

Energy Recovery, Inc.  
Form 10-Q  
November 06, 2009

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**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 September 30, 2009**

**OR**

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

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

**Commission File Number: 001-34112**

**Energy Recovery, Inc.**

(Exact name of registrant as specified in its charter)

**Delaware  
(State of Incorporation)**

**01-0616867  
(IRS Employer Identification No.)**

**1908 Doolittle Drive  
San Leandro, CA 94577  
(Address of Principal Executive Offices)**

**94577  
(Zip Code)**

**(510) 483-7370  
(Telephone No.)**

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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 Exchange Act Rule 12b-2).

Yes  No

As of October 31, 2009, there were 50,165,344 shares of the registrant's common stock outstanding.

**ENERGY RECOVERY, INC.**  
**QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED SEPTEMBER 30, 2009**  
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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements (unaudited)**

**ENERGY RECOVERY, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share data)  
**(unaudited)**

	<b>September 30, 2009</b>	<b>December 31, 2008</b>
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 74,725	\$ 79,287
Restricted cash	2,938	246
Accounts receivable, net of allowance for doubtful accounts of \$28 and \$59 at September 30, 2009 and December 31, 2008, respectively	10,319	20,615
Unbilled receivables, current	6,315	4,948
Inventories	10,510	8,493
Deferred tax assets, net	1,950	1,755
Prepaid income taxes	749	
Prepaid expenses and other current assets	1,515	984
<b>Total current assets</b>	<b>109,021</b>	<b>116,328</b>
Unbilled receivables, non-current	229	1,929
Restricted cash, non-current	2,588	19
Property and equipment, net	7,031	1,845
Intangible assets, net	309	321
Deferred tax assets, non-current, net	106	119
Other assets, non-current	52	51
<b>Total assets</b>	<b>\$ 119,336</b>	<b>\$ 120,612</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 803	\$ 2,270
Accrued expenses and other current liabilities	4,778	4,787
Income taxes payable	38	1,657
Accrued warranty reserve	312	270
Deferred revenue	1,549	4,000
Current portion of long-term debt	128	172
Current portion of capital lease obligations	36	37
<b>Total current liabilities</b>	<b>7,644</b>	<b>13,193</b>
Long-term debt	245	385
Capital lease obligations, non-current		27
Other non-current liabilities	4	8
<b>Total liabilities</b>	<b>7,893</b>	<b>13,613</b>

Commitments and Contingencies (Note 6)

**Stockholders equity:**

Preferred stock, \$0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding

Common stock, \$0.001 par value; 200,000,000 shares authorized; 50,164,317 and 50,015,718 shares issued and outstanding at September 30, 2009 and

December 31, 2008, respectively

Additional paid-in capital

Notes receivable from stockholders

Accumulated other comprehensive loss

Retained earnings

**Total stockholders equity**

**Total liabilities and stockholders equity**

50	50
100,749	98,527
(88)	(296)
(63)	(44)
10,795	8,762
111,443	106,999
\$ 119,336	\$ 120,612

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

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**ENERGY RECOVERY, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share data)  
(unaudited)

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
Net revenue	\$ 9,545	\$ 9,044	\$ 31,280	\$ 30,125
Cost of revenue	3,387	3,497	11,251	11,122
Gross profit	6,158	5,547	20,029	19,003
Operating expenses:				
General and administrative	3,043	2,696	9,705	8,211
Sales and marketing	1,634	1,467	4,795	4,263
Research and development	779	678	2,409	1,723
Total operating expenses	5,456	4,841	16,909	14,197
Income from operations	702	706	3,120	4,806
Other income (expense):				
Interest expense	(10)	(17)	(34)	(62)
Interest and other income (expense), net	30	217	59	841
Income before provision for income taxes	722	906	3,145	5,585
Provision for income taxes	172	283	1,112	2,186
Net income	\$ 550	\$ 623	\$ 2,033	\$ 3,399
Earnings per share:				
Basic	\$ 0.01	\$ 0.01	\$ 0.04	\$ 0.08
Diluted	\$ 0.01	\$ 0.01	\$ 0.04	\$ 0.07
Number of shares used in per share calculations:				
Basic	50,160	49,646	50,120	43,114
Diluted	52,584	52,396	52,614	45,647

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

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**ENERGY RECOVERY, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)  
(unaudited)

	<b>Nine Months Ended</b>	
	<b>September 30,</b>	
	<b>2009</b>	<b>2008</b>
<b>Cash Flows From Operating Activities</b>		
Net income	\$ 2,033	\$ 3,399
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	626	378
Interest accrued on notes receivables from stockholders	(4)	(12)
Stock-based compensation	1,815	676
Net unrealized gain on foreign currency transactions	(458)	(383)
Provision for doubtful accounts	(7)	6
Provision for (reversal of) warranty claims	55	(531)
Provision for excess or obsolete inventory	59	29
Changes in operating assets and liabilities:		
Accounts receivable	10,765	(1,069)
Unbilled receivables	325	495
Inventories	(2,076)	(5,017)
Deferred tax assets	(182)	
Prepaid and other assets	(1,280)	(2,700)
Accounts payable	(1,852)	393
Accrued expenses and other liabilities	(812)	2,653
Income taxes payable	(1,497)	(614)
Deferred revenue	(2,451)	3,489
<b>Net cash provided by operating activities</b>	<b>5,059</b>	<b>1,192</b>
<b>Cash Flows From Investing Activities</b>		
Capital expenditures	(4,635)	(376)
Restricted cash	(5,261)	1,587
Other	(7)	(1)
<b>Net cash (used in) provided by investing activities</b>	<b>(9,903)</b>	<b>1,210</b>
<b>Cash Flows From Financing Activities</b>		
Repayment of long-term debt	(184)	(129)
Repayment of capital lease obligation	(28)	(28)
Net proceeds from issuance of common stock	297	76,808
Repayment of notes receivables from stockholders	212	560
Other short term financing activities		(6)
<b>Net cash provided by financing activities</b>	<b>297</b>	<b>77,205</b>
<b>Effect of exchange rate differences on cash and cash equivalents</b>	<b>(15)</b>	<b>(26)</b>

<b>Net change in cash and cash equivalents</b>	(4,562)	79,581
<b>Cash and cash equivalents, beginning of period</b>	79,287	240
<b>Cash and cash equivalents, end of period</b>	\$ 74,725	\$ 79,821
<b>Supplemental disclosure of cash flow information</b>		
Cash paid for interest	\$ 34	\$ 60
Cash paid for income taxes	\$ 3,545	\$ 4,706
<b>Supplemental disclosure of non-cash transactions</b>		
Issuance of common stock in exchange for notes receivable from stockholders	\$	\$ 20

See accompanying notes to unaudited Condensed Consolidated Financial Statements.



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**ENERGY RECOVERY, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

**Note 1 The Company and Summary of Significant Accounting Policies**

***The Company***

Energy Recovery, Inc. ( the Company or ERI ) develops, manufactures and sells high-efficiency energy recovery devices for use in seawater desalination. Our products are sold under the trademarks ERI<sup>®</sup>, PX<sup>®</sup>, Pressure Exchanger<sup>®</sup> and PX Pressure Exchanger<sup>®</sup>. They make desalination affordable by recycling up to 98% of the otherwise lost pressure energy from the reject stream of the desalination process. Our products are developed and manufactured in the United States of America ( U.S. ) at ERI s headquarters located in San Leandro, California. The Company has direct sales offices and technical support centers in Madrid, Dubai, Shanghai and Fort Lauderdale.

The Company was incorporated in Virginia in April 1992 and reincorporated in Delaware in March 2001. The Company has three subsidiaries: Osmotic Power, Inc., Energy Recovery, Inc. International, and Energy Recovery Iberia, S.L. They were incorporated in September 2005, July 2006 and September 2006, respectively. ERI became a public company in July 2008.

***Use of Estimates***

The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles ( U.S. GAAP ) requires management to make judgments, estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. The Company s most significant estimates and judgments involve the determination of revenue recognition, allowance for doubtful accounts, allowance for product warranty, valuation of the Company s stock and stock-based compensation, reserve for excess and obsolete inventory, deferred taxes and valuation allowances on deferred tax assets. Actual results could materially differ from those estimates.

***Basis of Presentation***

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

The accompanying Condensed Consolidated Financial Statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to such rules and regulations. The December 31, 2008 Condensed Consolidated Balance Sheet was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP; however, the Company believes that the disclosures are adequate to make the information presented not misleading. Certain prior period amounts have been reclassified to conform to the current period presentation. These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the audited Consolidated Financial Statements and the notes thereto for the fiscal year ended December 31, 2008 included in the Company s Annual Report on Form 10-K filed with the SEC on March 27, 2009.

In the opinion of management, all adjustments, consisting of only normal recurring adjustments, which are necessary to present fairly the financial position, results of operations and cash flows for the interim periods, have been made. The results of operations for the interim periods are not necessarily indicative of the operating results for the full fiscal year or any future periods.

The significant accounting policies followed by the Company for interim financial reporting are consistent with the accounting policies followed for annual financial reporting as disclosed in the Company s Annual Report on Form 10-K for the year ended December 31, 2008.

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

**Table of Contents****Recent Accounting Pronouncements**

In June 2009, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2009-1, Topic 105, *Generally Accepted Accounting Principles*, which identifies the FASB Accounting Standards Codification ( ASC or Codification ) as the single source of authoritative U.S. GAAP effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Codification supersedes all non-SEC accounting and reporting standards. All future accounting standards will be issued in the form of Accounting Standards Updates. Generally, the Codification is not expected to change GAAP. The adoption of the Codification did not have any impact on our condensed consolidated financial statements other than changes to references to applicable accounting guidance.

