. We believe the use of the percentage-of-completion method of accounting for our distributed generation and utility infrastructure projects is preferable to the completed contract method because our typical projects occurs over several accounting periods and the percentage-of-completion method is a better method to match the revenues and costs to the reporting period in which the construction services are performed. Nearly all of our distributed generation and utility infrastructure projects are fixed-price contracts.

In applying the percentage-of-completion method to our distributed generation turn-key projects, we have identified the key output project phases that are standard components of these projects. We have further identified, based on past experience, an estimate of the value of each of these output phases based on a combination of costs incurred and the value added to the overall construction project. While the order of these phases varies depending on the project, each of these output phases is necessary to complete each project and each phase is an integral part of the turnkey product solution we deliver to our customers. We use these output phases and percentages to measure our progress toward completion of our construction projects. For each reporting period, the status of each project, by phase, is determined by employees who are managers of or are otherwise directly involved with the construction project and is reviewed by our accounting personnel. Utilizing this information, we recognize project revenues (and associated project costs) and gross profit based on the percentage associated with output phases that are complete or in process on each of our projects.

In applying the percentage-of-completion method to our utility infrastructure projects, revenues and gross profit are recognized as work is performed based on the relationship between actual costs incurred and total estimated costs at completion.



**Table of Contents**

In all cases where we utilize the percentage-of-completion, revenues and gross profit are adjusted prospectively for revisions in estimated total contract costs and contract values. Estimated losses, if any, are recorded when identified. While a project is in process, amounts billed to customers in excess of revenues recognized to date are classified as current liabilities. Likewise, amounts recognized as revenue in excess of actual billings to date are recorded as unbilled accounts receivable. In the event adjustments are made to the contract price, including, for example, adjustments for additional wire or other raw materials, we adjust the purchase price and related costs for these items when they are identified.

Because the percentage-of-completion method of accounting relies upon estimates described above, recognized revenues and profits are subject to revision as a project progresses to completion. Revisions in profit estimates are charged to income in the period in which the facts that give rise to the revision become known. In the event we were required to adjust any particular project's estimated revenues or costs, the effect on the current period earnings may or may not be significant. If, however, conditions arise that requires us to adjust our estimated revenues or costs for a series of similar construction projects, the effect on current period earnings would more likely be significant. In addition, certain contracts provide for cancellation provisions prior to completion of a project. The cancellation provisions generally provide for payment of costs incurred, but may result in an adjustment to profit already recognized in a prior period.

We recognize equipment and product revenue when persuasive evidence of a non-cancelable arrangement exists, delivery has occurred and/or services have been rendered, the price is fixed or determinable, and collectability is reasonably assured. Equipment and product sales are generally made directly to end users of the product, who are responsible for payment for the product.

Service revenue includes regulatory consulting and rate design services, power system engineering services, energy conservation services, and monitoring and maintenance services. Revenues from these services are recognized when the service is performed and the customer has accepted the work.

Additionally, our utility infrastructure business provides services to utilities involving construction, maintenance, and upgrades to their electrical transmission and distribution systems which is not fixed price project-based work. These services are delivered by us under contracts which are generally of two types. In the first type, we are paid a fixed fee based on the number of units of work we complete, an example of which is number of new utility poles we replace. In the second type, we are paid for the time and materials utilized to complete the work, plus a profit margin. In both cases, we recognize revenue as these services are delivered.

Revenues for our recurring revenue distributed generation projects are recognized over the term of the contract or when energy savings are realized by the customer at its site. Under these arrangements, we provide utilities and their customers with access to PowerSecure-owned and operated distributed generation systems for standby power and to deliver peak shaving benefits. These contracts can involve multiple parties, with one party paying us for the value of backup power (usually, but not always, a commercial, industrial, or institutional customer), and one party paying us for the value of the electrical capacity provided by the system (either the customer or a utility).

Sales of certain goods and services sometimes involve the provision of multiple deliverables. Revenues from contracts with multiple deliverables are recognized as each element is earned based on the selling price for each deliverable. The selling price for each deliverable is generally based on our selling price for that deliverable on a stand-alone basis, third-party evidence if we do not sell that deliverable on a stand-alone basis, or an estimated selling price if neither specific selling prices nor third-party evidence exists.

**Table of Contents**

***Cash and Cash Equivalents*** Cash and all highly liquid investments with a maturity of three months or less from the date of purchase, including money market mutual funds, short-term time deposits, and government agency and corporate obligations, are classified as cash and cash equivalents.

***Accounts Receivable*** Our customers include a wide variety of mid-sized and large businesses, utilities and institutions. We perform ongoing credit evaluations of our customers' financial condition and generally do not require collateral. We continuously monitor collections and payments from our customers and regularly adjust credit limits of customers based upon payment history and a customer's current credit worthiness, as judged by us. We maintain a provision for estimated credit losses.

***Concentration of Credit Risk*** We are subject to concentrations of credit risk from our cash and cash equivalents and accounts receivable. We limit our exposure to credit risk associated with cash and cash equivalents by placing it with multiple domestic financial institutions. Nevertheless, our cash in bank deposit accounts at these financial institutions frequently exceeds federally insured limits. We further limit our exposure to credit risk associated with these cash accounts by adherence to our investment policy. We have not experienced any losses in such accounts.

From time to time, we have derived a material portion of our revenues from one or more significant customers. To date, nearly all our revenues have been derived from sales to customers within the United States.

***Warranty Reserve*** We provide a standard warranty for our distributed generation equipment, switchgear equipment, utility infrastructure equipment, and our Energy Efficiency unit's lighting products, which range generally between one and five years. In addition, we offer extended warranty terms on our distributed generation turn-key and switchgear projects. We reserve for the estimated cost of product warranties when revenue is recognized, and we evaluate our reserve periodically by comparing our warranty repair experience by product. The purchase price for extended warranties or extended warranties included in the contract terms are deferred as a component of our warranty reserve. The balance of our warranty reserve included in accrued and other liabilities at March 31, 2011 and December 31, 2010 was \$1,075 and \$1,087, respectively.

***Share-Based Compensation*** We measure compensation cost for all stock-based awards at the fair value on date of grant and recognize the compensation expense over the service period for awards expected to vest, net of estimated forfeitures. We measure the fair value of restricted stock awards based on the number of shares granted and the quoted price of our common stock on the date of the grant, and we measure the fair value of stock options using the Black-Scholes valuation model.

Pre-tax share-based compensation expense for our stock options and restricted stock awards recognized during the three months ended March 31, 2011 and 2010 was \$480 and \$494, respectively. All share-based compensation expense is included in general and administrative expense in the accompanying consolidated statements of operations.

***Income Taxes*** We recognize deferred income tax assets and liabilities for the estimated future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. We have net operating loss carryforwards available in certain jurisdictions to reduce future taxable income. Future tax benefits for net operating loss carryforwards are recognized to the extent that realization of these benefits is considered more likely than not. To the extent that available evidence raises doubt about the realization of a deferred income tax asset, a valuation allowance is established.

## **Table of Contents**

We recognize a liability and income tax expense, including potential penalties and interest, for uncertain income tax positions taken or expected to be taken. The liability is adjusted for positions taken when the applicable statute of limitations expires or when the uncertainty of a particular position is resolved.

**Subsequent Events** Subsequent events are events or transactions that occur after the balance sheet date but before the financial statements are issued or are available to be issued and are classified as either recognized subsequent events or non-recognized subsequent events. We recognize and include in our financial statements the effects of subsequent events that provide additional evidence about conditions that existed at the balance sheet date. We disclose non-recognized subsequent events that provide evidence about conditions that arise after the balance sheet date but are not yet reflected in our financial statements when such disclosure is required to prevent the financial statements from being misleading.

### **Recent Accounting Pronouncements**

**Revenue Recognition Milestone Method** In April 2010, the FASB issued Accounting Standards Update ( ASU ) No. 2010-17 Revenue Recognition Milestone Method (Topic 605): Milestone Method of Revenue Recognition. This standard provides guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for certain research and development transactions. Under this new standard, a company can recognize as revenue consideration that is contingent upon achievement of a milestone in the period in which it is achieved, only if the milestone meets all criteria to be considered substantive. This standard became effective for us on a prospective basis commencing January 1, 2011. The adoption of this standard had no effect on our financial position or results of operations.

**Improving Disclosures about Fair Value Measurements** In January 2010, the FASB issued ASU No. 2010-06 Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. This standard amends the disclosure guidance with respect to fair value measurements for both interim and annual reporting periods. Specifically, this standard requires new disclosures for significant transfers of assets or liabilities between Level 1 and Level 2 in the fair value hierarchy; separate disclosures for purchases, sales, issuance and settlements of Level 3 fair value items on a gross, rather than net basis; and more robust disclosure of the valuation techniques and inputs used to measure Level 2 and Level 3 assets and liabilities. This standard became effective for us on a prospective basis commencing January 1, 2011. The adoption of this standard had no effect on our financial position or results of operations or financial statement disclosures.

**Multiple Deliverable Revenue Arrangements** In October 2009, the FASB issued ASU No. 2009-13 - Multiple Deliverable Revenue Arrangements A Consensus of the FASB Emerging Issues Task Force: (Topic 605) Revenue Recognition. ASU No. 2009-13 provides application guidance on whether multiple deliverables exist, how the deliverables should be separated and how the consideration should be allocated to one or more units of accounting. This update establishes a selling price hierarchy for determining the selling price of a deliverable. The selling price used for each deliverable will be based on vendor-specific objective evidence, if available, third-party evidence if vendor-specific objective evidence is not available, or estimated selling price if neither vendor-specific or third-party evidence is available. This standard became effective for us on a prospective basis commencing January 1, 2011. The adoption of this standard had no effect on our financial position or results of operations.

**Table of Contents****3. Earnings (Loss) per Share**

Basic earnings (loss) per share is computed by dividing net income (loss) attributable to PowerSecure International, Inc. common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share attributable to PowerSecure International, Inc. common stockholders is computed using the weighted average number of common shares outstanding and, when dilutive, potential common shares from stock options and warrants using the treasury stock method. Diluted earnings per share excludes the impact of potential common shares related to stock options and warrants in periods in which we reported a loss from continuing operations or in which the option or warrant exercise price is greater than the average market price of our common stock during the period because the effect would be antidilutive. A total of 369,000 common shares issuable upon the exercise of in-the-money stock options were excluded from the diluted weighted average number of shares outstanding for the three months ended March 31, 2011 because their effect was antidilutive to our loss from continuing operations for that period.

The following table sets forth the calculation of basic and diluted earnings (loss) per share attributable to PowerSecure International, Inc. common stockholders:

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Income from continuing operations	\$ (900)	\$ 698
Income from discontinued operations	5,636	519
Net income	\$ 4,736	\$ 1,217
Basic weighted-average common shares outstanding in period	18,719	17,237
Add dilutive effects of stock options and warrants		455
Diluted weighted-average common shares outstanding in period	18,719	17,692
Basic earnings per common share:		
Income from continuing operations	\$ (0.05)	\$ 0.04
Income from discontinued operations	0.30	0.03
Basic earnings per common share	\$ 0.25	\$ 0.07
Diluted earnings per common share:		
Income from continuing operations	\$ (0.05)	\$ 0.04
Income from discontinued operations	0.30	0.03
Diluted earnings per common share	\$ 0.25	\$ 0.07



**Table of Contents****4. Discontinued Operations**

On December 30, 2010, we entered into a purchase and sale agreement for the sale of Southern Flow which was part of our Energy Services segment. The sale closed on January 14, 2011, with an effective date of January 1, 2011. Pursuant to the terms of the purchase and sale agreement, Zedi, Inc., a Canadian corporation, through its wholly-owned subsidiary, purchased 100% of the stock of Southern Flow. Upon closing, we received cash proceeds of \$16,515, consisting of a base purchase price of \$15,550, and \$965 for additional Southern Flow working capital conveyed in the transaction. We recorded a gain on the sale of Southern Flow, net of transaction costs and income tax benefit, in the amount of \$5,636 during the three months ended March 31, 2011. The sale of Southern Flow was made pursuant to our review of our strategic alternatives for our non-core businesses. The operations of Southern Flow have been included in our consolidated statements of operations as discontinued operations for all periods presented. Results of discontinued operations for the three months ended March 31, 2011 and 2010 were as follows:

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Total revenues	\$	\$ 4,214
Operating expenses		3,674
Income before income taxes		540
Income tax provision		(21)
Income from operations		519
Gain on disposal	5,538	
Income tax benefit on disposal	98	
Income from discontinued operations	\$ 5,636	\$ 519

The following assets and liabilities of Southern Flow were segregated and included in Assets of discontinued operations held for sale and Liabilities of discontinued operations held for sale, as appropriate, in the consolidated balance sheet as of December 31, 2010, and represent the assets and liabilities of Southern Flow that were sold in January 2011:

	<b>December 31, 2010</b>
Cash and cash equivalents	\$ 250
Trade receivables, net of allowance for doubtful accounts	3,427
Inventories	2,182
Prepaid expenses and other current assets	169
Property, Plant and equipment, net	922
Goodwill	5,231
Other assets	2
Assets of discontinued operations held for sale	\$ 12,183
Accounts payable	519

Edgar Filing: POWERSECURE INTERNATIONAL, INC. - Form 10-Q

Accrued and other liabilities	871
Current income taxes payable	19
Capital lease obligations	2
Liabilities of discontinued operations held for sale	\$ 1,411

**Table of Contents****5. Investment in Unconsolidated Affiliate**

Through WaterSecure, we currently own 40.45% of the equity interests in MM 1995-2, which we account for under the equity method. MM 95-2 owns and operates several water processing, recycling, and disposal facilities located in northeastern Colorado. The balance of our equity investment in MM 1995-2 includes approximately \$630 and \$648 of unamortized purchase premiums we paid on our acquired interests at March 31, 2011 and December 31, 2010, respectively. The premiums are being amortized over a period of 14 years, which represents the weighted average useful life of the underlying assets acquired.

The following table sets forth certain summarized financial information for MM 1995-2 at March 31, 2011 and December 31, 2010 and for the three months ended March 31, 2011 and 2010:

	<b>March 31, 2011</b>	<b>December 31, 2010</b>
Total current assets	\$ 3,767	\$ 3,753
Property, plant and equipment, net	12,904	11,616
Total other assets	14	4
 Total assets	 \$ 16,685	 \$ 15,373
 Total current liabilities	 \$ 3,189	 \$ 2,462
Long-term note payable	3,686	4,100
Total shareholders' equity	9,810	8,811
 Total liabilities and shareholders' equity	 \$ 16,685	 \$ 15,373
	 <b>Three Months Ended March 31, 2011</b>	 <b>2010</b>
Total revenues	\$ 5,412	\$ 4,892
Total costs and expenses	2,913	2,346
 Net income	 \$ 2,499	 \$ 2,546

**6. Debt**

**Line of Credit** We have had a credit facility with Citibank, N.A. ( Citibank ), as administrative agent and lender, and other lenders since entering into a credit agreement in August 2007. At December 31, 2010, our credit agreement with Citibank along with SunTrust Bank and Branch Banking and Trust Company ( BB&T ) as additional lenders, provided for a \$50.0 million senior, first-priority secured revolving and term credit facility. In January 2011, the credit facility was amended to facilitate the sale of Southern Flow (see Note 4), modify certain financial covenants to accommodate our financial profile after that sale and reflect a change in lenders. The credit facility, as amended, is now a \$25.0 million senior, first-priority secured revolving credit facility with Citibank and BB&T as lenders. The credit facility is guaranteed by all of our active subsidiaries and secured by all of our assets and the assets of our active subsidiaries.

As amended, the credit facility, as a revolving credit facility, matures and terminates on November 12, 2013. However, we have the option prior to that maturity date to convert a portion of outstanding principal balance into a non-revolving term loan for a two year period expiring November 12, 2015, making quarterly payments based upon a four year fully amortized basis, with the remaining outstandings due as a balloon payment on November 12, 2015.

**Table of Contents**

We intend to continue to use the proceeds available under the credit facility to finance our PowerSecure subsidiary's recurring revenue projects as well as to finance capital expenditures, working capital, acquisitions, and general corporate purposes. Under the terms of the amended credit facility, we are required, at all times until April 1, 2012, to maintain cash balances of at least 65% of our outstanding borrowings under the revolving credit facility.

Outstanding balances under the credit facility bear interest, at our discretion, at either the London Interbank Offered Rate for the corresponding deposits of U. S. Dollars plus an applicable margin, which is on a sliding scale ranging from 200 basis points to 325 basis points based upon our leverage ratio, or at Citibank's alternate base rate plus an applicable margin, on a sliding scale ranging from 25 basis points to 150 basis points based upon our leverage ratio. Our leverage ratio is the ratio of our funded indebtedness as of a given date to our consolidated EBITDA as defined in the credit agreement for the four consecutive quarters ending on such date. Citibank's alternate base rate is equal to the higher of the Federal Funds Rate as published by the Federal Reserve of New York plus 0.50%, and Citibank's prime commercial lending rate.

The credit facility is not subject to any borrowing base computations, but does contain certain financial covenants. Our minimum asset coverage must be in excess of 1.25, where our asset coverage is defined as the summation of 80% of the book value of accounts receivable plus 60% of the book value of inventory plus 50% of the book value of net fixed assets, divided by total funded debt outstanding. In addition, we are required to maintain a minimum consolidated tangible net worth, computed on a quarterly basis, equal to approximately \$62.0 million. Finally, our debt to worth ratio, which is the ratio of our total consolidated indebtedness to our consolidated tangible net worth, cannot exceed 1.5 to 1.0 at the end of any quarter. At March 31, 2011, we were in compliance with our financial covenant requirements. In addition, commencing March 31, 2012, our maximum leverage ratio cannot exceed 3.25 and our minimum fixed charge coverage ratio must be in excess of 1.25, where the fixed charge coverage ratio is defined as the ratio of the aggregate of our trailing 12 month consolidated EBITDA plus our lease or rent expense minus our taxes based on income and payable in cash, divided by the sum of our consolidated interest charges plus our lease or rent expenses plus our scheduled principal payments and dividends, computed over the previous period. Under the credit facility, our cumulative capital expenditures beginning in 2008 cannot exceed the sum of \$5.0 million plus \$1.25 million per quarter, on a cumulative basis, plus an allowance for our PowerSecure subsidiary recurring revenue projects generated after December 31, 2007. The credit facility contains other representations and warranties and affirmative and negative covenants, including restrictions with respect to liens, indebtedness, loans and investments, material changes in our business, asset sales or leases or transfers of assets, restricted payments such as distributions and dividends, mergers or consolidations and transactions with affiliates.

Upon the sale of any of our assets or the assets of our subsidiaries other than in the ordinary course of business, or the public or private sale of any equity or debt other than equity issuances where the aggregate proceeds do not exceed \$10.0 million, we are required to use the net proceeds thereof to repay any indebtedness then outstanding under the credit facility, except for certain reinvestment provisions.

Our obligations under the credit facility are secured by guarantees and security agreements by each of our active subsidiaries, including but not limited to our PowerSecure subsidiary and WaterSecure. The guarantees guaranty all of our obligations under the credit facility, and the security agreements grant to the lenders a first priority security interest in virtually all of the assets of each of the parties to the credit agreement.

**Table of Contents**

The credit agreement also contains customary events of default, including payment defaults, breach of representations and warranties, covenant defaults, cross-defaults, certain bankruptcy or insolvency events, judgment defaults and certain ERISA-related events.

The maximum balance outstanding on the credit facility during the three months ended March 31, 2011 was \$5.0 million. The balance outstanding on the credit facility at March 31, 2011 and December 31, 2010 was \$5.0 million, which is also the same balance outstanding at May 5, 2011. Under the amended provisions of our credit facility, we currently have an additional \$20.0 million available to borrow under the credit facility. However, the availability of this capital under our credit facility includes restrictions on the use of proceeds, and is dependent upon our ability to satisfy certain financial and operating covenants, as described above.

**7. Capital Lease Obligations**

We have a capital lease with SunTrust Equipment Finance and Leasing, an affiliate of SunTrust Bank, from the sale and leaseback of distributed generation equipment placed in service at customer locations. We received \$5.9 million from the sale of the equipment in December 2008 which we are repaying under the terms of the lease with monthly principal and interest payments of \$85 over a period of 84 months. At the expiration of the term of the lease in December 2015, we have the option to purchase the equipment for \$1, assuming no default under the lease by us has occurred and is then continuing. The lease is guaranteed by us under an equipment lease guaranty. The lease and the lease guaranty constitute permitted indebtedness under our current credit agreement, under which an affiliate of the lessor is one of the lenders.

Proceeds of the lease financing were used to finance our PowerSecure subsidiary's recurring revenue projects. We account for the lease financing as a capital lease in our consolidated financial statements in accordance with generally accepted accounting principles.

The lease provides our PowerSecure subsidiary with limited rights, subject to the lessor's approval which will not be unreasonably withheld, to relocate and substitute equipment during its term. The lease contains representations and warranties and covenants relating to the use and maintenance of the equipment, indemnification and events of default customary for leases of this nature. The lease also grants to the lessor certain remedies upon a default, including the right to cancel the lease, to accelerate all rent payments for the remainder of the term of the lease, to recover liquidated damages, or to repossess and re-lease, sell or otherwise dispose of the equipment.

Under the lease guaranty, we have unconditionally guaranteed the obligations of our PowerSecure subsidiary under the lease for the benefit of the lessor. The balance of our capital lease obligations shown in the consolidated balance sheet at March 31, 2011 and December 31, 2010 consist entirely of our obligations under the equipment lease described above.

**8. Share-Based Compensation**

We recognize compensation expense for all share-based awards made to employees and directors based on estimated fair values on the date of grant.

**Table of Contents**

**Stock Plans** Historically, we have granted stock options and restricted stock awards to employees and directors under various stock plans. We currently maintain two stock plans. Under our 1998 Stock Incentive Plan, as amended (the 1998 Stock Plan ), we granted incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock, performance awards and other stock-based awards to our officers, directors, employees, consultants and advisors for shares of our common stock. Stock options granted under the 1998 Stock Plan contained exercise prices not less than the fair market value of our common stock on the date of grant, and had a term of 10 years from the date of grant. Nonqualified stock option grants to our directors under the 1998 Stock Plan generally vested over periods up to two years. Qualified stock option grants to our employees under the 1998 Stock Plan generally vested over periods up to five years. The 1998 Stock Plan expired on June 12, 2008, and no additional awards may be made under the 1998 Stock Plan, although awards granted prior to such date will remain outstanding and subject to the terms and conditions of those awards.

In March 2008, our board of directors adopted the PowerSecure International, Inc. 2008 Stock Incentive Plan (the 2008 Stock Plan ), which was approved by our stockholders at the Annual Meeting of Stockholders held on June 9, 2008. The 2008 Stock Plan authorizes our board of directors to grant incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock, performance awards and other stock-based awards to our officers, directors, employees, consultants and advisors for up to an aggregate of 600,000 shares of our common stock. Stock options granted under the 2008 Stock Plan must contain exercise prices not less than the fair market value of our common stock on the date of grant, and must contain a term not in excess of 10 years from the date of grant. The 2008 Stock Plan replaced our 1998 Stock Plan.

**Stock Options** Net income for the three months ended March 31, 2011 and 2010 includes \$90 and \$104, respectively, of pre-tax compensation costs related to outstanding stock options. All of the stock option compensation expense is included in general and administrative expenses in the accompanying consolidated statements of operations.

A summary of option activity for the three months ended March 31, 2011 is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Balance, December 31, 2010	1,247	\$ 5.98		
Granted	10	6.21		
Exercised	(135)	2.34		
Expired				
Forfeited	(13)	3.56		
Balance, March 31, 2011	1,109	\$ 6.45	5.03	\$ 2.15
Exercisable, March 31, 2011	866	\$ 6.31	4.14	\$ 2.29

**Table of Contents**

A summary of option activity for the three months ended March 31, 2010 is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Balance, December 31, 2009	1,627	\$ 5.18		
Granted				
Exercised	(1)	6.88		
Expired	(5)	17.38		
Forfeited				
Balance, March 31, 2010	1,621	\$ 5.14	4.70	\$ 2.74
Exercisable, March 31, 2010	1,351	\$ 4.91	4.00	\$ 2.97

The weighted average grant date fair value of the options granted during the three months ended March 31, 2011 was \$2.91. There were no stock options granted during the three months ended March 31, 2010. The fair value of the stock options granted during the three months ended March 31, 2011 was measured using the Black-Scholes valuation model with the following assumptions:

	March 31, 2011	2010
Expected stock price volatility	52.2%	n/a
Risk Free interest rate	2.00%	n/a
Annual dividends	\$	n/a
Expected life employee options	5 years	n/a
Expected life director options	n/a	n/a

The fair value of stock option grants are amortized to expense over their respective service periods using the straight-line method and assuming a forfeiture rate of 5%. As of March 31, 2011 and December 31, 2010, there was \$643 and \$731, respectively, of total unrecognized compensation costs related to stock options. These costs at March 31, 2011 are expected to be recognized over a weighted average period of approximately 1.8 years. During the three months ended March 31, 2011 and 2010, the total intrinsic value of stock options exercised was \$779 and \$2, respectively. Cash received, net of shares tendered, from stock option exercises for the three months ended March 31, 2011 and 2010 was \$230 and \$9, respectively. The total grant date fair value of stock options vested during the three months ended March 31, 2011 and 2010 was \$24 and \$163, respectively.

**Restricted Stock Awards** Net income for the three months ended March 31, 2011 and 2010 includes \$390 and \$390, respectively, of pre-tax compensation costs related to outstanding restricted stock awards granted to directors, certain officers and our employees. All of the restricted stock award compensation expense during the three months ended March 31, 2011 and 2010 is included in general and administrative expenses in the accompanying consolidated statements of operations.

**Table of Contents**

A summary of restricted stock award activity for the three months ended March 31, 2011 is as follows:

	<b>Unvested Restricted Shares</b>	<b>Weighted Average Grant Date Fair Value</b>
Balance, December 31, 2010	478	\$ 11.00
Granted		
Vested	(70)	8.09
Forfeited		
Balance, March 31, 2011	408	\$ 11.50

A summary of restricted stock award activity for the three months ended March 31, 2010 is as follows:

	<b>Unvested Restricted Shares</b>	<b>Weighted Average Grant Date Fair Value</b>
Balance, December 31, 2009	561	\$ 10.36
Granted		
Vested	(75)	7.50
Forfeited		
Balance, March 31, 2010	486	\$ 10.80

Restricted shares are subject to forfeiture and cannot be sold or otherwise transferred until they vest. If the holder of the restricted shares leaves us before the restricted shares vest, other than due to termination by us without cause, then any unvested restricted shares will be forfeited and returned to us. The restricted shares granted to directors vest in equal amounts over a period of one or three years, depending on the nature of the grant. The restricted shares granted to employees other than officers vest in equal annual amounts over five years. A total of 322,500 unvested restricted shares issued to officers cliff vest in 2012, while the remaining 64,500 unvested performance-based restricted shares issued to officers vest in 2012, assuming certain performance conditions are achieved. All restricted and unvested shares will automatically vest upon a change in control.

The fair value of employee and director restricted shares along with the cliff vesting restricted shares granted to officers are being amortized on a straight-line basis over the vesting period. The fair value of the performance-based restricted shares is expensed as the achievement of the performance criteria becomes probable and the related service period conditions are met. At March 31, 2011, the balance of unrecognized compensation cost related to unvested restricted shares was \$1,609, which, assuming all future performance criteria will be met, we expect will be recognized over a weighted average period of approximately 1.25 years.