Effective June 30, 2009, the Company adopted ASC 855 10 05, *Subsequent Events*. This ASC establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The adoption of this guidance did not impact the Company's financial position or results of operations. All events or transactions that occurred after September 30, 2009 up through November 6, 2009, the date that these financial statements were available for issuance, have been evaluated. During this period, there were no material recognizable or unrecognizable subsequent events.

In August 2009, the FASB issued ASU No. 2009-05, *Measuring Liabilities at Fair Value*. ASU 2009-05 amends ASC 820, *Fair Value Measurements*, by providing additional guidance on determining the fair value of liabilities when a quoted price in an active market for an identical liability is not available. This ASU will become effective for the Company on October 1, 2009 and is not expected to have a significant impact on the measurement of our liabilities as of that date; however, the ASU may affect the fair value measurement of liabilities for future acquisitions and divestitures.

In October 2009, the FASB issued ASU No. 2009-13, *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements (a consensus of the FASB Emerging Issues Task Force)*, which amends ASC 605-25, *Revenue Recognition: Multiple-Element Arrangements*. ASU No. 2009-13 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting and how to allocate consideration to each unit of accounting in the arrangement. This ASU replaces all references to fair value as the measurement criteria with the term selling price and establishes a hierarchy for determining the selling price of a deliverable. ASU No. 2009-13 also eliminates the use of the residual value method for determining the allocation of arrangement consideration. Additionally, ASU No. 2009-13 requires expanded disclosures. This ASU will become effective for the Company for revenue arrangements entered into or materially modified on or after April 1, 2011. Earlier application is permitted with required transition disclosures based on the period of adoption. We are currently evaluating the application date and the impact of this standard on our consolidated financial statements.

No other new accounting pronouncement issued or effective during the period had or is expected to have a material impact on the consolidated financial statements.

**Note 2 Earnings per Share**

In accordance with SFAS No. 128, *Earnings per Share*, the following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share data):

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
Numerator:				
Net income	\$ 550	\$ 623	\$ 2,033	\$ 3,399
Denominator:				
Weighted average common shares outstanding	50,160	49,646	50,120	43,114
Effect of dilutive securities:				
Nonvested shares				7
Stock options	528	786	582	626

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Warrants	1,896	1,964	1,912	1,900
Total shares for purpose of calculating diluted net income per share	52,584	52,396	52,614	45,647
Earnings per share:				
Basic	\$ 0.01	\$ 0.01	\$ 0.04	\$ 0.08
Diluted	\$ 0.01	\$ 0.01	\$ 0.04	\$ 0.07

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The following potential common shares were excluded from the computation of diluted net income per share because their effect would have been anti-dilutive (in thousands):

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
Stock options	2,877	973	2,196	479
Restricted stock units	60		20	

**Note 3 Balance Sheet Details*****Restricted Cash***

The Company has irrevocable standby letters of credit with two financial institutions securing performance and warranty commitments under contracts with customers and lessors and an outstanding equipment promissory note. The standby letters of credit are collateralized by either a line of credit (see Note 4) or restricted cash. At September 30, 2009 and December 31, 2008, the amount of restricted cash that collateralized irrevocable standby letters of credit was \$5.1 million and \$0.3 million, respectively. At September 30, 2009, restricted cash of \$0.4 million secured the promissory note. The Company has deposited a corresponding amount into non-interest bearing accounts.

***Inventories***

Inventories consisted of the following (in thousands):

	<b>September 30, 2009</b>	<b>December 31, 2008</b>
Raw materials	\$ 4,974	\$ 2,894
Work in process	430	139
Finished goods	5,106	5,460
	\$ 10,510	\$ 8,493

***Property and Equipment***

Property and equipment consisted of the following (in thousands):

	<b>September 30, 2009</b>	<b>December 31, 2008</b>
Machinery and equipment	\$ 2,827	\$ 2,434
Office equipment, furniture, and fixtures	1,100	772
Automobiles	22	22
Software	308	208
Leasehold improvements	476	466
Construction in progress	4,601	
	9,334	3,902
Less: accumulated depreciation and amortization	(2,303)	(2,057)
	\$ 7,031	\$ 1,845

Of the construction in progress costs at September 30, 2009, \$2.5 million related to the construction and installation of specialized manufacturing equipment and \$2.1 million related to the build out of leasehold improvements at the Company's new headquarters and manufacturing facilities. As of September 30, 2009, none of the

assets related to construction in progress have been placed in service and therefore have not yet been subject to depreciation or amortization. See Note 6 for purchase commitments related to these projects.

**Table of Contents*****Accrued Expenses and Other Current Liabilities***

Accrued expenses and other current liabilities consisted of the following (in thousands):

	<b>September 30, 2009</b>	<b>December 31, 2008</b>
Accrued payroll and commission expenses	\$ 2,934	\$ 2,929
Capital projects	760	
Professional fees	428	193
Inventory in transit	83	251
Collaboration fees	111	916
Other accrued expenses and current liabilities	462	498
	<b>\$ 4,778</b>	<b>\$ 4,787</b>

**Note 4 Long-Term Debt*****Promissory Notes***

In February 2009, the Company paid the outstanding balance of a fixed promissory note for a total of \$83,000, including accrued interest.

As of September 30, 2009, long term debt consisted of one equipment promissory note payable. Future minimum principal payments due under this long-term debt arrangement consist of the following (in thousands):

	<b>September 30, 2009</b>
2009 (remaining three months)	\$ 32
2010	128
2011	128
2012	85
	<b>\$ 373</b>

***Credit Agreements***

In February 2009, the Company terminated a March 2008 credit agreement with a financial institution. As a result, during the first quarter of 2009, the Company transferred \$9.1 million in cash to a restricted cash account as collateral for outstanding irrevocable standby letters of credit that were collateralized by the credit agreement as of the date of its termination and as collateral for an outstanding equipment promissory note. During the nine months ended September 30, 2009, \$3.6 million of the restricted cash was released.

Upon the termination of the credit agreement, a new loan and security agreement with another financial institution became effective. The new agreement provides a total available credit line of \$15.0 million. Under the new agreement, the Company is allowed to draw advances up to \$10.0 million on a revolving line of credit or utilize up to \$14.8 million as collateral for irrevocable standby letters of credit, provided that the aggregate of the advances and the collateral do not exceed \$15.0 million. Advances under the revolving line of credit incur interest based on either a prime rate index or LIBOR plus 1.375%. The new agreement expires on December 31, 2009 and is collateralized by substantially all of the Company's assets. The Company is subject to certain financial and administrative covenants under this new agreement. As of September 30, 2009, the Company was in compliance with these covenants.

During the periods presented, the Company provided certain customers with irrevocable standby letters of credit to secure its obligations for the delivery of products, performance guarantees and warranty commitments in accordance with sales arrangements. These letters of credit were issued under the Company's credit line and generally terminate

within 12 to 36 months from issuance. At September 30, 2009 and December 31, 2008, the amounts outstanding on the letters of credit collateralized by the Company's credit line totaled approximately \$4.3 million and \$8.4 million, respectively.

**Note 5 Income Taxes**

The Company's effective tax rate for the nine months ended September 30, 2009 and 2008 was 35.4% and 39.1%, respectively. These effective tax rates differ from the U.S. statutory rate principally due to the effect of state income taxes and non-deductible stock based compensation, offset in part by deductions and credits related to manufacturing and research and development, respectively.

There have been no material changes to the Company's income tax position during the nine months ended September 30, 2009.

**Note 6 Commitments and Contingencies**

*Lease Obligations*

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The Company leases facilities under fixed non-cancelable operating leases that expire on various dates through July 2019. Future minimum lease payments consist of the following (in thousands):

	<b>September 30, 2009</b>
2009 (remaining three months)	\$ 388
2010	1,589
2011	1,407
2012	1,379
2013	1,413
Thereafter	8,560
	<b>\$ 14,736</b>

**Product Warranty**

The Company sells products with a limited warranty for a period ranging from one to five years. The Company accrues for warranty costs based on estimated product failure rates, historical activity and expectations of future costs. The Company periodically evaluates and adjusts the warranty costs to the extent actual warranty costs vary from the original estimates.

The following table summarizes the activity related to the product warranty liability during the three and nine months ended September 30, 2009 and 2008 (in thousands):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2009</b>	<b>2008</b>	<b>2009</b>	<b>2008</b>
Balance at beginning of period	\$ 295	\$ 250	\$ 270	\$ 868
Warranty costs charged to cost of revenue	18	19	55	157
Utilization of warranty	(1)	(21)	(13)	(89)
Reduction of extended warranty reserve				(688)
Balance at end of period	<b>\$ 312</b>	<b>\$ 248</b>	<b>\$ 312</b>	<b>\$ 248</b>

**Purchase Obligations**

In 2008, the Company entered into a supply agreement with a vendor. Under this agreement, the Company is obligated to pay a fee of up to \$250,000 if the Company does not meet minimum purchase requirements by the end of 2011.

As of September 30, 2009, the Company had entered into purchase commitments with multiple vendors for the purchase and installation of specialized manufacturing equipment. If the orders are canceled, the Company is generally obligated to pay the greater of total costs incurred by the vendor through the date of cancellation or a penalty of 10-30% of the original purchase order. As of September 30, 2009, open purchase commitments with these vendors totaled approximately \$0.7 million.

The Company has entered into purchase commitments with multiple vendors for the construction and installation of leasehold improvements at a new corporate headquarters and manufacturing facility. Amounts remaining under these purchase commitments total approximately \$1.7 million as of September 30, 2009.

In addition, the Company had purchase order arrangements related to various key raw materials and components parts with several vendors for which it had not received the related goods or services as of September 30, 2009. These arrangements are subject to change based on the Company's sales demand forecasts and the Company has the right to cancel the arrangements prior to the date of delivery. As of September 30, 2009, the Company had approximately



\$3.8 million of these open purchase order arrangements.

***Guarantees***

The Company enters into indemnification provisions under its agreements with other companies in the ordinary course of business, typically with customers. Under these provisions, the Company generally indemnifies and holds harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of the Company's activities, generally limited to personal injury and property damage caused by the Company's employees at a customer's desalination plant in proportion to the employee's percentage of fault for the accident. Damages incurred for these indemnifications would be covered by the Company's general liability insurance to the extent provided by the policy limitations. The Company has not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the estimated fair value of these agreements is not material. Accordingly, the Company has no liabilities recorded for these agreements as of September 30, 2009 and December 31, 2008.

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In certain cases, the Company issues warranty and product performance guarantees to its customers for amounts ranging from 10% to 30% of the total sales agreement to endorse the execution of product delivery and the warranty of design work, fabrication and operating performance of the PX device. These guarantees are issued in the form of standby letters of credit under the Company's credit facility (see Note 4) or collateralized by restricted cash (see Note 3). These guarantees typically remain in place for periods ranging from 12 to 36 months and, in some cases, up to 65 months, which generally relate to the corresponding underlying product warranty period.

**Employee Agreements**

The Company has an agreement with its chief executive officer governing the terms of his employment. The agreement expires in December 2009.

**Litigation**

The Company is not currently a party to any material litigation, and the Company is not aware of any pending or threatened litigation against it that the Company believes would adversely affect its business, operating results, financial condition or cash flows. However, in the future, the Company may be subject to legal proceedings in the ordinary course of business.

**Note 7 Stockholders Equity****Equity Incentive Plans**

The following table summarizes the stock option activity under the Company's equity incentive plans for the nine months ended September 30, 2009:

		<b>Options Outstanding</b>		
	<b>Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Life (in years)</b>	<b>Aggregate Intrinsic Value (in thousands)(1)</b>
Balance at December 31, 2008	2,531,986	\$5.48	8.6	\$ 6,593
Options granted	1,612,800	7.04		
Options exercised	(148,599)	2.00		
Options forfeited	(138,085)	5.95		
Balance at September 30, 2009	3,858,102	6.25	8.6	\$ 3,638
Vested and exercisable at September 30, 2009	1,062,559	\$4.01	7.35	\$ 2,792

(1) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying options and the fair market value of the Company's stock as of September 30,

2009 of \$5.84 per share. The aggregate intrinsic value excludes the effect of stock options that have a zero or negative intrinsic value.

In July 2009, the Company issued 60,000 restricted stock units to key management team members under the 2008 Equity Incentive Plan. The restricted stock units vest 25% on the first grant date anniversary and 1/48th monthly thereafter dependent upon continued employment. As the restricted stock units vest, the units are settled in shares of common stock based on a one to one ratio. The units are valued based on the market price on the date of grant.

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A summary of the status and changes in restricted stock units for the nine months ended September 30, 2009 is presented below:

	Shares	Weighted Average Grant-Date Fair Value (per share)
Balance at December 31, 2008		\$
Awarded	60,000	7.13
Vested		
Forfeited		
Outstanding at September 30, 2009	60,000	7.13

As of September 30, 2008, 1,034,253 shares are available for issuance under the Company's stock based compensation plans.

**Stock-based Compensation Expense**

For the three and nine months ended September 30, 2009 and 2008, the Company recognized share-based compensation expense related to employees and consultants as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008 (1)	2009	2008 (1)
Cost of revenue	\$ 71	\$ 34	\$ 139	\$ 65
General and administrative	486	149	1,039	290
Sales and marketing	253	122	463	224
Research and development	93	52	174	97
	\$ 903	\$ 357	\$ 1,815	\$ 676

(1) Share-based compensation expense for the three and nine months ended September 30, 2008 included \$12,000 and \$155,000, respectively, related to employee share-based compensation arrangements accounted for in accordance with

the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ). APB 25 is part of a specific class of transactions, referred to as grandfathered GAAP, that is excluded from the initial release of the Codification because entities can no longer apply the guidance to new transactions. The Company did not recognize any expense under APB 25 during the three and nine months ended September 30, 2009.

As of September 30, 2009, total unrecognized compensation cost related to non-vested stock-based awards, net of forfeitures, was \$8.2 million, which is expected to be recognized as expense over a weighted-average period of approximately 3.2 years.

**Note 8 Business Segment and Geographic Information**

The Company manufactures and sells high efficiency energy recovery products and related services and operates under one segment. The Company’s chief operating decision maker is the chief executive officer ( CEO ). The CEO reviews financial information presented on a consolidated basis, accompanied by disaggregated information about revenue by geographic region for purposes of making operating decisions and assessing financial performance. Accordingly, the Company has concluded that it has one reportable segment.

The following geographic information includes net revenue to the Company’s domestic and international customers based on the customers’ requested delivery locations, except for certain cases in which the customer directed the Company to deliver the Company’s products to a location that differs from the known ultimate location of use. In such cases, the ultimate location of use, rather than the delivery location, is reflected in the table below (in thousands, except percentages):

Three Months Ended		Nine Months Ended	
September 30,		September 30,	
2009	2008	2009	2008

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Domestic revenue	\$ 415	\$ 1,442	\$ 1,837	\$ 3,309
International revenue	9,130	7,602	29,443	26,816
Total revenue	\$ 9,545	\$ 9,044	\$ 31,280	\$ 30,125
Revenue by country:				
Israel	33%	5%	32%	3%
Algeria	27	*	25	15
Venezuela	17		5	
United States	4	16	6	11
China	3	30	2	16
Spain	*	17	5	22
Others	16	32	25	33
Total	100%	100%	100%	100%

\* Less than 1%.

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Approximately 100% of the Company's long-lived assets were located in the United States at September 30, 2009 and December 31, 2008.

**Note 9 Concentrations**

Three customers accounted for approximately 46% of the Company's accounts receivable at September 30, 2009. As of December 31, 2008, five customers accounted for approximately 81% of accounts receivable.

Revenue from customers representing 10% or more of net revenue varies from period to period. For the three months ended September 30, 2009, IDE Technologies, Ltd., Acciona Agua, Via Maris Desalination Ltd. and UTE Cap Djinet, a consortium of Inima (Grupo OHL) and Aqualia (Grupo FCC), accounted for approximately 11%, 17%, 21% and 27% of the Company's net revenue, respectively. For the three months ended September 30, 2008, three customers, Hyflux Limited, GE Water and Process Technologies, and Geida, a consortium of Befesa Agua, Cobra-Tedagua, and Sadyt S.A, represented 20%, 14% and 13% of the Company's net revenue, respectively.

For the nine months ended September 30, 2009, IDE Technologies, Ltd. accounted for approximately 30% of net revenue and two consortiums formed by Inima and Aqualia, UTE Mostaganem and UTE Cap Djinet, accounted for approximately 17% and 8% of net revenue, respectively. For the nine months ended September 30, 2008, Multiplex Degremont J.V. and Geida, including its member companies, represented 15% and 19% of the Company's net revenue, respectively.

No other customer accounted for more than 10% of the Company's net revenue during any of these periods.

**Note 10 Related Party Transactions**

The Company entered into a supply agreement with Piedmont Pacific Corporation, a company owned by James Medanich, a former director of the Company. Expenses incurred under this supply agreement amounted to \$19,000 for the three months ended September 30, 2009 and less than \$1,000 for the three months ended September 30, 2008. Expenses incurred under this supply agreement for the nine months ending September 30, 2009 and 2008 were \$53,000 and \$4,000, respectively. There were no outstanding payments due to this vendor as of September 30, 2009 and December 31, 2008. The Company believes that the transactions under the supply agreement were conducted as if consummated on an arm's-length basis between two independent parties.

The Company entered into a consulting agreement with Darby Engineering, LLC (invoiced as Think Mechanical, LLC), a firm owned by Peter Darby, a former director of the Company. No expenses were incurred under this consulting agreement during the three months ended September 30, 2009. Expenses incurred under this consulting agreement amounted to \$32,000 for the three months ending September 30, 2008. For the nine months ending September 30, 2009 and 2008, \$38,000 and \$92,000 in expenses were incurred under this agreement, respectively. No amounts were due to this vendor as of September 30, 2009. A balance of \$27,000 was due to this vendor as of December 31, 2008. The Company believes that the transactions under the consulting agreement were conducted as if consummated on an arm's-length basis between two independent parties.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*This discussion contains forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements in this report include, but are not limited to, statements about our expectations, objectives, anticipations, plans, hopes, beliefs, intentions or strategies regarding the future.*

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

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

- our expectation that our expenditures for research and development will increase;*

- our expectation that we will continue to rely on sales of our PX devices for a substantial portion of our revenue;*

- our expectation that a significant portion of our annual sales will continue to occur during the fourth quarter;*

- our expectation that sales outside of the United States will remain a significant portion of our revenue;*

- our expectation that future sales and marketing expense will increase; and*

- our belief that our existing cash balances and cash generated from our operations will be sufficient to meet our anticipated capital requirements for at least the next 12 months*

*All forward-looking statements included in this document are subject to additional risks and uncertainties further discussed under Part II, Item 1A: Risk Factors and are based on information available to us as of November 6, 2009. We assume no obligation to update any such forward-looking statements. It is important to note that our actual results could differ materially from the results set forth or implied by our forward-looking statements. The factors that could cause our actual results to differ from those included in such forward-looking statements are set forth under the heading Part II, Item 1A: Risk Factors, and our results disclosed from time to time in our reports on Forms 10-K, 10-Q and 8-K and our Annual Reports to Stockholders.*

*The following should be read in conjunction with the condensed financial statements and related notes included in Part I, Item 1: Financial Statements of this quarterly report and the consolidated financial statements and related notes included in our Annual Report on Form 10-K as filed on March 27, 2009.*

**Overview**

We are in the business of designing, developing and manufacturing energy recovery devices for seawater reverse osmosis desalination. Our company was founded in 1992 and we introduced the initial version of our energy recovery device, the PX<sup>®</sup>, in early 1997. As of September 30, 2009, we had shipped approximately 7,100 PX devices to desalination plants worldwide.