**9. Commitments and Contingencies**

From time to time, we hire employees that are subject to restrictive covenants, such as non-competition agreements with their former employers. We comply, and require our employees to comply, with the terms of all known restrictive covenants. However, we have in the past and may in the future receive claims and demands by some former employers alleging actual or potential violations of these restrictive covenants. While we do not believe any pending

claims have merit, we cannot provide any assurance of the outcome of these claims.

## **Table of Contents**

From time to time, in the ordinary course of business we encounter performance issues with component parts that affect the performance of our distributed generation systems, switchgear systems, utility infrastructure products, engines, generators, alternators, breakers, fuel systems, LED and other lighting products, electrical circuit boards, power drivers, and other complex electrical products. While we strive to utilize high quality component parts from reputable suppliers, and to back-up their quality and performance with manufacturers' warranties, even the best parts and components have performance issues from time to time, and these performance issues create significant financial and operating risks to our business, operations and financial results. Because we regularly develop new products and technical designs, we often incorporate component parts into these new products in configurations, for uses, and in environments, for which limited experience exists and that exposes us to performance risks which may not be covered by warranties. As we strive to bring solutions to customers with unique capabilities that provide performance and cost advantages, from time-to-time we use new suppliers and new products for applications where track record of performance does not exist, or is difficult to ascertain. Although we believe our suppliers' warranties cover many of these performance issues, from time to time we face disputes with our suppliers with respect to those performance issues and their warranty obligations. Additionally, the outcome of any warranty claims is inherently difficult to predict due to the uncertainty of technical solutions, cost, customer requirements, and the uncertainty inherent in litigation and disputes generally, and thus there is no assurance we will not be adversely affected by these, or other performance issues with key parts and components. Moreover, from time to time performance issues are not covered by manufacturer's warranties, certain suppliers may not be financially able to fulfill their warranty obligations, and customers may also claim damages as a result of those performance issues. Also, the mere existence of performance issues, even if finally resolved with our suppliers and customers, can have an adverse effect on our reputation for quality, which could adversely affect our business.

We estimate that from time to time we have performance issues related to component parts which have a cost basis of approximately 5-20% of our estimated annual revenues, although not necessarily limited to this amount, which are installed in equipment we own and have sold to various customers across our business lines, and additional performance issues could arise in the future. In addition, the failure or inadequate performance of these components pose potential material and adverse effects on our business, operations, reputation and financial results, including reduced revenues for projects in process or future projects, reduced revenues for recurring revenue contracts which are dependent on the performance of the affected equipment, additional expenses and capital cost to repair or replace the affected equipment, inventory write-offs for defective components held in inventory, asset write-offs for company-owned systems which have been deployed, the cancellation or deferral of contracts by our customers, or claims made by our customers for damages as a result of performance issues.

Through May 5, 2011, we have experienced performance issues with two types of component parts, in particular, which we are working to resolve: 1) an instance of a supplier of a substantial distributed generation system component that has indicated its warranty does not cover performance issues related to a component from another supplier which is in many of the distributed generation systems deployed for our customers, and 2) generators from a certain supplier which have had performance issues in a distributed generation system we own, and for which we have a performance-based recurring revenue contract that is dependent on the system's positive operating performance. In both of these instances, we are actively working to assess and correct the performance issues, and when possible, we have sought the assistance of the suppliers in resolving these issues.

## **Table of Contents**

Given that we are in the process of assessing and addressing these performance issues, the uncertainty regarding the assistance we may or may not receive from our suppliers, our track record of repairing many of these types of issues as well as the inherent uncertainty in addressing technical issues specifically and disputes generally, at present we are unable to estimate the potential negative impacts from these particular items, if any, in addition to other component part performance issues discussed above. In addition, at this time we have not recorded any adjustment to our warranty reserve for these particular performance issues, other than an immaterial amount for certain minor repairs, as the estimated cost, if any, of fulfilling our warranty obligations for these performance issues within a possible range of outcomes is not determinable as of this date.

From time to time, we are involved in other disputes, claims, proceedings and legal actions arising in the ordinary course of business. We intend to vigorously defend all claims against us. Although the ultimate outcome of these proceedings cannot be accurately predicted due to the inherent uncertainty of litigation, in the opinion of management, based upon current information, no other currently pending or overtly threatened proceeding is expected to have a material adverse effect on our business, financial condition or results of operations.

### **10. Income Taxes**

The income tax benefit recorded at March 31, 2011 is our best estimate of our expected tax benefit taking into consideration our expectation of future earnings, federal alternative minimum tax, state income tax for state jurisdictions in which we expect taxable income, potential effects of adverse outcomes on tax positions we have taken, true-up effects of prior tax provision estimates compared to actual tax returns, and our net operating loss carryforwards and valuation allowance.

### **11. Segment Information**

Our operating segments represent components of our business for which discrete financial information is available and is reviewed regularly by the chief operating decision-maker, or decision-making group, to evaluate performance and make operating decisions. We conduct our operations through two operating segments: Energy and Smart Grid Solutions, and Energy Services. Our reportable segments are strategic business units that offer different products and services and serve different customer bases. They are managed separately because each business requires different technology and marketing strategies. Our Southern Flow business, which previously operated in our Energy Services segment, was sold in January 2011 pursuant to the execution of a purchase agreement in December 2010.

Accordingly, the Southern Flow business has been discontinued and the results of its operations are excluded from our Energy Services segment for all periods presented in the information below.

***Energy and Smart Grid Solutions*** Through our PowerSecure subsidiary we serve utilities and commercial, institutional, and industrial customers in the areas of Interactive Distributed Generation, Utility Infrastructure and Energy Efficiency. Each of these PowerSecure subsidiary business units operates in a distinct market with distinct technical disciplines, but shares a common customer base, sales force, and administrative infrastructure with other PowerSecure subsidiary products and services and which we grow through shared resources and customer relationships. Accordingly, these units are included within our Energy and Smart Grid Solutions segment results; and

***Energy Services*** Through our WaterSecure subsidiary we serve customers in the oil and natural gas production business with water processing and disposal services. WaterSecure, through its equity investment in MM 1995-2, provides water processing, recycling, and disposal for oil and natural gas producers. The operations of our Southern Flow subsidiary, which previously was included in this segment, were sold in January 2011 pursuant to the execution of a purchase agreement in December 2010. Accordingly, the Southern Flow business has been discontinued and the results of its operations are excluded from our Energy Services segment for all periods presented in the information below.

**Table of Contents**

The accounting policies of the reportable segments are the same as those described in Note 1 of the Notes to Consolidated Financial Statements. We evaluate the performance of our operating segments based on income (loss) before income taxes. There are no intersegment sales.

Summarized financial information concerning our reportable segments is shown in the following table. Unallocated corporate cost amounts include corporate overhead, other income and interest expense which, for purposes of evaluating the operations of our segments, are not allocated to our segment activities. Total asset amounts exclude intercompany receivable balances eliminated in consolidation.

**Three Months Ended March 31, 2011**

	<b>Energy and Smart Grid Solutions</b>	<b>Energy Services</b>	<b>Unallocated Corporate Costs</b>	<b>Total</b>
Revenues	\$ 23,713	\$	\$	\$ 23,713
Cost of sales	16,054			16,054
Gross profit	7,659			7,659
Operating expenses:				
General and administrative	6,722		1,197	7,919
Selling, marketing and service	1,158			1,158
Depreciation and amortization	787	18	1	806
Total operating expenses	8,667	18	1,198	9,883
Operating income (loss)	(1,008)	(18)	(1,198)	(2,224)
Other income and (expenses):				
Equity income		1,011		1,011
Management fees		168		168
Interest income and other income			20	20
Interest expense	(90)		(52)	(142)
Income (loss) before income taxes	\$ (1,098)	\$ 1,161	\$ (1,230)	\$ (1,167)
Total capital expenditures	\$ 4,372	\$ 0	\$ 0	\$ 4,372
Total investment in unconsolidated affiliate	\$ 0	\$ 4,732	\$ 0	\$ 4,732
Total goodwill	\$ 7,970	\$ 0	\$ 0	\$ 7,970

Total assets	\$	103,475	\$	4,900	\$	18,851	\$	127,226
--------------	----	---------	----	-------	----	--------	----	---------

**Table of Contents****Three Months Ended March 31, 2010**

	<b>Energy and Smart Grid Solutions</b>	<b>Energy Services</b>	<b>Unallocated Corporate Costs</b>	<b>Total</b>
Revenues	\$ 20,460	\$	\$	\$ 20,460
Cost of sales	12,351			12,351
Gross profit	8,109			8,109
Operating expenses:				
General and administrative	5,135		1,327	6,462
Selling, marketing and service	1,046			1,046
Depreciation and amortization	564	19	1	584
Total operating expenses	6,745	19	1,328	8,092
Operating income (loss)	1,364	(19)	(1,328)	17
Other income and (expenses):				
Equity income		1,030		1,030
Management fees		154		154
Interest income and other income			30	30
Interest expense	(70)		(71)	(141)
Income (loss) before income taxes	\$ 1,294	\$ 1,165	\$ (1,369)	\$ 1,090
Total capital expenditures	\$ 1,388	\$ 0	\$ 0	\$ 1,388
Total investment in unconsolidated affiliate	\$ 0	\$ 4,177	\$ 0	\$ 4,177
Total goodwill	\$ 2,025	\$ 0	\$ 0	\$ 2,025

\* \* \* \*

**Table of Contents**

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

**Introduction**

The following discussion and analysis of our consolidated results of operations for the three month period ended March 31, 2011, which we refer to as the first quarter 2011, and the three month period ended March 31, 2010, which we refer to as the first quarter 2010, and of our consolidated financial condition as of March 31, 2011 should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this report.

**Cautionary Note Regarding Forward-Looking Statements**

This Quarterly Report on Form 10-Q and the documents incorporated into this report by reference contain forward-looking statements within the meaning of and made under the safe harbor provisions of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. From time to time in the future, we may make additional forward-looking statements in presentations, at conferences, in press releases, in other reports and filings and otherwise. Forward-looking statements are all statements other than statements of historical fact, including statements that refer to plans, intentions, objectives, goals, strategies, hopes, beliefs, projections, prospects, expectations or other characterizations of future events or performance, and assumptions underlying the foregoing. The words may, could, should, would, will, project, intend, continue, believe, anticipate, estimate, plan, potential, opportunity and scheduled, variations of such words, and other comparable terminology and similar expressions are often, but not always, used to identify forward-looking statements. Examples of forward-looking statements include, but are not limited to, statements about the following:

- our prospects, including our future business, revenues, expenses, net income, margins, profitability, cash flow, cash position, liquidity, financial condition and results of operations, our targeted growth rate and our expectations about realizing the revenue in our backlog and in our sales pipeline;
- the effects on our business, financial condition and results of operations of current and future economic, business, market and regulatory conditions, including the current challenging economic and market conditions and their adverse effects on our customers and their capital spending and ability to finance purchases of our products, services, technologies and systems;
- the effects of fluctuations in sales on our business, revenues, expenses, net income, margins, profitability, cash flow, liquidity, financial condition and results of operations;
- our products, services, technologies and systems, including their quality and performance in absolute terms and as compared to competitive alternatives, their benefits to our customers and their ability to meet our customers' requirements, and our ability to successfully develop and market new products, services, technologies and systems;
- our markets, including our market position and our market share;
- our ability to successfully develop, operate, grow and diversify our operations and businesses;
- our business plans, strategies, goals and objectives, and our ability to successfully achieve them;
- the effects on our financial condition, results of operations and impact of the loss of income from the sale of our Southern Flow business and the ability to effectively and profitably redeploy the proceeds of this sale in our core business, our strategy to monetize other non-core assets where beneficial;

**Table of Contents**

the sufficiency of our capital resources, including our cash and cash equivalents, funds generated from operations, availability of borrowings under our credit and financing arrangements and other capital resources, to meet our future working capital, capital expenditure, lease and debt service and business growth needs;

the value of our assets and businesses, including the revenues, profits and cash flow they are capable of delivering in the future;

industry trends and customer preferences and the demand for our products, services, technologies and systems;

the nature and intensity of our competition, and our ability to successfully compete in our markets;

fluctuations in our effective tax rates;

business acquisitions, combinations, sales, alliances, ventures and other similar business transactions and relationships; and

the effects on our business, financial condition and results of operations of litigation, warranty claims and other claims and proceedings that arise from time to time.

Any forward-looking statements we make are based on our current plans, intentions, objectives, goals, strategies, hopes, beliefs, projections and expectations, as well as assumptions made by and information currently available to management. Forward-looking statements are not guarantees of future performance or events, but are subject to and qualified by substantial risks, uncertainties and other factors, which are difficult to predict and are often beyond our control. Forward-looking statements will be affected by assumptions and expectations we might make that do not materialize or that prove to be incorrect and by known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from those expressed, anticipated or implied by such forward-looking statements. These risks, uncertainties and other factors include, but are not limited to, those described in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010, as amended or supplemented in subsequently filed Quarterly Reports on Form 10-Q and Current Reports on Form 8-K, as well as other risks, uncertainties and factors discussed elsewhere in this report, in documents that we include as exhibits to or incorporate by reference in this report, and in other reports and documents we from time to time file with or furnish to the Securities and Exchange Commission. In light of these risks and uncertainties, you are cautioned not to place undue reliance on any forward-looking statements that we make.

Any forward-looking statements contained in this report speak only as of the date of this report, and any other forward-looking statements we make from time to time in the future speak only as of the date they are made. We undertake no duty or obligation to update or revise any forward-looking statement or to publicly disclose any update or revision for any reason, whether as a result of changes in our expectations or the underlying assumptions, the receipt of new information, the occurrence of future or unanticipated events, circumstances or conditions or otherwise.

**Table of Contents**

**Overview**

PowerSecure International, Inc., headquartered in Wake Forest, North Carolina, is a leading provider of Energy and Smart Grid Solutions to electric utilities and their commercial, institutional and industrial customers, and of Energy Services to oil and natural gas producers.

Our core business is our Energy and Smart Grid Solutions segment, which we operate through our primary wholly-owned subsidiary PowerSecure, Inc., which we refer to as our PowerSecure subsidiary. In this business segment we conduct our operations through our three core strategic business areas: Interactive Distributed Generation, Utility Infrastructure and Energy Efficiency. These three business areas are focused on providing utilities and their commercial, institutional and industrial customers with products and services to help them generate, deliver and utilize electricity more efficiently and are intended to deliver strong returns on investment. They share common or complementary utility relationships and customer types, common sales and overhead resources, and use of the same facilities. However, each business area in this segment possesses distinct technical disciplines and specific capabilities that are designed to provide a competitive advantage in the marketplace for its specific products and services, including personnel, technology, engineering and intellectual capital.

We conduct our non-core business through our Energy Services segment. Until recently, our Energy Services segment was operated through two principal operating subsidiaries, Southern Flow Companies, Inc., which we refer to as

Southern Flow, and WaterSecure Holdings, Inc., which we refer to as WaterSecure. However, as part of our strategy to monetize our non-core assets to focus on the businesses in our Energy and Smart Grid Solutions business segment, we sold our Southern Flow business effective January 1, 2011. Since the sale of Southern Flow, our Energy Services segment has consisted only of our WaterSecure business. WaterSecure holds an investment of approximately 40% of the equity interests in an unconsolidated business, Marcum Midstream 1995-2 Business Trust, which we refer to as

MM 1995-2 or as our WaterSecure operations. Our WaterSecure operations provide water processing, recycling, and disposal services for oil and natural gas producers in northeastern Colorado utilizing environmentally responsible technologies and processes.

***Interactive Distributed Generation***

Our Interactive Distributed Generation business involves manufacturing, installing, and operating electric generation systems on site at the facility where the power is used, including commercial, institutional, and industrial operations, generally on behalf of electric utilities. Our systems provide a dependable backup power supply during power outages, and provide a more efficient and environmentally friendly source of power during high cost periods of peak power demand.

Our Interactive Distributed Generation systems are sold to customers utilizing two basic economic models, each of which can vary depending on the specific customer and application. In our original business model, which is still our primary model, we sell the distributed generation system to the customer. We refer to this as a project-based or a customer-owned model. For distributed generation systems sold under the project-based model, the customer acquires ownership of the distributed generation assets upon our completion of the project. Our revenues and profits from the sale of systems under this model are recognized over the period during which the system is installed. In the project-based model, we will also usually receive a modest amount of on-going monthly revenue to monitor the system for backup power and peak shaving purposes, as well as to maintain the system.

## **Table of Contents**

Our second business model is structured to generate long-term recurring revenues, which we refer to as our recurring revenue model or our PowerSecure-owned model. Our PowerSecure-owned model, while relatively new, represents an increasing portion of our distributed generation business. For distributed generation systems completed under this model, we retain ownership of the distributed generation system after it is installed at the customer's site. Because of this, we invest the capital required to design and build the system, and our revenues are derived from regular fees paid over the life of the recurring revenue contract by the utility or the customer, or both, for access to the system for standby power and peak shaving. The life of these recurring revenue contracts is typically from five to fifteen years. The fees that generate our revenues in the recurring revenue model are generally paid to us on a monthly basis and are set at a level intended to provide us with attractive returns on the capital we invest in installing and maintaining the distributed generation system. Our fees for recurring revenue contracts are generally structured either as a fixed monthly payment, or as a shared savings recurring revenue contract. For our shared savings recurring revenue contracts, all, or some portion, of our fees are earned out of the pool of peak shaving savings the system generates for the customer.

In our PowerSecure-owned model, where we pay for, install and maintain ownership of the system in exchange for the customer paying us smaller fees over a period of years, utilities and their customers receive access to our system and the related benefits of distributed generation without making a large up-front investment of capital. Under the PowerSecure-owned model, contracts can be structured between us and the utility, us and the customer, or all three parties.

In the first quarter 2011, 83.4% of our distributed generation revenues consisted of customer-owned sales, and 16.6% of our distributed generation revenues were derived from recurring revenue sales. Sales of customer-owned systems deliver revenues and profits that are recorded on our financial statements over the course of the project and thus are more proximate to the time of the sale and our expenses of that project and generally larger in dollar amount in any particular period than sales of PowerSecure-owned projects, which can cause our consolidated revenues and profits to be more inconsistent from period-to-period as sales fluctuate. By contrast, sales under the PowerSecure-owned system model generate revenues and profits that are more consistent from period-to-period and have higher gross margins, while at the same time generating revenues and profits over a longer time period although smaller in dollar amount in any particular period, because the revenues and profits are recognized over the life of the contract. The PowerSecure-owned recurring revenue model also requires us to invest our own capital in the project without any return on capital until after the project is completed, installed and successfully operating.

### ***Utility Infrastructure***

Our Utility Infrastructure business is focused on helping electric utilities design, build, upgrade, and maintain infrastructure that enhances the efficiency of their grid systems. Through our UtilityServices business, we provide transmission and distribution system construction and maintenance products and services, install advanced metering and efficient lighting, and provide emergency storm restoration services. Additionally, through our UtilityEngineering and PowerServices consulting engineering firms, we provide utilities with a wide range of engineering and design services, as well as consulting services for regulatory and rate design matters.

Revenues for our UtilityEngineering and PowerServices businesses are earned, billed, and recognized based on the number of hours invested in the particular projects and engagements they are serving. Similar to most traditional consulting businesses, these hours are billed at rates that reflect the general technical skill or experience level of the consultant or supervisor providing the services. In some cases, our engineers and consultants are engaged on an on-going basis with utilities, providing resources to supplement utilities' internal engineering teams over long-term time horizons. In other cases, our engineers and consultants are engaged to provide services for very specific projects and assignments.

## **Table of Contents**

Revenues for our UtilityServices business are generally earned, billed, and recognized in two primary models. Under the first model, we have regular, on-going assignments with utilities to provide regular maintenance and upgrade services. These services are earned, billed, and recognized either on a fixed fee basis, based on the number of work units we perform, such as the number of transmission poles we upgrade, or on an hourly fee basis, based on the number of hours we invest in a particular project, plus amounts for the materials we utilize and install. Under the second model, we are engaged to design, build and install large infrastructure projects, including substations, transmission lines, and similar infrastructure, for utilities and their customers. In these types of projects we are generally paid a fixed price for the project, plus any modifications or scope additions. We recognize revenues from these projects on a percentage-of-completion basis as they are completed. In addition to these two primary models, in some cases, we are engaged by utilities and their customers to build or upgrade transmission and distribution infrastructure that we own and maintain. In those cases, we receive fees over a long-term contract for the customer to have access to the infrastructure to transmit or receive power.

### ***Energy Efficiency***

Our Energy Efficiency business is focused on providing energy solutions to utilities, municipalities, and commercial, institutional, and industrial customers that deliver strong returns on investment by reducing energy costs, improving their operations, and benefiting the environment. Our Energy Efficiency area includes our EfficientLights, IES and EnergyLite businesses and brands. Our EfficientLights business is focused on bringing our EfficientLights branded LED-based lighting products to grocery, drug, and convenience stores. These LED lighting products include our largest volume product, our EfficientLights fixture for reach-in refrigerated cases, as well as lighting for walk-in storage coolers and open refrigerated display cases. Additionally, our EfficientLights business is in the process of developing and marketing LED-based parking lot lights and street lights. Our IES business designs and manufactures new LED-based lighting products for commercial, industrial and consumer applications. The business of IES includes turn-key product development, engineering, and manufacturing of solid state LED-based lights, including power drivers, light engines, and thermal management solutions. IES provides its products directly to OEMs, electronics manufacturers, and retailers, either as component solutions or as turn-key products.

We generate revenues in our EfficientLights business through the sale of our proprietary LED lights. These lights are primarily sold as retrofits for existing traditional lighting, although they are also sold for initial lighting installations. From time to time we also provide installation services, although that is not a significant portion of our business. We also assist our customers in receiving utility incentives for LED lighting. Our customers are primarily large retail chains, and their installations of EfficientLights have been across various numerous stores within their store base over a diverse geographic scope. We also sell our LED lights to, and through, original equipment manufacturers, or OEMs, of refrigerator and freezer cases. We expect our customer base and sales channels to continue to grow and develop as LED technology continues to be more widely adopted. As we bring additional products to market, including our LED-based parking lot light and street light, we expect to employ a similar business model, although for the street light our customers will likely include utilities and municipalities.

We also generate revenues in our IES business through the sale of proprietary LED lights, as well as the sale of LED-lighting components including power drivers, light engines, and thermal management solutions. Our IES business designs and manufactures these LED-based lighting products for commercial, industrial and consumer applications. IES provides its products directly to OEMs, electronics manufacturers, and retailers, either as component solutions or as turn-key products. Additionally, IES's turn-key products are distributed through our EnergyLite business and brand, including our SecureLite and PowerLite family of area lights and street lights. We expect our IES business to bring additional LED lighting products and components to market, and employ a similar business and distribution model.

## **Table of Contents**

Additionally, through our EnergyLite business and brand we market our SecureLite and PowerLite family of area lights and street lights. These products are marketed to utilities and municipalities directly, and through third party distribution arrangements.

### ***Energy Services Business***

We currently conduct our Energy Services operations through our WaterSecure business. Through WaterSecure, we own approximately 40% of the equity interests of MM 1995-2, an unconsolidated business. Equity income at our Energy Services segment consists of our minority ownership interest in the earnings of the WaterSecure operations. Our equity income is a direct function of the net income of the WaterSecure operations as well as changes in our ownership interest. The WaterSecure operations own and operate water processing, recycling, and disposal facilities in northeastern Colorado, and the business serves oil and natural gas production companies in that area. The WaterSecure operations primarily operate under long term contracts to process and dispose of water utilized in customers' natural gas production operations. This processing utilizes techniques that are environmentally responsible, and the quality of the services of the WaterSecure operations and the location of its facilities provides it with a strong position in its markets.

Our Energy Services operations previously included Southern Flow, which we sold effective January 1, 2011 pursuant to a purchase and sale agreement we entered into with the purchaser on December 30, 2010. Southern Flow provides a variety of oil and natural gas measurement services principally to customers involved in the business of oil and natural gas production, gathering, transportation and processing, with a focus on the natural gas market. As a result of the sale of Southern Flow, its results of operations are now reflected as discontinued operations in our consolidated statements of operations for all periods presented in this report.

### ***Recent Developments***

On May 3, 2011, we announced that our EnergyLite division had entered into a relationship with National Rural Telecommunications Cooperative ( NRTC ) to bring LED lighting to electric cooperatives across the U.S. Through a newly established distribution agreement, NRTC will market and distribute EnergyLite's LED-based area light, called the SecureLite<sup>™</sup>, which provides utilities an energy efficient, environmentally friendly, low maintenance alternative to traditional HID lighting.

On April 27, 2011, we announced that we had received \$15 million of new awards for products and services across our Energy and Smart Grid Solutions business lines. The new business includes orders for approximately \$8 million of Interactive Distributed Generation<sup>®</sup> (IDG<sup>®</sup>) smart grid power systems, \$5 million of Utility Infrastructure projects, and \$2 million of LED lighting products. The new awards were issued by a broad range of utilities and commercial and industrial customers. The largest of the awards includes an Interactive Distributed Generation system to support a municipality, the installation of a new substation on behalf of a second municipality, and the installation of our new EfficientLights LED shelf lighting product for a major U.S. grocer's open-style refrigerated cases. Virtually all of this \$15 million of new business is turn-key project-based revenue, which we expect to recognize primarily during the second through fourth quarters of 2011.

On April 11, 2011, we announced the commissioning of a state-of-the-art Smart Charging Micro-Grid for the U.S. Army, in a recent ceremony at Wheeler Army Airfield in Hawaii. The breakthrough technology was developed to help the U.S. Army reduce fuel consumption and costs, and improve safety and power reliability at remote U.S. Army locations. Additionally, it incorporates the use of renewable resources, including solar and optional wind power, and enables electric vehicles to be charged by, and provide power to the Micro-Grid system. The technology demonstrated in this system can be applied to power management applications for military field locations.

## **Table of Contents**

The Smart Charging Micro-Grid provides energy autonomy for facilities in remote locations, improving power availability and reliability. It is designed to enable reductions in the number and sizes of generators required to power facilities, and to control a wide range of generator types, providing significant battlefield flexibility. Additionally, it utilizes advanced energy storage to maximize the use of renewable power resources. The system has the ability to prioritize electrical load to individual receptacles, so the distribution of electricity can be optimized to maximize reliability and optimize fuel efficiency. Importantly, it will improve troop safety because of its ability to reduce fuel consumption and therefore reduce the number of convoys needed to transport fuel.

### **Financial Results Highlights**

Our consolidated revenues during the first quarter 2011 increased by \$3.3 million, or 15.9%, compared to our consolidated revenues during the first quarter 2010. The drivers of this quarter-over-quarter revenue increase were a 7.5% increase in revenues from our Interactive Distributed Generation products, a 41.1% increase in revenues from our Utility Infrastructure products and services, and a 5.6% increase in revenues from our Energy Efficiency business. Our gross profit margin as a percentage of revenue was 32.3% during the first quarter 2011, a decrease of 7.3 percentage points compared to the first quarter 2010. The decline in gross profit margin reflected changes in the mix of projects and products completed in the first quarter 2011 compared to the first quarter 2010, as well as a higher level of equipment and personnel to support new business awards. Our operating expenses increased in the first quarter 2011 compared to the first quarter of 2010 due to investments we made in our Energy and Smart Grid Solutions Segment to drive and support our future growth, including expenses relating to new product development, engineering, facilities, personnel, selling expense, compensation expense in each of our Distributed Generation, Energy Efficiency, and Utility Infrastructure business areas, as well as additional depreciation expense resulting from capital deployed to support our growing recurring revenue business. As a result, our total operating expenses during the first quarter 2011 increased by \$1.8 million, or 22.1%, compared to our operating expenses during the first quarter 2010. During the remainder of 2011, we expect our operating costs to stabilize near levels at which we operated during the first quarter 2011, and then to increase in 2012 and beyond, assuming economic conditions demonstrate sustained improvement and our revenues increase. However, the timing and the amount of this increase in operating expenses will depend on how much and how quickly economic conditions improve and the effects of such economic recovery on our revenues. While we anticipate that an improvement in the economic and financial conditions will lead to an improvement in our business and revenues, we cannot provide any assurance as to when, how much or for how long economic conditions will improve, or the effects of future economic conditions on our revenues, expenses or net income. Over the long-term, we expect to continue to invest in operational infrastructure and sales and new business development to drive and support our growth.