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

Due to the fact that a single order for PX devices by a large engineering and construction firm for a particular plant may represent significant revenue, we often experience significant fluctuations in net revenue from quarter to quarter. In addition, our engineering and construction firm customers tend to order a significant amount of equipment for delivery in the fourth quarter and, as a consequence, a significant portion of our annual sales typically occurs during that quarter.



A limited number of our customers accounts for a substantial portion of our net revenue and accounts receivables.  
Revenue from

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customers representing 10% or more of total revenue varies from period to period.

For the three months ended September 30, 2009, four customers accounted for approximately 76% of the Company's net revenue. For the three months ended September 30, 2008, three customers accounted for approximately 47% of the Company's net revenue.

For the nine months ended September 30, 2009, three customers accounted for approximately 55% of the Company's net revenue. For the nine months ended September 30, 2008, two customers accounted for approximately 34% of the Company's net revenue.

As of September 30, 2009, three customers accounted for approximately 46% of our accounts receivable.

During the three and nine months ended September 30, 2009 and 2008, most of our revenue was attributable to sales outside of the United States. We expect sales outside of the United States to remain a significant portion of our revenue for the foreseeable future.

Our revenue is principally derived from the sales of our PX devices. We receive a small amount of revenue from the sale of high pressure circulation pumps, which we manufacture or purchase and sell in connection with PX devices to smaller desalination plants. We also receive incidental revenue from the sales of spare parts and services, such as product support, that we provide to our PX customers.

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

***Third Quarter of 2009 Compared to Third Quarter of 2008*****Results of Operations**

The following table sets forth certain data from our historical operating results as a percentage of revenue for the periods indicated (in thousands, except percentages):

	<b>Three Months Ended September 30,</b>				<b>Change Increase / (Decrease)</b>	
	<b>2009</b>		<b>2008</b>			
<b>Results of Operations:*</b>						
Net revenue	\$ 9,545	100.0%	\$ 9,044	100.0%	\$ 501	6%
Cost of revenue	3,387	35.5%	3,497	38.7%	(110)	(3)%
Gross profit	6,158	64.5%	5,547	61.3%	611	11%
Operating expenses:						
General and administrative	3,043	31.9%	2,696	29.8%	347	13%
Sales and marketing	1,634	17.1%	1,467	16.2%	167	11%
Research and development	779	8.2%	678	7.5%	101	15%
Total operating expenses	5,456	57.2%	4,841	53.5%	615	13%
Income from operations	702	7.4%	706	7.8%	(4)	(1)%
Other income (expense):						
Interest expense	(10)	(0.1)%	(17)	(0.2)%	(7)	(41)%

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Interest income and other income (expense)	30	0.3%	217	2.4%	(187)	86%
Income before provision for income taxes	722	7.6%	906	10.0%	(184)	(20)%
Provision for income taxes	172	1.8%	283	3.1%	(111)	(39)%
Net income	\$ 550	5.8%	\$ 623	6.9%	\$ (73)	(12)%

\* Percentages  
may not add up  
to 100% due to  
rounding.

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Our net revenue increased 6% to \$9.5 million for the three months ended September 30, 2009 from \$9.0 million for the three months ended September 30, 2008. The increase in net revenue is primarily due to an overall increase in the average sales price of PX units resulting largely from increased sales of our higher-capacity PX-260 devices. The overall increase is partially offset by a slight decline in the number of PX units sold, primarily related to OEM customer shipments due to project delays attributable to the global economic downturn and financial market crisis. Additionally, there was a slight increase in service revenue due to efforts targeted at increasing after market sales and services.

For the three months ended September 30, 2009, the sales of PX devices accounted for approximately 89% of our revenue, pump sales accounted for approximately 4% and spare parts and service accounted for 7%. For the three months ended September 30, 2008, the sales of PX devices accounted for approximately 90% of revenue, pump sales accounted for approximately 6%, and spare parts and service accounted for 4%.

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

	<b>Three Months Ended September 30,</b>	
	<b>2009</b>	<b>2008</b>
Domestic revenue	\$ 415	\$ 1,442
International revenue	9,130	7,602
<b>Total revenue</b>	<b>\$ 9,545</b>	<b>\$ 9,044</b>
Revenue by country:		
Israel	33%	5%
Algeria	27	*
Venezuela	17	
United States	4	16
China	3	30
Spain	*	17
Others	16	32
<b>Total</b>	<b>100%</b>	<b>100%</b>

\* Less than 1%.

**Gross Profit**

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including stock-based compensation), manufacturing overhead, warranty costs, capital costs, excess and obsolete inventory expense, and manufactured components. The largest component of our cost of revenue is raw materials, primarily ceramic materials, which we obtain from multiple suppliers. For the three months ended September 30, 2009, gross profit as a percentage of net revenue was 64.5%. For the three months ended September 30, 2008, gross profit as a percentage of net revenue was 61.3%. The increase in gross margin as a percentage of net revenue was largely due to a higher average selling price during the third quarter of 2009 as compared to the third quarter of 2008 resulting largely from increased sales of our higher-capacity PX-260 devices.

Stock compensation expense included in cost of revenue was \$71,000 and \$34,000 for the three months ended September 30, 2009 and September 30, 2008, respectively.

Future gross profit as a percentage of net revenue is highly dependent on the product and customer mix of our future sales. Accordingly, we are not able to predict our future gross profit percentages with certainty.

*General and Administrative Expense*

General and administrative expense increased by \$347,000, or 13%, to \$3.0 million for the three months ended September 30, 2009 from \$2.7 million for the three months ended September 30, 2008. As a percentage of net revenue, general and administrative expense was 31.9% for the three months ended September 30, 2009 and 29.8% for the three months ended September 30, 2008. The increase of general and administrative expense was attributable primarily to the increase in general and administrative headcount and professional services to support our growth in operations and to support the requirements for operating as a public company. General and administrative average headcount increased to 36 for the third quarter of 2009 from 27 for the third quarter of 2008.

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Of the \$347,000 increase in general and administrative expense, increases of \$379,000 related to compensation and employee-related benefits, \$241,000 related to professional services and \$48,000 related to occupancy and other administrative costs were offset in part by a decrease of \$272,000 related to bad debt expense and \$49,000 related to Value Added Taxes (VAT). Stock-based compensation expense included in general and administrative expense was \$486,000 for the three months ended September 30, 2009 and \$149,000 for the three months ended September 30, 2008.

*Sales and Marketing Expense*

Sales and marketing expense increased by \$167,000, or 11%, to \$1.6 million for the three months ended September 30, 2009 from \$1.5 million for the three months ended September 30, 2008. This increase was primarily related to the growth in our sales force that resulted in higher average headcount with sales and marketing average headcount increasing to 22 for the third quarter of 2009 from 20 for the third quarter of 2008.

As a percentage of our net revenue, sales and marketing expense increased slightly to 17% for the three months ended September 30, 2009 compared to 16% for the three months ended September 30, 2008. The increase was attributable primarily to our net revenue growing at a slightly lesser rate than our sales and marketing expense during the third quarter of 2009 compared to the same period last year.

Of the \$167,000 net increase in sales and marketing expense for the three months ended September 30, 2009, \$227,000 related to compensation, employee-related benefits and commissions to outside sales representatives and \$16,000 related to occupancy and other administrative costs. The increases were partially offset by a decrease of \$76,000 related to other sales and marketing costs. Stock-based compensation expense included in sales and marketing expense was \$253,000 for the three months ended September 30, 2009 and \$122,000 for the three months ended September 30, 2008.

We expect that our future sales and marketing expense will increase in absolute dollars as we continue to develop our sales and marketing operations.

*Research and Development Expense*

Research and development expense increased by \$101,000, or 15%, to \$779,000 for the three months ended September 30, 2009 from \$678,000 for the three months ended September 30, 2008. This increase was primarily attributable to recent efforts to develop and strengthen our expertise in ceramics material science.

As a percentage of our net revenue, research and development expense remained constant at 8% for the three months ended September 30, 2009 compared to the three months ended September 30, 2008, as research and development expense increased at approximately the same rate as net revenue for those periods.

Of the \$101,000 increase, increases of \$122,000 related to compensation and employee-related benefits and \$49,000 related to occupancy and other miscellaneous costs were partially offset by decreases of \$39,000 related to research and development direct project costs and \$31,000 related to consulting and professional service.

Average headcount in our research and development department increased to 11 for the third quarter of 2009 from nine for the third quarter of 2008. Stock-based compensation expense included in research and development expense was \$93,000 for three months ended September 30, 2009 and \$52,000 for the three months ended September 30, 2008.

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

*Other Income, Net*

Other income, net, decreased \$180,000 to \$20,000 for the three months ended September 30, 2009 from \$200,000 for the three months ended September 30, 2008. The decrease was primarily due to a decrease in interest income of \$402,000 as a result of lower

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interest rates during the third quarter of 2009 compared to the third quarter of 2008. This decrease was partially offset by a favorable change of \$215,000 related to net foreign currency gains and losses as a result of a decrease in our foreign currency denominated contracts and favorable changes in foreign currency rates for the three months ended September 30, 2009 compared to the three months ended September 30, 2008. Additionally, interest expense decreased \$7,000 as a result of a reduction of debt in the first quarter of 2009.