Income from our Energy Services Segment, which consists of our management fees and equity income from the WaterSecure operations, decreased less than 1% during the first quarter 2011 compared to the first quarter 2010, driven by a slight decrease in our equity income partially offset by an increase in our management fees from the WaterSecure operations.

Our loss from continuing operations attributable to PowerSecure International, Inc. shareholders for the first quarter 2011 was (\$0.9) million, or (\$0.05) per diluted share, compared to income from continuing operations attributable to PowerSecure International, Inc. shareholders of \$0.7 million, or \$0.04 per diluted share, for the first quarter 2010.

**Table of Contents**

Our income from discontinued operations for the first quarter 2011, consisting of the gain we recorded on the sale of Southern Flow, was \$5.6 million, or \$0.30 per diluted share. This compares to income from discontinued operations for the first quarter 2010 of \$0.5 million, or \$0.03 per diluted share, which consisted of the operating results of Southern Flow during the first quarter 2010.

In total, our consolidated net income attributable to PowerSecure International, Inc. common stockholders for the first quarter 2011 was \$4.7 million, or \$0.25 per diluted share, which compared to net income attributable to PowerSecure International, Inc. common stockholders of \$1.2 million, or \$0.07 per diluted share, for the first quarter 2010.

As discussed below under *Fluctuations*, our financial results will fluctuate from quarter to quarter and year to year. Thus, there is no assurance that our past results, including the results of our year ended December 31, 2010 or our quarter ended March 31, 2011, will be indicative of our future results, especially in light of the current significant downturn in the economy and unfavorable credit and capital markets.

**Backlog**

As of the date of this report, our revenue backlog expected to be recognized after March 31, 2011 is \$146 million. This includes revenue related to the new business announcement made by us on April 27, 2011, and compares to \$150 million of revenue backlog we reported in our Annual Report on Form 10-K for the year ended December 31, 2010 filed on March 10, 2011 (the date we last reported our backlog). Our revenue backlog and the estimated timing of revenue recognition is outlined below, including *project-based revenues* expected to be recognized as projects are completed and *recurring revenues* expected to be recognized over the life of the contracts:

***Revenue Backlog to be recognized after March 31, 2011***

Description	Anticipated Revenue	Estimated Primary Recognition Period
Project-based Revenue    Near term	\$ 60 Million	2Q11 through 4Q11
Project-based Revenue    Long term	\$ 17 Million	1Q12 through 2013
Recurring Revenue	\$ 69 Million	2Q11 through 2019
<b>Revenue Backlog to be recognized after March 31, 2011</b>	<b>\$ 146 Million</b>	

*Note: Anticipated revenue and estimated primary recognition periods are subject to risks and uncertainties as indicated in *Cautionary Note Regarding Forward-Looking Statements* above. Consistent with past practice, these amounts are not intended to constitute the Company's total revenue over the indicated time periods, as the Company has additional, regular on-going revenues. Examples of additional, regular recurring revenues include revenues from the engineering fees, and service revenue, among others. Numbers may not add due to rounding.*

Orders in our backlog are subject to delay, deferral, acceleration, resizing, or cancellation from time to time by our customers, subject to contractual rights. Given the irregular sales cycle of customer orders, and especially of large orders, our revenue backlog at any given time is not necessarily an accurate indication of our future revenues.

**Table of Contents****Operating Segments**

We conduct our operations through two operating segments: Energy and Smart Grid Solutions, and Energy Services. Our reportable segments are strategic business units that offer different products and services and serve different customer bases. They are managed separately because each business has a different customer base, requires different technology and personnel, and has different marketing strategies.

***Energy and Smart Grid Solutions***

Through our PowerSecure subsidiary we serve utilities and commercial, institutional, and industrial customers in the areas of Interactive Distributed Generation, Utility Infrastructure and Energy Efficiency. Each of these PowerSecure subsidiary business units operates in a distinct market with distinct technical disciplines, but share a common or complementary customer base with other PowerSecure subsidiary products and services and which we grow through shared resources and customer relationships. Accordingly, these units are included within our Energy and Smart Grid Solutions segment results.

***Energy Services***

Through our WaterSecure subsidiary we serve customers in the oil and natural gas production business with water processing and disposal services. WaterSecure, through its equity investment in MM 1995-2, provides water processing and disposal for oil and natural gas producers. Our Southern Flow business has been sold and the results of its discontinued operations are excluded from our Energy Services segment for all periods presented in the information below.

**Results of Operations**

The following discussion regarding segment revenues, gross profit, costs and expenses, and other income and expenses for the first quarter 2011 compared to the first quarter 2010 excludes revenues, gross profit, and costs and expenses of our Southern Flow subsidiary, which we sold in January 2011 and is classified as a discontinued operation in our financial statements.

***First Quarter 2011 Compared to First Quarter 2010******Revenues***

Our consolidated revenues are generated entirely by sales and services provided by our PowerSecure subsidiary, which operates our Energy and Smart Grid Solutions segment. We currently provide a variety of Energy and Smart Grid Solutions products and services through three product categories: Interactive Distributed Generation, Utility Infrastructure, and Energy Efficiency. The following table summarizes our Energy and Smart Grid Solutions segment revenues for the periods indicated (dollars in thousands):

	<b>Quarter Ended March 31,</b>		<b>Period-over-Period Difference</b>	
	<b>2011</b>	<b>2010</b>	<b>\$</b>	<b>%</b>
Energy and SmartGrid Solutions:				
Interactive Distributed Generation	\$ 11,202	\$ 10,420	\$ 782	7.5%
Utility Infrastructure	7,578	5,370	2,208	41.1%
Energy Efficiency	4,933	4,670	263	5.6%
Total	\$ 23,713	\$ 20,460	\$ 3,253	15.9%

**Table of Contents**

Our consolidated revenues for the first quarter 2011 increased \$3.3 million, or 15.9%, compared to the first quarter 2010 due to an increase in sales in each of our Interactive Distributed Generation, Utility Infrastructure, and Energy Efficiency products and services categories.

Our Energy and Smart Grid Solutions segment distributed generation revenues are very heavily affected by the number, size and timing of our Interactive Distributed Generation projects as well as the percentage of completion of in-process projects, and the percentage of turn-key as opposed to recurring revenue projects. Our Interactive Distributed Generation sales have fluctuated significantly in the past and are expected to continue to fluctuate significantly in the future. Our Energy and Smart Grid Solutions segment revenues increased by \$3.3 million, or 15.9%, during the first quarter 2011 compared to the first quarter 2010. The increase in those revenues in the first quarter 2011 over the first quarter 2010 was primarily attributable to a \$0.8 million, or 7.5%, increase in revenues from our Interactive Distributed Generation products and services, a \$2.2 million, or 41.1%, increase in revenues from our Utility Infrastructure products and services, and a \$0.3 million, or 5.6%, increase in revenues from our Energy Efficiency products and services. The increase in our Interactive Distributed Generation product sales and services reflects gradual improvements in economic conditions and increased business investment spending by large industrial, institutional, and municipal customers. The increase in our Utility Infrastructure product sales and services was due to an increase in the number of utilities that we service, and an increase in those customers' spending levels on transmission and distribution system maintenance and construction. The increase in our Energy Efficiency sales and services in the first quarter 2011 compared the first quarter 2010 reflects the inclusion of revenues from our IES LED lighting business operations which we acquired in the second quarter of 2010.

The future level of our revenues will depend on the timing and degree of the recovery of the domestic economy, the health of the credit markets and the return to pre-recession levels of customer spending for capital improvements and energy efficiency, as well as our ability to secure new significant purchase orders. The level and timing of our future revenues will also be affected by the amount and proportion of revenues coming from recurring revenue projects in the future, which results in revenue being recognized over a longer period. We are particularly susceptible to changes in economic conditions due to the fact that our product offerings are largely discretionary investment items for our customers, and this can therefore subject them to delay or deferment especially when economic conditions are not positive.

While it appears that economic and credit conditions are beginning to improve, the pace of the recovery is modest and inconsistent. These external conditions, in combination with our current revenue backlog and expected timing of project completion and revenue recognition of these projects leads us to expect that our Energy and Smart Grid Solutions segment quarterly revenues will gradually improve as 2011 progresses. We expect this general pattern of modest, gradual improvement in revenues for each of our Distributed Generation, Energy Efficiency, and Utility Infrastructure business units. The absolute pace of our revenue growth will depend on how quickly economic conditions improve and the confidence with which our utility partners and customers believe the economy will demonstrate a consistent recovery.

**Table of Contents***Gross Profit and Gross Profit Margin*

Our segment gross profit represents our revenues less our cost of sales. Our segment gross profit margin represents our gross profit divided by our revenues. The following tables summarize our Energy and Smart Grid Solutions segment cost of sales along with our segment gross profit and gross profit margin for the periods indicated (dollars in thousands):

	Quarter Ended March 31,		Period-over-Period Difference	
	2011	2010	\$	%
Energy and Smart Grid Solutions:				
Cost of Sales	\$ 16,054	\$ 12,351	\$ 3,703	30.0%
Gross Profit	\$ 7,659	\$ 8,109	\$ (450)	-5.5%
Gross Profit Margin	32.3%	39.6%		

Cost of sales and services include materials, personnel and related overhead costs incurred to manufacture products and provide services. The 30.0% increase in our consolidated cost of sales and services for the first quarter 2011, compared to the first quarter 2010, was driven by the increase in costs associated with the 15.9% increase in sales, together with the factors discussed below leading to the decrease in our gross profit margin.

Our Energy and Smart Grid Solutions segment gross profit decreased \$0.5 million, or 5.5%, in the first quarter 2011, compared to the first quarter 2010. As a percentage of revenue, our Energy and Smart Grid Solutions segment gross profit margin decreased by 7.3 percentage points in the first quarter 2011 compared to the first quarter 2010, to 32.3%. The decrease in our Energy and Smart Grid Solutions gross profit margin reflects changes in the mix of projects and products completed in the first quarter 2011 compared to the first quarter 2010, as well as investments we made in equipment and personnel to support new business awards. In the long-term, however, we expect that gross profit margins for this segment will increase because of anticipated greater productivity, operations and manufacturing efficiencies, improvements in technology, and growth in our higher-margin recurring revenue projects.

Our gross profit and gross profit margin have been, and we expect will continue to be, affected by many factors, including the following:

- The absolute level of revenue achieved in any particular period, given that portions of our cost of sales are relatively fixed over the near-term, the most significant of which is personnel and equipment costs;
- Our ability to improve our operating efficiency and benefit from economies of scale;
- Our level of investments in our businesses, particularly for anticipated or new or business awards;
- Improvements in technology and manufacturing methods and processes;
- The mix of higher and lower margin projects, products and services, and the impact of new products and technologies on our pricing and volumes;
- Our ability to manage our materials and labor costs, including any future inflationary pressures;
- The costs to maintain and operate distributed generation systems we own in conjunction with recurring revenue contracts, including the price of fuel, as well as their operating performance;
- The geographic density of our projects;

**Table of Contents**

The selling price of products and services sold to customers, and the revenues we expect to generate from recurring revenue projects;

The rate of growth of our new businesses, which tend to incur costs in excess of revenues in their earlier phases and then become profitable and more efficient over time if they are successful; and

Other factors described below under *Fluctuations*.

Some of these factors are not within our control, and we cannot provide any assurance that we can continue to improve upon those factors that are within our control, especially given the current economic climate as well as our movement to an expected higher percentage of recurring revenue projects. Moreover, our gross revenues are likely to fluctuate from quarter to quarter and from year to year, as discussed in *Fluctuations* below. Accordingly, there is no assurance that our future gross profit margins will improve or even remain at historic levels in the future, and will likely decrease if revenues decrease.

*Operating Expenses*

Our operating expenses include general and administrative expense, selling, marketing and service expense, and depreciation and amortization. The following table sets forth our consolidated operating expenses for the periods indicated (dollars in thousands):

	Quarter Ended March 31,		Period-over-Period Difference	
	2011	2010	\$	%
Consolidated Operating Expenses:				
General and administrative	\$ 7,919	\$ 6,462	\$ 1,457	22.5%
Selling, marketing and service	1,158	1,046	112	10.7%
Depreciation and amortization	806	584	222	38.0%
Total	\$ 9,883	\$ 8,092	\$ 1,791	22.1%

Costs related to personnel, including wages, stock compensation, bonuses and commissions, are the most significant component of our operating expenses. During the first quarter 2011, our operating expenses increased due to investments in new product development, engineering, facilities, and personnel, as well as increases in selling expense, compensation expense, and increases in depreciation from capital deployed to support our recurring revenue business. Our operating expense investments were in support of, and driven by, increasing levels of revenue and identified new business opportunities in 2010 and early 2011. In the future, we expect to continue to make investments designed to support and drive our future business growth, subject to the general economic conditions demonstrating sustained improvement and our continuing positive expectations regarding our future growth opportunities. We expect our quarterly operating expense levels for the remainder of 2011 to be similar to our quarterly operating expenses during the first quarter 2011. In 2012 and beyond, if economic conditions continue to improve, we expect demand for our business to expand allowing us to grow our business and to invest in future business opportunities.

**Table of Contents**

*General and Administrative Expenses.* General and administrative expenses include personnel wages, benefits, stock compensation, and bonuses and related overhead costs for the support and administrative functions incurred primarily in our Energy and Smart Grid Solutions segment. The 22.5% increase in our consolidated general and administrative expenses in the first quarter 2011, as compared to the first quarter 2010, was due to investment in personnel and other administrative expenses to support our increasing levels of revenue and investments in new business opportunities. The following table provides further detail of our general and administrative expenses by segment (dollars in thousands):

	Quarter Ended March 31,		Period-over-Period Difference	
	2011	2010	\$	%
Segment G&A Expenses:				
Energy and Smart Grid Solutions:				
Personnel costs	\$ 4,498	\$ 3,178	\$ 1,320	41.5%
Vehicle lease and rental	510	389	121	31.1%
Insurance	148	211	(63)	-29.9%
Rent-office and equipment	230	199	31	15.6%
Professional fees and consulting	218	166	52	31.3%
Travel	287	252	35	13.9%
Development costs	161	19	142	747.4%
Other	670	721	(51)	-7.1%
Energy Services				n/m
Unallocated Corporate Costs	1,197	1,327	(130)	-9.8%
Total	\$ 7,919	\$ 6,462	\$ 1,457	22.5%

The increase in our Energy and Smart Grid Solutions segment personnel costs during the first quarter 2011, as compared to the first quarter 2010, was due to staffing increases to support growth in our Energy and Smart Grid Solutions Segment and investments in new business opportunities. Other general and administrative expenses including vehicle costs, professional and consulting fees, travel and other expenses similarly increased to support our current growth and future growth opportunities. In the near-term, we expect our Energy and Smart Grid Solutions general and administrative expenses levels for the remainder of 2011 to be similar to our quarterly level during the first quarter 2011. Over the long-term, we expect our expenses in these areas to further increase at our Energy and Smart Grid Solutions segment as we continue to invest in and support long-term growth.

Unallocated corporate general and administrative expenses include similar personnel costs as described above as well as costs incurred for the benefit of all of our business operations, such as legal, Sarbanes-Oxley, public company reporting, director expenses, accounting costs, and stock compensation expense on our stock options and restricted stock grants which we do not allocate to our operating segments. The decrease in unallocated corporate costs during the first quarter 2011 as compared to the first quarter 2010 was due to decreased incentive compensation costs and professional fees. We expect our quarterly unallocated corporate costs for the remainder of 2011 to remain consistent or increase slightly from the level we incurred during the first quarter 2011.

**Table of Contents**

*Selling, Marketing and Service Expenses.* Selling, marketing and service expenses consist of personnel and related overhead costs, including commissions for sales and marketing activities, together with travel, advertising and promotion costs incurred in our Energy and Smart Grid Solutions segment. The 10.7% increase in selling, marketing and service expenses in the first quarter 2011, as compared to the first quarter 2010, was due to increases in sales compensation incurred to stimulate revenue growth and respond to an increasing level of sales opportunities for our Energy and Smart Grid Solutions segment. The following table provides further detail of our segment selling, marketing and service expenses (dollars in thousands):

	Quarter Ended March 31,		Period-over-Period Difference	
	2011	2010	\$	%
Segment Selling, Marketing and Service:				
Energy and Smart Grid Solutions:				
Salaries	\$ 658	\$ 499	\$ 159	31.9%
Commission	231	286	(55)	-19.2%
Travel	175	165	10	6.1%
Advertising and promotion	98	116	(18)	-15.5%
Bad debt expense (recovery)	(4)	(20)	16	-80.0%
Energy Services				n/m
Total	\$ 1,158	\$ 1,046	\$ 112	10.7%

In the future, we expect our near-term and long-term Energy and Smart Grid Solutions segment selling, marketing and services expenses to grow in order to reflect, drive and support future growth.

*Depreciation and Amortization Expenses.* Depreciation and amortization expenses include the depreciation of property, plant and equipment and the amortization of certain intangible assets including capitalized software development costs and other intangible assets. The 38.0% increase in depreciation and amortization expenses in the first quarter 2011, as compared to the first quarter 2010, primarily reflects increased depreciation and amortization resulting from capital investments at our Energy and Smart Grid Solutions segment throughout 2010 and the first quarter 2011. These capital investments are primarily investments in PowerSecure-owned distributed generation systems for projects deployed under our recurring revenue model.

**Table of Contents***Other Income and Expenses*

Our other income and expenses include management fees and equity income earned by our Energy Services segment as managing trustee of MM 1995-2 relating to the WaterSecure operations, interest income, interest expense and income taxes. The following table sets forth our other income and expenses for the periods indicated, by segment (dollars in thousands):

	Quarter Ended March 31,		Period-over-Period Difference	
	2011	2010	\$	%
Other Segment Income and (Expenses):				
Energy and Smart Grid Solutions:				
Interest income and other income	\$	\$	\$	n/m
Interest expense	(90)	(70)	(20)	-28.6%
Segment total	(90)	(70)	(20)	
Energy Services:				
Equity income	1,011	1,030	(19)	-1.8%
Management fees	168	154	14	9.1%
Segment total	1,179	1,184	(5)	
Unallocated Corporate:				
Interest income and other income	20	30	(10)	-33.3%
Interest expense	(52)	(71)	19	26.8%
Income tax benefit (provision)	83	(205)	288	140.5%
Segment total	51	(246)	297	
Total	\$ 1,140	\$ 868	\$ 272	

*Equity Income.* Equity income at our Energy Services segment consists of our minority ownership interest in the earnings of the WaterSecure operations. Our equity income is a direct function of the net income of the WaterSecure operations. During the first quarter 2011, our equity income decreased by \$19, or 1.8%, compared to the first quarter 2010 due to higher operating expenses in this business. Notwithstanding the slight decrease in our first quarter 2011 equity income, the performance of the WaterSecure operations, and our related equity income, continues to be favorably affected by increases in oil and natural gas prices and production in the first quarter 2011.

*Management Fees.* Management fees at our Energy Services segment consist entirely of fees we earn as the managing trustee of the WaterSecure operations. These fees, to a large extent, are based on a percentage of the revenues of the WaterSecure operations. Increases in oil and natural gas prices and production in the first quarter 2011 compared to the first quarter 2010, positively affected the revenues of the WaterSecure operations in the first quarter 2011. As a direct result, our Energy Services segment management fees increased in the first quarter 2011 by \$14, or 9.1%, compared to the first quarter 2010.

*Interest Income and Other Income.* Interest income and other income for each segments consists primarily of interest we earn on the interest-bearing portion of our cash and cash equivalent balances. In total, interest income and other income decreased by \$10 during the first quarter 2011, as compared to the first quarter 2010. This decrease was

attributable to a decline in our interest income resulting from both a decline in our interest-bearing cash and cash equivalent balances as well as declining interest rates earned on our cash and cash equivalent balances in the first quarter 2011 compared to the first quarter 2010. Our future interest income will depend on our cash and cash equivalent balances, which will increase and decrease depending upon our profit, capital expenditures, and our working capital needs, and future interest rates.

*Interest Expense.* Interest expense for each segment consists of interest and finance charges on our credit facilities and capital leases. In total, interest expense increased by slightly during the first quarter 2011, as compared to the first quarter 2010. The increase in our interest expense reflects the increased rates of interest for borrowings under our credit facility during the first quarter 2011, partially offset by the reduction in balances outstanding on our capital lease obligation due to regular payments made on our capital leases over the year. We expect our future interest and finance charges to increase over time as a result of anticipated borrowings under our credit facility to fund future working capital needs and recurring revenue projects at our Energy and Smart Grid Solutions segment.

## **Table of Contents**

*Income Taxes.* Historically, our current federal income tax expense has been modest, generally limited to federal alternative minimum tax, because of our consolidated net operating losses in prior years that are used to offset taxable income in current years. The income tax benefit or provision we record is the result of applying our expected annual effective tax rate by our net income or loss. Our effective tax rate and our income tax provision or benefit includes the effects of permanent differences between our book and taxable income, changes in our deferred tax assets and liabilities, changes in the valuation allowance for our net deferred tax asset, state income taxes in various state jurisdictions in which we have taxable activities, and expenses associated with uncertain tax positions that we have taken or expense reductions from tax positions as a result of a lapse of the applicable statute of limitations. The first quarter 2011 income tax benefit reflects the benefit for the current period losses we expect to recover through taxable earnings during the remainder of 2011.

*Noncontrolling Interest.* The noncontrolling ownership interests in the income or losses of our majority-owned subsidiaries is included in our consolidated statements of operations as a reduction or addition to net income to derive income attributable to PowerSecure International stockholders. Until April 30, 2010, our PowerSecure subsidiary held a 67% controlling ownership interest in EfficientLights which is consolidated in our financial statements. On April 30, 2010, we acquired the 33% noncontrolling ownership interest in EfficientLights at which time EfficientLights became a wholly-owned subsidiary of our PowerSecure subsidiary. Also, on April 1, 2010, our PowerSecure subsidiary acquired a 67% controlling ownership interest in IES. Accordingly, our noncontrolling interest for the three months ended March 31, 2011, consists solely of the results of IES. Similarly, our noncontrolling interest for the three month ended March 31, 2010 consists solely of the results of EfficientLights. As a result, these period-to-period comparisons of the aggregate amount of noncontrolling interests are not comparable.

The addition for the noncontrolling interest in the loss of IES in the first quarter 2011 is a result of start up and development expenses of IES, which we acquired on April 1, 2010. The reduction for the noncontrolling interest in the income of EfficientLights in the first quarter 2010 is a result of income related to the EfficientLights noncontrolling interest prior to the exercise of our option to acquire the minority interest position in EfficientLights on April 30, 2010.

### **Fluctuations**

Our revenues, expenses, margins, net income, cash flow, cash, working capital debt, balance sheet positions, and other operating results have fluctuated significantly from quarter-to-quarter, period-to-period and year-to-year in the past and are expected to continue to fluctuate significantly in the future due to a variety of factors, many of which are outside of our control. These factors include, without limitation, the following:

- the effects of general economic and financial conditions, including the ongoing challenges in the economy and the difficult capital and credit markets, and the potential for such economic and market challenges to continue or recur in the future, negatively impacting our business operations and our revenues and net income, including the negative impact these conditions could have on the timing of and amounts of orders from our customers, and the potential these factors have to negatively impact our access to capital to finance our business;

**Table of Contents**

the size, timing and terms of sales and orders, including large customer orders, as well as the effects of the timing of project phases of completion, and customers delaying, deferring or canceling purchase orders or making smaller purchases than expected;

our ability to increase our revenues through long-term recurring revenue projects, recognizing that increasing revenues from recurring revenue projects will require significant up-front capital expenditures and will protract revenue and profit recognition, while increasing our gross margins over the long-term, as well as our ability to sell, complete, and recognize satisfactory levels of quarterly revenue and profits related to our project-based sales and product and service revenue, in order to maintain current profits, cash flow, and to satisfy our financial covenants in our debt facilities and successfully finance the recurring portion of our business model;

our ability to maintain and grow our utility infrastructure revenues, and maintain and increase pricing, utilization rates, and productivity rates, given the significant levels of vehicles, tools, and labor in which we have invested and is required to serve utilities in this business area;

the recent sale of our Southern Flow business, and the associated loss of revenues, cash flow and income from that business, and our ability to redeploy the proceeds from the sale productively and profitably;

our ability to obtain adequate supplies of key components and materials of suitable quality for our products on a timely and cost-effective basis, including the impact of potential supply line constraints, substandard parts, and fluctuations in the cost of raw materials and commodity prices, including without limitation with respect to our Energy Efficiency business unit in relation to third party manufacturing arrangements we have with vendors in China, and other component parts which have their origins in Japan;

the performance of our products, services and technologies, and the ability of our systems to meet the performance standards they are designed and built to deliver to our customers, including but not limited to our recurring revenue projects for which we retain the on-going risks associated with the performance and ownership of the systems;

our ability to access significant capital resources on a timely basis in order to fund working capital requirements, fulfill large customer orders, and finance capital required for recurring revenue projects and equipment for our utility infrastructure business;

our ability to implement our business plans and strategies and the development of new products and services the timing of such implementation;

the pace of revenue and profit realization from our new businesses and the development and growth of their markets, including the timing, pricing and market acceptance of our new products and services;

changes in our pricing policies and those of our competitors, including the introduction of lower cost competing technologies and the potential for them to impact our pricing and our profit margins;

variations in the length of our sales cycle and product and service delivery and construction process;

changes in the mix of products and services having differing margins;

changes in our operating expenses, including prices for materials including but not limited to copper, aluminum, and other raw materials, labor costs, and other components of our products and services, fuel prices including diesel, natural gas, oil and gasoline, and our ability or inability to hedge or otherwise manage these prices to protect our costs and revenues, minimize the impact of volatile exchange rates and mitigate unforeseen or unanticipated expenses;

**Table of Contents**

changes in our valuation allowance for our net deferred tax asset, and the resulting impact on current tax expense, future tax expense, and balance sheet account balances;

the effects of severe weather conditions, such as hurricanes, on the business operations of our customers, and the potential effect of such conditions on our results of operations;

the life cycles of our products and services, and competitive alternatives in the marketplace;

budgeting cycles of utilities and other industrial, commercial, and institutional customers, including impacts of the current downturn in the economy and difficult capital market conditions on capital projects and other spending items;

changes and uncertainties in the lead times required to obtain the necessary permits and other governmental and regulatory approvals for projects;

the development and maintenance of business relationships with strategic partners such as utilities and large customers;

economic conditions and regulations in the energy industry, especially in the electricity, natural gas and oil sectors, including the effects of changes in energy prices and electricity pricing and utility tariffs;

changes in the prices charged by our suppliers;

the effects of governmental regulations and regulatory changes in our markets;

the effects of litigation, claims and other proceedings; and

our ability to make and obtain the expected benefits from the development of or acquisition of technology or businesses, and the costs related to such development or acquisitions.