***Nine Months Ended September 30, 2009 Compared to Nine Months Ended September 30, 2008*****Results of Operations**

The following table sets forth certain data from our historical operating results as a percentage of revenue for the periods indicated (in thousands, except percentages):

	<b>Nine Months Ended September 30,</b>				<b>Change</b>	
	<b>2009</b>		<b>2008</b>		<b>Increase /</b>	<b>(Decrease)</b>
<b>Results of Operations:*</b>						
Net revenue	\$ 31,280	100.0%	\$ 30,125	100.0%	\$ 1,155	4%
Cost of revenue	11,251	36.0%	11,122	36.9%	129	1%
Gross profit	20,029	64.0%	19,003	63.1%	1,026	5%
Operating expenses:						
General and administrative	9,705	31.0%	8,211	27.3%	1,494	18%
Sales and marketing	4,795	15.3%	4,263	14.2%	532	12%
Research and development	2,409	7.7%	1,723	5.7%	686	40%
Total operating expenses	16,909	54.1%	14,197	47.1%	2,712	19%
Income from operations	3,120	10.0%	4,806	16.0%	(1,686)	(35)%
Other income (expense):						
Interest expense	(34)	(0.1)%	(62)	(0.2)%	(28)	(45)%
Interest income and other income (expense)	59	0.2%	841	2.8%	(782)	(93)%
Income before provision for income taxes	3,145	10.1%	5,585	18.5%	(2,440)	(44)%
Provision for income taxes	1,112	3.6%	2,186	7.3%	(1,074)	(49)%
Net income	\$ 2,033	6.5%	\$ 3,399	11.3%	\$ (1,366)	(40)%

\* Percentages may not add up to 100% due to rounding.

Our net revenue increased by \$1.2 million, or 4%, to \$31.3 million for the nine months ended September 30, 2009 from \$30.1 million for the nine months ended September 30, 2008. The increase in net revenue is primarily due to an increase in the average sales price of PX units resulting largely from increased sales of our higher-capacity PX-260 devices. The overall increase is partially offset by a slight decline in the number of PX units sold, primarily related to OEM customer shipments due to project delays attributable to the global economic downturn and financial market crisis. Additionally, there was a slight increase in service revenue due to efforts targeted at increasing after market

sales and services.

For the nine months ended September 30, 2009, the sales of PX devices accounted for approximately 90% of our revenue, pump sales accounted for approximately 5% and spare parts and service accounted for 5%. For the nine months ended September 30, 2008, the sales of PX devices accounted for approximately 92% of revenue, pump sales accounted for approximately 5%, and spare parts and service accounted for 3%.

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



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	<b>Nine Months Ended September 30,</b>	
	<b>2009</b>	<b>2008</b>
Domestic revenue	\$ 1,837	\$ 3,309
International revenue	29,443	26,816
<b>Total revenue</b>	<b>\$ 31,280</b>	<b>\$ 30,125</b>
Revenue by country:		
Israel	32%	3%
Algeria	25	15
United States	6	11
Spain	5	22
China	2	16
Others	30	33
<b>Total</b>	<b>100%</b>	<b>100%</b>

\* Less than 1%.

*Gross Profit*

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including stock-based compensation), manufacturing overhead, warranty costs, capital costs, excess and obsolete inventory expense, and manufactured components. The largest component of our cost of revenue is raw materials, primarily ceramic materials, which we obtain from multiple suppliers. For the nine months ended September 30, 2009, gross profit as a percentage of net revenue was 64.0%, as compared to 60.8% for the nine months ended September 30, 2008, excluding the reversal of a warranty provision in the amount of \$688,000, or 2.3%, related to the cancellation of an extended product warranty contract. The increase in gross margin as a percentage of net revenue, when adjusted for the one time warranty provision reversal in 2008, was largely due to a higher average selling price during the first nine months of 2009 as compared to the first nine months of 2008 resulting largely from increased sales of our higher-capacity PX-260 devices.

Stock compensation expense included in cost of revenue was \$139,000 and \$65,000 for the nine months ended September 30, 2009 and September 30, 2008, respectively.

Future gross profit as a percentage of net revenue is highly dependent on the product and customer mix of our future sales. Accordingly, we are not able to predict our future gross profit percentages with certainty.

*General and Administrative Expense*

General and administrative expense increased by \$1.5 million, or 18%, to \$9.7 million for the nine months ended September 30, 2009 from \$8.2 million for the nine months ended September 30, 2008. As a percentage of net revenue, general and administrative expense was 31% for the nine months ended September 30, 2009 and 27% for the nine months ended September 30, 2008. The increase of general and administrative expense was attributable primarily to the increase in general and administrative headcount to support our growth in operations and to support the requirements for operating as a public company. General and administrative average headcount increased to 35 for the nine months ended September 30, 2009 from 21 for the nine months ended September 30, 2008.

Of the \$1.5 million increase in general and administrative expense, increases of \$2.1 million in compensation and employee-related benefits and \$110,000 in occupancy and other administrative costs were partially offset by decreases of \$495,000 in professional services and \$211,000 in Value Added Taxes (VAT). Stock-based compensation expense included in general and administrative expense was \$1.0 million for the nine months ended September 30, 2009 and

\$290,000 for the nine months ended September 30, 2008.

*Sales and Marketing Expense*

Sales and marketing expense increased by \$532,000, or 12%, to \$4.8 million for the nine months ended September 30, 2009 from \$4.3 million for the nine months ended September 30, 2008. This increase was primarily related to growth in our sales force that resulted in higher headcount with sales and marketing average headcount increasing to 21 for the nine months ended September 30, 2009 from 18 for the nine months ended September 30, 2008. In addition, our sales team is compensated in part by commissions, resulting in increased sales expense as our sales increase.

As a percentage of our net revenue, sales and marketing expense increased to 15% for the nine months ended September 30, 2009 from 14% for the nine months ended September 30, 2008. The increase in 2009 was attributable primarily to our net revenue growing at a slightly lesser rate than our sales and marketing expense during the first nine months of 2009.

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Of the net increase in sales and marketing expense for the nine months ended September 30, 2009, \$581,000 related to compensation, employee-related benefits and commissions to outside sales representatives and \$49,000 related to occupancy and other administrative costs. These increases were partially offset by a decrease of \$98,000 related to other sales and marketing costs. Stock-based compensation expense included in sales and marketing expense was \$463,000 for the nine months ended September 30, 2009 and \$224,000 for the nine months ended September 30, 2008.

We expect that our future sales and marketing expense will increase in absolute dollars as we continue to develop our sales and marketing operations.

*Research and Development Expense*

Research and development expense increased by \$686,000, or 40%, to \$2.4 million for the nine months ended September 30, 2009 from \$1.7 million for the nine months ended September 30, 2008. As a percentage of our net revenue, research and development expense increased to 8% for the nine months ended September 30, 2009 compared to 6% for the nine months ended September 30, 2008. The increase in expense was primarily attributable to recent efforts to develop and strengthen our expertise in ceramics material science.

Of the \$686,000 increase, compensation and employee-related benefits accounted for \$384,000, research and development direct project costs accounted for \$140,000, consulting and professional service fees accounted for \$103,000, and occupancy and other miscellaneous costs accounted for \$59,000.

Average headcount in our research and development department increased to 10 for the nine months ended September 30, 2009 from eight for the nine months ended September 30, 2008. Stock-based compensation expense included in research and development expense was \$174,000 for the nine months ended September 30, 2009 and \$97,000 for the nine months ended September 30, 2008.

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

*Other Income, Net*

Other income, net, decreased \$754,000 to \$25,000 for the nine months ended September 30, 2009 from \$779,000 for the nine months ended September 30, 2008. The change was primarily due to decreases in interest income and gains/(losses) from foreign currency transactions. Lower money market interest rates resulted in a \$369,000 reduction in interest income during the nine months ended September 30, 2009 compared to the nine months ended September 30, 2008. A reduction in foreign currency denominated contracts and unfavorable changes in foreign currency rates resulted in a net loss from foreign currency transactions of \$(30,000) for the nine months ended September 30, 2009 compared to a net gain of \$383,000 for the same period last year, an unfavorable change of \$413,000. The unfavorable changes in other income, net, were slightly offset by a decrease in net interest expense of \$28,000 resulting from the reduction of debt during the first quarter of 2009.

**Liquidity and Capital Resources***Overview*

Our primary source of cash historically has been proceeds from the issuance of common stock, customer payments for our products and services, and borrowings under our credit facility. From January 1, 2005 through September 30, 2009, we issued common stock for aggregate net proceeds of \$83.8 million, excluding common stock issued in exchange for promissory notes. The proceeds from the sales of common stock have been used to fund our operations and capital expenditures.

As of September 30, 2009, our principal sources of liquidity consisted of cash and cash equivalents of \$74.7 million, which are invested primarily in money market funds, and accounts receivable of \$10.3 million.

In February 2009, we terminated a March 2008 credit agreement with a financial institution. As a result, we transferred \$9.1 million in cash to a restricted cash account as collateral for outstanding irrevocable standby letters of credit that were collateralized by the credit agreement as of the date of its termination and collateral for the outstanding equipment promissory note. During the nine

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months ended September 30, 2009, \$3.6 million of the restricted cash was released.

Upon the termination of the credit agreement, a new loan and security agreement with another financial institution became effective. The new agreement provides a total available credit line of \$15.0 million. Under the new agreement, we are allowed to draw advances up to \$10.0 million on a revolving line of credit or utilize up to \$14.8 million as collateral for irrevocable standby letters of credit, provided that the aggregate of the advances and the collateral do not exceed \$15.0 million. Advances under the revolving line of credit incur interest based on either a prime rate index or LIBOR plus 1.375%. The new agreement expires on December 31, 2009 and is collateralized by substantially all of the company's assets. As of September 30, 2009, we were in compliance with all financial and administrative covenants under this new agreement.

During the periods presented, we provided certain customers with irrevocable standby letters of credit to secure our obligations for the delivery of products, performance guarantees and warranty commitments in accordance with sales arrangements. Some of these letters of credit were issued under our revolving note credit facility. The letters of credit generally terminate within 12 to 36 months, and in some cases up to 65 months, from issuance. At September 30, 2009, the amounts outstanding on irrevocable letters of credit collateralized under our credit agreement totaled approximately \$4.3 million.

***Cash Flows from Operating Activities***

Net cash provided by operating activities was \$5.1 million and \$1.2 million for the nine months ended September 30, 2009 and 2008, respectively. For the nine months ended September 30, 2009 and 2008, net income of \$2.0 million and \$3.4 million, respectively, was adjusted to \$4.1 million and \$3.6 million, respectively, by non-cash items totaling \$2.1 million and \$0.2 million respectively. Non-cash items include depreciation and amortization expense, unrealized gains and losses on foreign exchange, stock-based compensation expense, and provisions for doubtful accounts, warranty reserves and excess and obsolete inventory. Changes in assets and liabilities created net cash inflow effect of approximately \$1.0 million and a net cash outflow effect of approximately \$(2.4) million for the nine months ended September 30, 2009 and 2008, respectively. Net changes in assets and liabilities are primarily attributable to changes in accounts receivable and unbilled receivables as a result of timing of invoices and collections for large projects, increases in inventory as a result of the growth of our business, changes in prepaid expenses and accrued liabilities as a result of the timing of payments to employees, vendors and other third parties, and changes in deferred revenue as a result of timing of advance billings and product deliveries.

***Cash Flows from Investing Activities***

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

Net cash (used in) provided by investing activities was \$(9.9) million and \$1.2 million for the nine months ended September 30, 2009 and 2008, respectively. The change to net cash used in investing activities during the first nine months of 2009 from net cash provided by investing activities during the first nine months of 2008 was primarily due to a net increase of \$6.8 million in cash used to collateralize letters of credit and equipment loans. Additionally, cash used for purchases of plant, property and equipment increased \$4.3 million during the first nine months of 2009 compared to the first nine months of 2008 due to the purchase of manufacturing equipment and the integration of a new manufacturing, administrative and warehouse facility during the nine months ended September, 30 2009.

***Cash Flows from Financing Activities***

Net cash provided by financing activities decreased \$76.9 million to \$0.3 million for the nine months ended September 30, 2009 from \$77.2 million for the nine months ended September 30, 2008. The decrease in net cash flows from financing activities is primarily due to the receipt of IPO net proceeds of \$76.7 million in July 2008. Additionally, a decrease in repayments of promissory notes by stockholders and an increase in long term debt payments reduced net cash provided by financing by \$0.4 million during the nine months ended September 30, 2009 compared to the nine months ended September 30, 2008. The decreases are partially offset by a net increase in proceeds from stock option exercises and other financing activities of \$0.2 million.

***Liquidity and Capital Resource Requirements***

We believe that our existing cash balances and cash generated from our operations will be sufficient to meet our anticipated capital requirements for at least the next 12 months. However, we may need to raise additional capital or

incur additional indebtedness to continue to fund our operations in the future. Our future capital requirements will depend on many factors, including our rate of

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revenue growth, if any, the expansion of our sales and marketing and research and development activities, the timing and extent of our expansion into new geographic territories, the timing of introductions of new products and the continuing market acceptance of our products. We may enter into potential material investments in, or acquisitions of, complementary businesses, services or technologies, in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

**Contractual Obligations**

We lease facilities under fixed non-cancelable operating leases that expire on various dates through 2019. The total of the future minimum lease payments under these leases as of September 30, 2009 is \$14.7 million. For additional information, see Note 6 Commitments and Contingencies to the unaudited Condensed Consolidated Financial Statements.

As of September 30, 2009, we entered into purchase commitments with multiple vendors for the purchase and installation of specialized manufacturing equipment. If the orders are canceled, we are generally obligated to pay the greater of total costs incurred by the vendor through the date of cancellation or a penalty of 10-30% of the original purchase order. As of September 30, 2009, open purchase commitments with these vendors totaled approximately \$0.7 million.

Recently, we entered into purchase commitments with multiple vendors for the construction and installation of leasehold improvements at a new corporate headquarters and manufacturing facility. Amounts remaining under these purchase commitments total approximately \$1.7 million as of September 30, 2009.

In the course of our normal operations, we also entered into purchase commitments with our suppliers for various key raw materials and components parts. The purchase commitments covered by these arrangements are subject to change based on our sales forecasts for future deliveries and we have the right to cancel the arrangements prior to the date of delivery. As of September 30, 2009, these open purchase orders totaled approximately \$3.8 million.

We have agreements with guarantees or indemnity provisions that we have entered into with, among others, customers and OEMs in the ordinary course of business. Based on our experience and information known to us as of September 30, 2009, we believe that our exposure related to these guarantees and indemnities as of September 30, 2009 was not material.

**Off-Balance Sheet Arrangements**

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

**Recent Accounting Pronouncements**

See Note 1 The Company and Summary of Significant Accounting Policies to the condensed consolidated financial statements regarding the impact of certain recent accounting pronouncements on our condensed consolidated financial statements.

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

The information in this section should be read in connection with the information on financial market risk related to changes in non-U.S. currency exchange rates and interest rates in Part II, Item 7A, Quantitative and Qualitative Disclosures About Market Risk, in our Annual Report on Form 10-K for the year ended December 31, 2008.

***Foreign Currency Risk***

Currently, the majority of our revenue contracts have been denominated in United States dollars. In some circumstances, we have priced certain international sales in Euros.

As we expand our international sales, we expect that a portion of our revenue could continue to be denominated in foreign currencies. As a result, our cash and cash equivalents and operating results could be increasingly affected by changes in exchange rates. Our international sales and marketing operations incur expense that is denominated in foreign currencies. This expense could be materially affected by currency fluctuations. Our exposures are primarily due to fluctuations in exchange rates for the United States dollar versus the Euro. Changes in currency exchange rates could adversely affect our consolidated operating results or financial



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position. Additionally, our international sales and marketing operations maintain cash balances denominated in foreign currencies. In order to decrease the inherent risk associated with translation of foreign cash balances into our reporting currency, we have not maintained excess cash balances in foreign currencies. We have not hedged our exposure to changes in foreign currency exchange rates because expenses in foreign currencies have been insignificant to date, and exchange rate fluctuations have had little impact on our operating results and cash flows.

**Interest Rate Risk**

At September 30, 2009, we had cash and cash equivalents totaling \$80.3 million, including restricted cash of \$5.5 million. These amounts were invested primarily in a money market fund backed by U.S. Treasury securities. The unrestricted cash and cash equivalents are held for working capital purposes, capital expenditures and possible future acquisitions. We do not enter into investments for trading or speculative purposes. We believe that we do not have any material exposure to changes in the fair value as a result of changes in interest rates due to the short term nature of our cash and cash equivalents. Declines in interest rates, however, would reduce future interest income.

**Concentration of Credit Rate Risk**

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

**Item 4. Controls and Procedures.**

Under the supervision and with the participation of our management, including the President and Chief Executive Officer and the Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended September 30, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Part II OTHER INFORMATION****Item 1. Legal Proceedings**

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

**Item 1A. Risk Factors**

*We have relied and expect to continue to rely on sales of our PX devices for almost all of our revenue; a decline in demand for desalination, reverse osmosis desalination or our PX devices will reduce demand for our products and will cause our sales and revenue to decline.*

Our primary product is the PX device, and sales of our PX device historically have accounted for a high percentage of our revenue. While we sell a variety of models of the PX device depending on the design of the desalination plant and its desired output, all of our models rely on the same basic technology developed and refined over the past 12 years. We expect that the revenue from our PX devices will continue to account for most of our revenue for the foreseeable future. Any factors adversely affecting the demand for desalination, including changing weather patterns, increased precipitation, new technology for producing fresh water, increased water conservation or reuse, new energy technology or reduced energy costs, changes in the global economy, and political changes, would reduce the demand for PX devices and would cause a significant decline in our revenue. Similarly, any other factors adversely affecting the demand for our PX devices, including new methods of desalination that reduce pressure and energy requirements, improvements in membrane technology, new energy recovery technology, changes in customer spending priorities and industry regulations would also cause a significant decline in our revenue.

Some of the factors that may affect sales of our PX device may be out of our control.



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

We derive substantially all of our revenue from sales of products and services used in desalination plants for municipalities, hotels, resorts and agricultural operations in dry or drought-ridden regions of the world. The demand for our products may decrease if the construction of desalination plants declines, especially in these regions. Other factors could affect the number and capacity of desalination plants built or the timing of their completion, including the current weak global economy, the current crisis in the credit and banking systems, changes in government priorities, changes in governmental regulations, reduced capital spending for desalination and lower energy costs, which could result in cancelled orders or delays in plant construction and the installation of our products. As a result of these factors, we have experienced and may in the future experience significant variability in our revenue, on both an annual and a quarterly basis. Pronounced variability, extended delays or reductions in spending with respect to the construction of desalination plants could negatively impact our sales and revenue and make it difficult for us to accurately forecast our future sales, which could lead to increased spending by us that is not matched by equivalent or higher revenue.