Because we have little or no control over most of these factors, our operating results are difficult to predict. Any substantial adverse change in any of these factors could negatively affect our business and results of operations. Our revenues and other operating results are heavily dependent upon the size and timing of customer orders, payments, and the timing of the completion of those projects. The timing of large individual sales, and of project completion, is difficult for us to predict. Because our operating expenses are based on anticipated revenues and because a high percentage of these are relatively fixed, a shortfall or delay in recognizing revenue can cause our operating results to vary significantly from quarter-to-quarter and can result in significant operating losses or declines in profit margins in any particular quarter. If our revenues fall below our expectations in any particular quarter, we may not be able to or it may not be prudent to reduce our expenses rapidly in response to the shortfall, which can result in us suffering significant operating losses or declines in profit margins in that quarter.

As we develop new related lines of business, our revenues and costs will fluctuate because generally new businesses require start-up expenses but take time for revenues to develop. Another factor that could cause material fluctuations in our quarterly results is the amount of recurring, as opposed to project-based, sources of revenue for our distributed generation and utility infrastructure projects. To date, the majority of our Energy and Smart Grid Solutions segment revenues have consisted of project-based distributed generation revenues, which are recognized as the project is completed. However, we have marketing efforts focused on developing more sales under our recurring revenue model, for which the costs and capital is invested initially and the related revenue and profit is recognized over the life of the contract, generally five to fifteen years. Recurring revenue projects, compared to project-based sales, are generally more profitable, but result in delayed recognition of revenue and net income, especially in the short-term, as we implement an increased number of these recurring revenue projects.

**Table of Contents**

Our Energy Services segment operating results will vary as a result of fluctuations in energy prices. Results from our WaterSecure operations fluctuate significantly with changes in oil and natural gas prices and production in Colorado. Due to all of these factors and the other risks, uncertainties and other factors discussed in this report and in our Annual Report on Form 10-K for the year ended December 31, 2010, quarter-to-quarter, period-to-period or year-to-year comparisons of our results of operations should not be relied on as an indication of our future performance. Quarterly, period or annual comparisons of our operating results are not necessarily meaningful or indicative of future performance.

**Liquidity and Capital Resources**

***Overview***

We have historically financed our operations and growth primarily through a combination of cash on hand, cash generated from operations, borrowings under credit facilities, leasing, and proceeds from private and public sales of equity. On a going forward basis, we expect to require capital primarily to finance our:

- operations;
- inventory;
- accounts receivable;
- property and equipment expenditures, including capital expenditures related to recurring revenue projects;
- additional equity investments in our WaterSecure operations;
- software purchases or development;
- debt service requirements;
- lease obligations;
- deferred compensation obligations; and
- business and technology acquisitions and other growth transactions.

***Working Capital***

At March 31, 2011, we had working capital of \$55.5 million, including \$14.9 million in cash and cash equivalents, compared to working capital of \$54.5 million, including \$8.2 million in cash and cash equivalents at December 31, 2010. Changes in the components of our working capital from December 31, 2010 to March 31, 2011 and from December 31, 2009 to March 31, 2010 are explained in greater detail below. At both March 31, 2011 and December 31, 2010, we had \$20.0 million of additional borrowing capacity from our credit facility. However, the availability of this capacity under our credit facility includes restrictions on the use of proceeds, and is dependent upon our ability to satisfy certain financial and operating covenants including financial ratios and a minimum cash balance, as discussed below.

**Table of Contents*****Cash Flows***

The following table summarizes our cash flows for the periods indicated (dollars in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Net cash flows used in operating activities	\$ (5,332)	\$ (1,805)
Net cash flows provided by (used in) investing activities	12,143	(1,404)
Net cash used in financing activities	(123)	(347)
Net increase (decrease) in cash and cash equivalents	\$ 6,688	\$ (3,556)

***Cash Used in Operating Activities***

Cash used in operating activities consists primarily of net income adjusted for certain non-cash items including depreciation and amortization, stock-based compensation expenses and equity income. Cash used in operating activities also include cash distributions from our unconsolidated affiliate, cash distributions to the EfficientLights noncontrolling member, and the effect of changes in working capital and other activities.

Cash used in operating activities of \$5.3 million for the first quarter 2011 included the effects of the following:

- our loss from continuing operations of \$1.1 million;
- non-cash charges of \$0.8 million in depreciation and amortization;
- stock-based compensation expense of \$0.5 million;
- non-cash equity income from our WaterSecure operations of \$1.0 million partially offset by cash distributions from those operations of \$0.6 million;
- an increase of \$3.4 million in accounts receivable;
- an increase of \$4.9 million in inventories;
- an increase of \$0.1 million in other assets and liabilities
- an increase of \$1.0 million of accounts payable; and
- an increase of \$2.2 million of accrued expenses.

Cash used in operating activities of \$1.8 million for the first quarter 2010 included the effects of the following:

- our income from continuing operations of \$0.9 million;
- non-cash charges of \$0.6 million in depreciation and amortization;
- stock-based compensation expense of \$0.5 million;
- cash distributions to the noncontrolling member of EfficientLights of \$0.6 million;
- non-cash equity income from our WaterSecure operations of \$1.0 million partially offset by cash distributions from those operations of \$0.8 million;
- an increase of \$1.2 million in accounts receivable;
- an increase of \$4.4 million in inventories;
- a decrease of \$0.4 million in other current assets and liabilities
- an increase of \$5.3 million of accounts payable;
- a decrease of \$3.5 million of accrued expenses;
- cash payments of \$0.2 million on our restructuring obligations; and
- cash provided by our discontinued operations of \$0.6 million.

**Table of Contents**

*Cash Provided by (Used in) Investing Activities*

Cash provided by investing activities was \$12.1 million in the first quarter 2011 and cash used by investing activities was \$1.4 million in the first quarter 2010. Historically, our principal cash investments have related to the purchase of equipment used in our production facilities, the acquisitions of certain contract rights, the acquisition and installation of equipment related to our recurring revenue sales, and the acquisition of businesses or technologies. During the first quarter 2011, we received \$16.5 million from the sale of our Southern Flow business, we used \$3.4 million to purchase and install equipment at our recurring revenue distributed generation sites, and we used \$1.0 million at our PowerSecure subsidiary principally to acquire operational assets. During the first quarter 2010, we used \$0.5 million to purchase and install equipment at our recurring revenue distributed generation sites and \$0.6 million at our PowerSecure subsidiary principally to acquire operational assets.

*Cash Used in Financing Activities*

Cash used in financing activities was \$0.1 million in the first quarter 2011 and cash used in financing activities was \$0.3 million in the first quarter 2010. During the first quarter 2011, we received \$0.1 million from the exercise of stock options and we used \$0.2 million to repay our capital lease obligations. During the first quarter 2010, we used \$0.2 million to repay our capital lease obligations.

***Capital Spending***

Our capital expenditures during the first quarter 2011 were approximately \$4.4 million, of which we used \$3.4 million to purchase and install equipment at our recurring revenue distributed generation sites, and \$1.0 million to purchase equipment and other capital items at our PowerSecure subsidiary. Our capital expenditures during the first quarter 2010 were approximately \$1.4 million, of which we used \$0.5 million to purchase and install equipment at our recurring revenue distributed generation sites, and \$0.6 million to purchase equipment and other capital items at our PowerSecure subsidiary.

We anticipate making capital expenditures of approximately \$10-15 million in 2011, although customer demand for our Interactive Distributed Generation systems under recurring revenue contract arrangements, and economic and financial conditions could cause us to reduce or increase those capital expenditures. The vast majority of our capital spending has to date been and will continue to be used for investments in assets related to our recurring revenue projects as well as equipment to support the growth of our Energy and Smart Grid Solutions segment.

***Indebtedness***

*Line of Credit.* We have had a credit facility with Citibank, N.A. ( Citibank ), as administrative agent and lender, and other lenders since entering into a credit agreement in August 2007. At December 31, 2010, our credit agreement with Citibank along with SunTrust Bank and Branch Banking and Trust Company ( BB&T ) as additional lenders, provided for a \$50.0 million senior, first-priority secured revolving and term credit facility. In January 2011, the credit facility was amended to facilitate the sale of Southern Flow, modify certain financial covenants to accommodate our financial profile after that sale and reflect a change in lenders. The credit facility, as amended, is now a \$25.0 million senior, first-priority secured revolving credit facility with Citibank and BB&T as lenders. The credit facility is guaranteed by all of our active subsidiaries and secured by all of our assets and the assets of our active subsidiaries.

**Table of Contents**

As amended, the credit facility, as a revolving credit facility, matures and terminates on November 12, 2013. However, we have the option prior to that maturity date to convert a portion of outstanding principal balance into a non-revolving term loan for a two year period expiring November 12, 2015, making quarterly payments based upon a four year fully amortized basis, with the remaining outstandings due as a balloon payment on November 12, 2015. We intend to continue to use the proceeds available under the credit facility to finance our PowerSecure subsidiary's recurring revenue projects as well as to finance capital expenditures, working capital, acquisitions, and general corporate purposes. Under the terms of the amended credit facility, we are required, at all times until April 1, 2012, to maintain cash balances of at least 65% of our outstanding borrowings under the revolving credit facility. Outstanding balances under the credit facility bear interest, at our discretion, at either the London Interbank Offered Rate for the corresponding deposits of U. S. Dollars plus an applicable margin, which is on a sliding scale ranging from 200 basis points to 325 basis points based upon our leverage ratio, or at Citibank's alternate base rate plus an applicable margin, on a sliding scale ranging from 25 basis points to 150 basis points based upon our leverage ratio. Our leverage ratio is the ratio of our funded indebtedness as of a given date to our consolidated EBITDA as defined in the credit agreement for the four consecutive quarters ending on such date. Citibank's alternate base rate is equal to the higher of the Federal Funds Rate as published by the Federal Reserve of New York plus 0.50%, and Citibank's prime commercial lending rate. The credit facility is not subject to any borrowing base computations, but does contain certain financial covenants. Our minimum asset coverage must be in excess of 1.25, where our asset coverage is defined as the summation of 80% of the book value of accounts receivable plus 60% of the book value of inventory plus 50% of the book value of net fixed assets, divided by total funded debt outstanding. In addition, we are required to maintain a minimum consolidated tangible net worth, computed on a quarterly basis, equal to approximately \$62.0 million. Finally, our debt to worth ratio, which is the ratio of our total consolidated indebtedness to our consolidated tangible net worth, cannot exceed 1.5 to 1.0 at the end of any quarter. At March 31, 2011, we were in compliance with our financial covenant requirements. In addition, commencing March 31, 2012, our maximum leverage ratio cannot exceed 3.25 and our minimum fixed charge coverage ratio must be in excess of 1.25, where the fixed charge coverage ratio is defined as the ratio of the aggregate of our trailing 12 month consolidated EBITDA plus our lease or rent expense minus our taxes based on income and payable in cash, divided by the sum of our consolidated interest charges plus our lease or rent expenses plus our scheduled principal payments and dividends, computed over the previous period. Under the credit facility, our cumulative capital expenditures beginning in 2008 cannot exceed the sum of \$5.0 million plus \$1.25 million per quarter, on a cumulative basis, plus an allowance for our PowerSecure subsidiary recurring revenue projects generated after December 31, 2007. The credit facility contains other representations and warranties and affirmative and negative covenants, including restrictions with respect to liens, indebtedness, loans and investments, material changes in our business, asset sales or leases or transfers of assets, restricted payments such as distributions and dividends, mergers or consolidations and transactions with affiliates. Upon the sale of any of our assets or the assets of our subsidiaries other than in the ordinary course of business, or the public or private sale of any equity or debt other than equity issuances where the aggregate proceeds do not exceed \$10.0 million, we are required to use the net proceeds thereof to repay any indebtedness then outstanding under the credit facility, except for certain reinvestment provisions.

## **Table of Contents**

Our obligations under the credit facility are secured by guarantees and security agreements by each of our active subsidiaries, including but not limited to our PowerSecure subsidiary and WaterSecure. The guarantees guaranty all of our obligations under the credit facility, and the security agreements grant to the lenders a first priority security interest in virtually all of the assets of each of the parties to the credit agreement.

The credit agreement also contains customary events of default, including payment defaults, breach of representations and warranties, covenant defaults, cross-defaults, certain bankruptcy or insolvency events, judgment defaults and certain ERISA-related events.

The maximum balance outstanding on the credit facility during the three months ended March 31, 2011 was \$5.0 million. The balance outstanding on the credit facility at March 31, 2011 and December 31, 2010 was \$5.0 million, which is also the same balance outstanding at May 5, 2011. Under the amended provisions of our credit facility, we currently have an additional \$20.0 million available to borrow under the credit facility. However, the availability of this capital under our credit facility includes restrictions on the use of proceeds, and is dependent upon our ability to satisfy certain financial and operating covenants, as described above.

*Capital Lease Obligations.* We have a capital lease with SunTrust Equipment Finance and Leasing, an affiliate of SunTrust Bank, from the sale and leaseback of distributed generation equipment placed in service at customer locations. We received \$5.9 million from the sale of the equipment in December 2008 which we are repaying under the terms of the lease with monthly principal and interest payments of \$85 over a period of 84 months. At the expiration of the term of the lease in December 2015, we have the option to purchase the equipment for \$1, assuming no default under the lease by us has occurred and is then continuing. The lease is guaranteed by us under an equipment lease guaranty. The lease and the lease guaranty constitute permitted indebtedness under our current credit agreement, under which an affiliate of the lessor is one of the lenders.

Proceeds of the lease financing were used to finance our PowerSecure subsidiary's recurring revenue projects. We account for the lease financing as a capital lease in our consolidated financial statements in accordance with generally accepted accounting principles.

The lease provides our PowerSecure subsidiary with limited rights, subject to the lessor's approval which will not be unreasonably withheld, to relocate and substitute equipment during its term. The lease contains representations and warranties and covenants relating to the use and maintenance of the equipment, indemnification and events of default customary for leases of this nature. The lease also grants to the lessor certain remedies upon a default, including the right to cancel the lease, to accelerate all rent payments for the remainder of the term of the lease, to recover liquidated damages, or to repossess and re-lease, sell or otherwise dispose of the equipment.

Under the lease guaranty, we have unconditionally guaranteed the obligations of our PowerSecure subsidiary under the lease for the benefit of the lessor. Our capital lease obligation at March 31, 2011 and December 31, 2010 was \$4.2 million and \$4.4 million, respectively, and consists entirely of our obligations under the equipment lease described above.

*Preferred Stock Redemption.* The terms of our Series B preferred stock required us to redeem all shares of our Series B preferred stock that remained outstanding on December 9, 2004 at a redemption price equal to the liquidation preference of \$1,000 per share plus accumulated and unpaid dividends. Our remaining redemption obligation at March 31, 2011, to holders of outstanding shares of Series B preferred stock that have not been redeemed, is \$0.1 million.

**Table of Contents*****Contractual Obligations and Commercial Commitments***

We incur various contractual obligations and commercial commitments in our normal course of business. We lease certain office space, operating facilities and equipment under long-term lease agreements; to the extent we borrow under our credit facility, we are obligated to make future payments under that facility; we have a deferred compensation obligation; and in 2009 we entered into a non-compete agreement providing for on-going payments. At March 31, 2011, we also had a liability for unrecognized tax benefits and related interest and penalties totaling \$1.7 million. We do not expect a significant payment related to these obligations within the next year and we are unable to make a reasonably reliable estimate if and when cash settlement with a taxing authority would occur. Accordingly, the information in the table below, which is as of March 31, 2011, does not include the liability for unrecognized tax benefits (dollars in thousands):

	Total	Payments Due by Period			More than 5 Years
		Remainder of 2011	1 - 3 Years	4 - 5 Years	
<b>Contractual Obligations</b>					
Credit facility (1)	\$ 5,000	\$	\$ 5,000	\$	\$
Capital lease obligations (2)	4,823	762	2,031	2,030	
Operating leases	7,273	1,190	2,824	1,752	1,507
Deferred compensation (3)	2,661				2,661
Non-compete agreement	400		200	200	
Series B preferred stock	104	104			
 Total	 \$ 20,261	 \$ 2,056	 \$ 10,055	 \$ 3,982	 \$ 4,168

- (1) Total repayments are based upon borrowings outstanding as of March 31, 2011, not actual or projected borrowings after such date. Repayments do not include interest that may become due and payable in any future period.
- (2) Repayment amounts include interest on the capital lease obligation.
- (3) Total amount represents our expected obligation on the deferred compensation arrangement and does not include the value of the restricted annuity contract, or interest earnings thereon, that we purchased to fund our obligation.

***Off-Balance Sheet Arrangements***

During the first quarter 2011, we did not engage in any material off-balance sheet activities or have any relationships or arrangements with unconsolidated entities established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, we have not guaranteed any obligations of unconsolidated entities nor do we have any commitment or intent to provide additional funding to any such entities.

## **Table of Contents**

### ***Liquidity***

Based upon our plans and assumptions as of the date of this report, we believe that our capital resources, including our cash and cash equivalents, amounts available under our credit facility, along with funds expected to be generated from our operations, will be sufficient to meet our anticipated cash needs, including for working capital, capital spending and debt service commitments, for at least the next 12 months. However, any projections of future cash needs and cash flows are subject to substantial risks and uncertainties. See *Cautionary Note Regarding Forward-Looking Statements* above in this item and Part II, *Item 1A. Risk Factors* below. Although we believe that we have sufficient capital to fund our activities and commitments for at least the next 12 months, our future cash resources and capital requirements may vary materially from those now planned. Our ability to meet our capital needs in the future will depend on many factors, including the effects of the current economic and financial crisis, the timing of sales, the mix of products, the amount of recurring revenue projects, our ability to meet our financial covenants under our credit facility, unanticipated events over which we have no control increasing our operating costs or reducing our revenues beyond our current expectations, and other factors listed under *Fluctuations* above. For these reasons, we cannot provide any assurance that our actual cash requirements will not be greater than we currently expect or that these sources of liquidity will be available when needed.

We also continually evaluate opportunities to expand our current, or to develop new, products, services, technology and businesses that could increase our capital needs. In addition, from time to time we consider the acquisition of, or the investment in, complementary businesses, products, services and technology that might affect our liquidity requirements. We may seek to raise any needed or desired additional capital from the proceeds of public or private equity or debt offerings at the parent level or at the subsidiary level or both, from asset or business sales, from traditional credit financings or from other financing sources. In addition, we continually evaluate opportunities to improve our credit facilities, through increased credit availability, lower debt costs or other more favorable terms. However, our ability to obtain additional capital or replace or improve our credit facilities when needed or desired will depend on many factors, including general economic and market conditions, our operating performance and investor and lender sentiment, and thus cannot be assured. In addition, depending on how it is structured, a financing could require the consent of our current lending group. Even if we are able to raise additional capital, the terms of any financings could be adverse to the interests of our stockholders. For example, the terms of a debt financing could restrict our ability to operate our business or to expand our operations, while the terms of an equity financing, involving the issuance of capital stock or of securities convertible into capital stock, could dilute the percentage ownership interests of our stockholders, and the new capital stock or other new securities could have rights, preferences or privileges senior to those of our current stockholders. We cannot provide any assurance that sufficient additional funds will be available to us when needed or desired or that, if available, such funds can be obtained on terms favorable to us and our stockholders and acceptable to those parties who must consent to the financing. Our inability to obtain sufficient additional capital on a timely basis on favorable terms when needed or desired could have a material adverse effect on our business, financial condition and results of operations.

### **Critical Accounting Policies**

Management's discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates, judgments and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an on-going basis, we evaluate our estimates, including those related to revenue recognition and percentage of completion, fixed price contracts, product returns, warranty obligations, bad debt, inventories, cancellations costs associated with long term commitments, incentive compensation, investments, intangible assets, assets subject to disposal, income taxes, restructuring, service contracts, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making estimates and judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Estimates, by their nature, are based on judgment and available information. Therefore, actual results could differ from those estimates and could have a material impact

on our consolidated financial statements.

## **Table of Contents**

We have identified the accounting principles which we believe are most critical to understanding our reported financial results by considering accounting policies that involve the most complex or subjective decisions or assessments. These accounting policies described below include:

- revenue recognition;
- allowance for doubtful accounts;
- inventories;
- warranty reserve;
- impairment of long-lived assets;
- deferred tax valuation allowance;
- uncertain tax positions;
- costs of exit or disposal activities and similar nonrecurring charges; and
- stock-based compensation.

These accounting policies are described in our Annual Report on Form 10-K for the year ended December 31, 2010 in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

### **Recent Accounting Pronouncements**

***Revenue Recognition Milestone Method*** In April 2010, the FASB issued Accounting Standards Update (ASU) No. 2010-17 Revenue Recognition Milestone Method (Topic 605): Milestone Method of Revenue Recognition. This standard provides guidance on defining a milestone and determining when it may be appropriate to apply the milestone method of revenue recognition for certain research and development transactions. Under this new standard, a company can recognize as revenue consideration that is contingent upon achievement of a milestone in the period in which it is achieved, only if the milestone meets all criteria to be considered substantive. This standard became effective for us on a prospective basis commencing January 1, 2011. The adoption of this standard had no effect on our financial position or results of operations.

***Improving Disclosures about Fair Value Measurements*** In January 2010, the FASB issued ASU No. 2010-06 Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. This standard amends the disclosure guidance with respect to fair value measurements for both interim and annual reporting periods. Specifically, this standard requires new disclosures for significant transfers of assets or liabilities between Level 1 and Level 2 in the fair value hierarchy; separate disclosures for purchases, sales, issuance and settlements of Level 3 fair value items on a gross, rather than net basis; and more robust disclosure of the valuation techniques and inputs used to measure Level 2 and Level 3 assets and liabilities. This standard became effective for us on a prospective basis commencing January 1, 2011. The adoption of this standard had no effect on our financial position or results of operations or financial statement disclosures.

**Table of Contents**

**Multiple Deliverable Revenue Arrangements** In October 2009, the FASB issued ASU No. 2009-13 Multiple Deliverable Revenue Arrangements A Consensus of the FASB Emerging Issues Task Force: (Topic 605) Revenue Recognition. ASU No. 2009-13 provides application guidance on whether multiple deliverables exist, how the deliverables should be separated and how the consideration should be allocated to one or more units of accounting. This update establishes a selling price hierarchy for determining the selling price of a deliverable. The selling price used for each deliverable will be based on vendor-specific objective evidence, if available, third-party evidence if vendor-specific objective evidence is not available, or estimated selling price if neither vendor-specific or third-party evidence is available. This standard became effective for us on a prospective basis commencing January 1, 2011. The adoption of this standard had no effect on our financial position or results of operations.

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

We are exposed to certain market risks arising from transactions we enter into in the ordinary course of business. These market risks are primarily due to changes in interest rates and commodity prices, which may adversely affect our financial condition, results of operations and cash flow.

**Interest Rate Risk.** Our exposure to market risk resulting from changes in interest rates relates primarily to income from our investments in short-term interest-bearing marketable securities, which is dependent upon the interest rate of the securities held, and to interest expenses attributable to our credit facility, which is based on floating interest rates as described in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations of this report. Our lease with SunTrust is at a fixed interest rate and thus not impacted by changes in interest rates. At March 31, 2011, our cash and cash equivalent balance was approximately \$14.9 million and we had an outstanding balance on our credit facility of \$5.0 million. Our cash equivalents are invested in a combination of bank deposits, money market or U.S. government mutual funds, short-term time deposits, and government agency and corporate obligations, or similar kinds of instruments, the income of which generally increases or decreases in proportion to increases or decreases, respectively, in interest rates. We do not believe that changes in interest rates have had a material impact on us in the past or are likely to have a material impact on us in the foreseeable future. For example, a change of 1% (100 basis points) in the interest rate on either our investments or any future reasonably likely borrowings would not have a material impact on our financial condition, results of operations or cash flow. While we believe we have our cash and cash equivalents invested in relatively risk-free investments, the current capital market crisis make it difficult to accurately assess the risk of each of our holdings. This risk includes, but is not limited to, bank deposits in excess of FDIC insurance limits.

**Commodity Price Risk.** From time to time we are subject to market risk from fluctuating commodity prices in certain raw materials we use in our products and diesel fuel we use to power our generators. To date, in our Energy and Smart Grid Solutions segment, we have managed this risk by using alternative raw materials acceptable to our customers or we have been able to pass these cost increases to our customers. While we do not believe that changes in commodity prices have had a material impact on us in the past, commodity price fluctuations could have a material impact on us in the future, depending on the magnitude and timing of such fluctuations. The impact of these fluctuations could result in an increase in our operating costs and expenses and reduction in our gross margins and income due to increases in the price and costs of engines, generators, copper, aluminum, electrical components, labor, electricity, diesel fuel, gasoline, oil and natural gas. In our Energy Services segment, we have on-going commodity price risk primarily related to the price of oil and natural gas. Movements in prices of these commodities can materially impact our results in this segment.

## **Table of Contents**

*Foreign Exchange Risk.* Since substantially all of our revenues, expenses and capital spending are transacted in U.S. dollars, we face minimal exposure to adverse movements in foreign currency exchange rates. However, as our international operations expand in the future as we expect, then our exposure to foreign currency risks will increase, which could affect our business and our results of operations. In addition, because our EfficientLights business purchases component parts manufactured in China, then to the extent the U.S. Dollar exchange rate with the Chinese Yuan changes significantly, our business and results of operations could be materially impacted.

We do not use derivative financial instruments to manage or hedge our exposure to interest rate changes, foreign currency exchange risks or other market risks, or for trading or other speculative purposes.

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

#### **Evaluation of Disclosure Controls and Procedures**

Our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of March 31, 2011, the end of the period covered by this report. Based upon management's evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that, as of March 31, 2011, our disclosure controls and procedures were designed at the reasonable assurance level and were effective at the reasonable assurance level to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

#### **Changes in Internal Control Over Financial Reporting**

We regularly review our system of internal control over financial reporting and make changes to our processes and systems to improve controls and increase efficiency, while ensuring that we maintain an effective internal control environment. Changes may include such activities as implementing new, more efficient systems, consolidating activities and migrating processes. There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarter ended March 31, 2011 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

#### **Limitations in Control Systems**

Our controls and procedures were designed at the reasonable assurance level. However, because of inherent limitations, any system of controls and procedures, no matter how well designed and operated, can provide only reasonable, not absolute, assurance of achieving the desired objectives of the control system. In addition, the design of a control system must reflect the fact that there are resource constraints, and management must apply its judgment in evaluating the benefits of controls relative to their costs. Further, no evaluation of controls and procedures can provide absolute assurance that all errors, control issues and instances of fraud will be prevented or detected. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls and procedures is also based in part on certain assumptions regarding the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

**Table of Contents**

**PART II  
OTHER INFORMATION**

**Item 1. Legal Proceedings**

From time to time, we are involved in disputes and legal proceedings. There has been no material change in our pending legal proceedings as described in Item 3. Legal Proceedings in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

**Item 1A. Risk Factors**

Our business and operating results are subject to many risks, uncertainties and other factors. If any of these risks were to occur, our business, affairs, assets, financial condition, results of operations, cash flows and prospects could be materially and adversely affected. These risks, uncertainties and other factors include the information discussed elsewhere in this report as well as the risk factors set forth in Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010, which have not materially changed as of the date of this report.

**Item 6. Exhibits**

- (31.1) Certification of Chief Executive Officer pursuant to Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Filed herewith.)
- (31.2) Certification of Chief Financial Officer pursuant to Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Filed herewith.)
- (32.1) Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350 and Rule 13a-14(b) or 15d-14(b) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Filed herewith.)
- (32.2) Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350 and Rule 13a-14(b) or 15d-14(b) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Filed herewith.)

**Table of Contents**

**SIGNATURES**

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

POWERSECURE INTERNATIONAL, INC.

Date: May 5, 2011

By: /s/ Sidney Hinton  
Sidney Hinton  
President and Chief Executive Officer

Date: May 5, 2011

By: /s/ Christopher T. Hutter  
Christopher T. Hutter  
Executive Vice President, Chief Financial  
Officer,  
Treasurer and Assistant Secretary