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

Planned seawater reverse osmosis desalination projects can be cancelled or delayed due to delays in, or failure to obtain, financing or the approval of or permitting for, plant construction because of political factors, adverse and increasingly uncertain financing conditions or other factors, especially in countries with political unrest. Even though we may have a signed contract to provide a certain number of PX devices by a certain date, if a customer requests a delay of shipment and we delay shipment of our PX devices, our results of operations and revenue will be negatively impacted.

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

A limited number of our customers can account for a substantial portion of our net revenue. Revenue from engineering and construction firms and other customers representing 10% or more of total revenue varies from year to year. See Note 9 Concentrations to the condensed consolidated financial statements regarding the impact of customer concentrations on our condensed consolidated financial statements. We do not have long-term contracts with our customers; instead, we sell to them on a purchase order or project basis or under individual stand-alone contracts. Orders may be postponed or delayed by our customers on short or no notice. If these customers reduce their purchases, our projected revenue may significantly decrease, which will adversely affect our financial condition and future growth. If one of our engineering and construction firm customers delays or cancels one or more of its projects, or if it fails to pay amounts due to us or delays its payments, our revenue or operating results could be negatively affected. There are a limited number of engineering and construction firms which are involved in the desalination industry. Thus, if one of them decides not to continue to use our energy recovery devices in its future projects, we may not be able to replace such a lost customer with another such customer and our net revenue would be negatively affected.

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

The market for energy recovery devices for desalination plants is competitive and continually evolving. The PX device competes with slow cycle isobaric, turbine and hydraulic energy recovery devices. Our three primary competitors are Flowserve Corporation, which recently acquired Calder AG, Fluid Equipment Development Company and Pump Engineering Incorporated. Other potential competitors may enter the market. We expect competition, especially competition on price to persist and intensify as the desalination market opportunity grows. Some of our current and potential competitors, including Flowserve, may have significantly greater financial, technical, marketing and other resources than we do and may be able to devote greater resources to the development, promotion, sale and

support of their products. Also, our competitors may have more extensive customer bases and broader customer relationships than we do, including long-standing relationships or exclusive contracts with our current or potential customers. For instance, we have had difficulties penetrating some of the Caribbean markets because Consolidated Water Co. Ltd., a major builder of seawater reverse osmosis desalination plants in that area, has an exclusive agreement with Calder AG to use Calder's technology. In addition, our competitors may have longer operating histories and greater name recognition than we do. Our competitors may be in a stronger position to respond quickly to new technologies and may be able to market and sell their products more effectively.

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Moreover, if another one or more of our competitors were to merge or partner with another company, the change in the competitive landscape could adversely affect our ability to compete effectively which would affect our business, operating results and financial condition.

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

Current economic conditions may continue to negatively impact our business and make forecasting future operating results more difficult and uncertain. For example, due to project delays related to the global economic downturn, we experienced a decrease in shipments to OEM customers during the second and third quarters of 2009. A weakening global economy may continue to cause our customers to delay or push out orders for our products or may result in the delay, postponement or canceling of planned or new desalination projects or retrofits, which would reduce our revenue. Turmoil in the financial and credit markets may also make it difficult for our customers to obtain needed project financing, resulting in lower sales. Negative economic conditions may also affect our suppliers, which could impede their ability to remain in business and supply us with parts, resulting in delays in the availability of our products. In addition, most of our cash and cash equivalents are currently invested in money market funds backed by United States Treasury securities; however, given the current weak global economy and the instability of financial institutions, we cannot be assured that we will not experience losses on our deposits, which would adversely affect our financial condition. If current economic conditions persist or worsen and negatively impact the desalination industry, our business, financial condition or results of operations could be materially and adversely affected.

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

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

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

fluctuations in demand, adoption, sales cycles and pricing levels for our products and services;

the cyclical nature of purchasing for seawater reverse osmosis desalination plant construction, which typically reflects a seasonal increase in shipments of PX devices in the fourth quarter;

changes in customers' budgets for desalination plants and the timing of their purchasing decisions;

adverse changes in the local or global financing conditions facing our customers;

delays or postponements in the construction of desalination plants;

our ability to develop, introduce and ship in a timely manner new products and product enhancements that meet customer demand, certification requirements and technical requirements;

the ability of our customers to obtain other key components of a plant such as high pressure pumps or membranes;

our ability to implement scalable internal systems for reporting, order processing, product delivery, purchasing, billing and general accounting, among other functions;

unpredictability of governmental regulations and political decision-making as to the approval or building of a desalination plant;

our ability to control costs, including our operating expenses;

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our ability to purchase key PX components, principally ceramics, from third party suppliers;

our ability to compete against other companies that offer energy recovery solutions;

our ability to attract and retain highly skilled employees, particularly those with relevant industry experience;  
and

general economic conditions in our domestic and international markets.

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

Our customer contracts generally contain holdback provisions pursuant to which the final installments to be paid under such sales contracts are due up to 24 months after the product has been shipped to the customer and revenue has been recognized. Typically, between 10 and 20%, and in some instances up to 30% of the revenue we receive pursuant to our customer contracts are subject to such holdback provisions and are accounted for as unbilled receivables until we deliver invoices for payment. As of September 30, 2009, we had approximately \$6.3 million of current unbilled receivables and approximately \$229,000 of non-current unbilled receivables. If we are unable to invoice and collect, or if our customers fail to make payments due under our sales contracts, our results of operations will be adversely affected.

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

Given the specialized nature of our business, we must hire highly skilled professionals with industry-specific experience. Our ability to successfully grow depends on recruiting skilled and experienced employees. We often compete with larger, better known companies for talented employees. Also, retention of key employees, such as our chief executive officer, who has over 30 years of experience in the water treatment industry, is vital to the successful execution of our growth strategies. Our failure to retain existing or attract future key personnel could harm our business.

***The success of our business depends in part on our ability to develop new products and services and increase the functionality of our current products.***

Since 2004, we have invested more than \$7 million in research and development costs associated with our PX products. From time to time, our customers have expressed a need for greater processing efficiency. In response, and as part of our strategy to enhance our energy recovery solutions and grow our business, we plan to continue to make substantial investments in the research and development of new technologies. While new products have the potential to meet specified needs of key markets, their pricing may not meet customer expectations and they may not perform as well as our other PX devices. It is possible that potential customers may not accept new pricing structures. It is also possible that the release of new products may be delayed if testing reveals unexpected flaws. Our future success will depend in part on our ability to continue to design and manufacture new products, to enhance our existing products and to provide new value-added services. We may experience unforeseen problems in the performance of our existing and new technologies or products. Furthermore, we may not achieve market acceptance of our new products and solutions. If we are unable to develop competitive new products, or if the market does not accept such products, our business and results of operations will be adversely affected.

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

We currently outsource the production of our ceramic components from a limited number of ceramic vendors. To diversify our supply of ceramics and retain more control over our intellectual property, we intend to vertically integrate by producing a portion of our ceramic component needs in house. If we are less efficient at producing our ceramic components or are unable to achieve required yields that are equal to or greater than the vendors to which we outsource, then our cost of revenue may be adversely affected. If we are unable to initiate the production of our ceramics parts on schedule, unable to manufacture these parts in-house efficiently and/or another of our ceramics suppliers goes out of business, we may be exposed to increased risk of supply chain disruption and capacity shortages.

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

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If there is a downturn in the seawater reverse osmosis desalination industry, our sales would be directly and adversely impacted. Changes in seawater reverse osmosis desalination technology could also reduce the demand for our devices. For example, a reduction in the operating pressure used in seawater reverse osmosis desalination plants could reduce the need for and viability of our energy recovery devices. Membrane manufacturers are actively working on lower pressure membranes for seawater reverse osmosis desalination that could potentially be used on a large scale to desalinate seawater at a much lower pressure than is currently necessary. Engineers are also evaluating the possibility of diluting seawater prior to reverse osmosis desalination to reduce the required membrane pressure. Similarly, an increase in the recovery rate would reduce the number of energy recovery devices required and would reduce the demand for our product. A significant reduction in the cost of power may reduce demand for our product or favor a less expensive product from a competitor. Any of these changes would adversely impact our revenue and growth.

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

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

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

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

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

A significant portion of our annual sales typically occurs during the fourth quarter, which we believe generally reflects engineering and construction firm customer buying patterns. Any delays or cancellation of expected sales during the fourth quarter would reduce our quarterly and annual revenue from what we anticipated. Such a reduction might cause our quarterly and annual revenue or quarterly and annual operating results to fall below the expectations of investors or securities analysts or below any guidance we may provide to the market, causing the price of our common stock to decline.

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

We rely on a limited number of vendors to produce the ceramics used in our products. Two ceramics vendors provided all ceramic components purchased during the nine months ended September 30, 2009. If any of our ceramic suppliers were to have financial difficulties, cancel or materially change their commitments with us or fail to meet the quality or delivery requirements needed to satisfy customer orders for our products, we could lose customer orders, be unable to develop or sell our products cost-effectively or on a timely basis, if at all, and have significantly decreased revenue, which would harm our business, operating results and financial condition.

***We depend on single suppliers for some of our components, including stainless steel castings. If our suppliers are not able to meet our demand and/or requirements, our business could be harmed.***

We rely on single suppliers to produce certain components, including all of our stainless steel castings, for use in our PX products. Our reliance on single manufacturers for these parts involves a number of significant risks, including reduced control over delivery schedules, quality assurance, manufacturing yields, production costs and lack of guaranteed production capacity or product supply. We do not have a long term supply agreement with these suppliers and instead secure manufacturing availability on a purchase order



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basis. Our suppliers have no obligation to supply products to us for any specific period, in any specific quantity or at any specific price, except as set forth in a particular purchase order. Our requirements represent a small portion of the total production capacities of these suppliers and our suppliers may reallocate capacity to other customers, even during periods of high demand for our products. We have in the past experienced and may in the future experience quality control issues and delivery delays with our suppliers due to factors such as high industry demand or the inability of our vendors to consistently meet our quality or delivery requirements. If our suppliers were to cancel or materially change its commitment with us or fail to meet the quality or delivery requirements needed to satisfy customer orders for our products, we could lose time-sensitive customer orders, be unable to develop or sell our products cost-effectively or on a timely basis, if at all, and have significantly decreased revenue, which would harm our business, operating results and financial condition. We may qualify additional suppliers in the future which would require time and resources. If we do not qualify additional suppliers, we may be exposed to increased risk of capacity shortages due to our complete dependence on our current supplier.

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

We provide a warranty for our products for a period of one to two years and provide a five year warranty for the ceramic components of our PX brand products. We test our products in our manufacturing facilities through a variety of means. However, there can be no assurance that our testing will reveal latent defects in our products, which may not become apparent until after the products have been sold into the market. Accordingly, there is a risk that warranty claims may be filed due to product defects. We may incur additional operating expenses if our warranty provisions do not reflect the actual cost of resolving issues related to defects in our products. If these additional expenses are significant, they could adversely affect our business, financial condition and results of operations. While the number of warranty claims has not been significant to date, we have offered a five year warranty on our ceramic components for new sales agreements executed after August 7, 2007. Accordingly, we cannot quantify the error rate of the ceramic components of our products with statistical accuracy and cannot assure that a large number of warranty claims will not be filed in a given year. As a result, our operating expenses may increase if a large number of warranty claims are filed in any specific year, particularly towards the end of any given warranty period.

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

Our competitive position depends on our ability to establish and maintain proprietary rights in our technology and to protect our technology from copying by others. We rely on trade secret, patent, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which may offer only limited protection. We hold five United States patents and fourteen patents outside the U.S. that are counterparts to two of the U.S. patents. The expiration terms of the U.S. patents range from 2011 to 2025, at which time we could become more vulnerable to increased competition. In addition, we have applied for four new United States patents and filed one new international application. There are twenty-five pending foreign applications corresponding to U.S. patents and patent applications. We do not hold issued patents in many of the countries into which we sell our PX devices, including Saudi Arabia, Algeria and China, though we do have pending applications in those and other countries where we have substantial sales activity. Accordingly, the protection of our intellectual property in some of those countries may be limited. We also do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims, and even if patents are issued, they may be contested, circumvented or invalidated. Moreover, while we believe our remaining issued patents are essential to the protection of the PX technology, the rights granted under any of our issued patents or patents that may be issued in the future may not provide us with proprietary protection or competitive advantages, and, as with any technology, competitors may be able to develop similar or superior technologies to our own now or in the future. In addition, our granted patents may not prevent misappropriation of our technology, particularly in foreign countries where intellectual property laws may not protect our proprietary rights as fully as those in the United States. This may render our patents impaired or useless and ultimately expose us to currently unanticipated competition. Protecting against the unauthorized use of our products, trademarks and other proprietary rights is expensive, difficult and, in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual property rights or to

determine the validity and scope of the proprietary rights of others. This litigation could result in substantial costs and diversion of management resources, either of which could harm our business.

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

Third parties could claim that our technology infringes their proprietary rights. In addition, we may be contacted by third parties suggesting that we obtain a license to certain of their intellectual property rights they may believe we are infringing. We expect that infringement claims against us may increase as the number of products and competitors in our market increases and overlaps occur. In

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

***If we fail to expand our manufacturing facilities to meet our future growth, our operating results could be adversely affected.***

Our existing manufacturing facilities are capable of meeting current demand and demand for the foreseeable future. However, the future growth of our business depends on our ability to successfully expand our manufacturing, research and development and technical testing facilities. Larger products currently under development require a larger manufacturing facility with greater capacity. We have entered into a 10 year lease for a 170,000 square foot facility in San Leandro, California. While this space will be available to accommodate the consolidation of our U.S. operations and the expansion of our manufacturing operations, the space is being built out and will not be available until November 2009 or later. If the build-out is delayed, our production capability could be limited, which could adversely affect our operating results.

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

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

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

Our products are used in seawater reverse osmosis desalination plants which are often times constructed and maintained through government guarantees and subsidies. The rate of construction of desalination plants depends on each government's willingness and ability to allocate funds for such projects, which may be affected by the current crisis in the financial system and credit markets and the weak global economy. In addition, some desalination projects in the Middle East and North Africa have been funded by budget surpluses resulting from once high crude oil and natural gas prices. Since prices for crude oil and natural gas have fallen, governments in those countries may not have budget surpluses to fund such projects and may cancel such projects or divert funds allocated for them to other projects. As a result, the demand for our products could decline and negatively affect our revenue base, which could harm the overall profitability of our business.

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

The manufacture of our products is highly technical, and our products may contain latent defects or flaws. We test our products prior to commercial release and during such testing have discovered and may in the future discover flaws and defects that need to be resolved prior to release. Resolving these flaws and defects can take a significant amount of time and prevent our technical personnel from working on other important tasks. In addition, our products have contained and may in the future contain one or more flaws that were not detected prior to commercial release to our customers. Some flaws in our products may only be discovered after a product has been installed and used by customers. Any flaws or defects discovered in our products after commercial release could result in loss

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of revenue or delay in revenue recognition, loss of customers and increased service and warranty cost, any of which could adversely affect our business, operating results and financial condition. In addition, we could face claims for product liability, tort or breach of warranty. Our contracts with our customers contain provisions relating to warranty disclaimers and liability limitations, which may not be upheld. Defending a lawsuit, regardless of its merit, is costly and may divert management's attention and adversely affect the market's perception of us and our products. In addition, if our business liability insurance coverage proves inadequate or future coverage is unavailable on acceptable terms or at all, our business, operating results and financial condition could be harmed.

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

Historically, we have derived a significant portion of our revenue from customers whose seawater reverse osmosis desalination facilities utilizing the PX device are outside the United States. Many of such customers' projects are in emerging growth countries with relatively young and unstable market economies and volatile political environments. These countries may also be affected significantly by the current crisis in the global financial system and credit markets and the weak global economy. We have sales and technical support personnel stationed in Spain, Asia and the Middle East, among other regions, and we expect to continue to add personnel in other countries. As a result, any governmental changes or reforms or disruptions in the business, regulatory or political environments of the countries in which we operate or sell our products could have a material adverse effect on our business, financial condition and results of operations.

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

Our international contracts and operations subject us to a variety of additional risks, including:  
political and economic uncertainties, which the current global economic crisis may exacerbate;

reduced protection for intellectual property rights;

trade barriers and other regulatory or contractual limitations on our ability to sell and service our products in certain foreign markets;

difficulties in enforcing contracts, beginning operations as scheduled and collecting accounts receivable, especially in emerging markets;

increased travel, infrastructure and legal compliance costs associated with multiple international locations;

competing with non-U.S. companies not subject to the U.S. Foreign Corrupt Practices Act;

difficulty in attracting, hiring and retaining qualified personnel; and

increasing instability in the capital markets and banking systems worldwide, especially in developing countries, that may limit project financing availability for the construction of desalination plants.

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

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

Future growth in our business, if it occurs, will place significant demands on our management, infrastructure and other resources. To manage any future growth, we will need to hire, integrate and retain highly skilled and motivated

employees. We will also need to continue to improve our financial and management controls, reporting and operational systems and procedures. If we do not effectively manage our growth, our business, operating results and financial condition would be adversely affected.

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

As a public company, SEC rules require that we maintain internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and preparation of published financial statements in accordance with generally accepted accounting principles. Accordingly, we will be required to document and test our internal controls and procedures to assess the effectiveness of our internal control over financial reporting. In addition, our independent registered public accounting firm will be required to report on the effectiveness of our internal control over financial reporting. In the future, we may identify material weaknesses and deficiencies which we may not be able to remediate in a timely manner. Material weaknesses may exist when we are first required to report on the effectiveness of our internal control over financial reporting in our Annual Report on Form 10-K for the year ending December 31, 2009. If there are material weaknesses or deficiencies in our internal control, we will not be able to conclude that we have maintained effective internal control over financial reporting or our independent registered public accounting firm may not be able to issue an unqualified report on the effectiveness of our internal control over financial reporting. As a result, our ability to report our financial results on a timely and accurate basis may be adversely affected and investors may lose confidence in our financial information, which in turn could cause the market price of our common stock to decrease. We may also be required to restate our financial statements from prior periods. In addition, testing and maintaining internal control will require increased management time and resources. Any failure to maintain effective internal control over financial reporting could impair the success of our business and harm our financial results and you could lose all or a significant portion of your investment. If we have material weaknesses in our internal control over financial reporting, the accuracy and timing of our financial reporting may be adversely affected.

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

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

***We may engage in future acquisitions that could disrupt our business, cause dilution to our stockholders and harm our financial condition and operating results.***

In the future, we may acquire companies or assets that we believe may enhance our market position. We may not be able to find suitable acquisition candidates and we may not be able to complete acquisitions on favorable terms, if at all. If we do complete acquisitions, we cannot assure you that they will ultimately strengthen our competitive position or that they will not be viewed negatively by customers, financial markets or investors. In addition, any acquisitions that we make could lead to difficulties in integrating personnel and operations from the acquired businesses and in retaining and motivating key personnel from these businesses. Acquisitions may disrupt our ongoing operations, divert management from day-to-day responsibilities, increase our expenses and harm our operating results or financial condition. Future acquisitions may reduce our cash available for operations and other uses and could result in an increase in amortization expense related to identifiable assets acquired, potentially dilutive issuances of equity securities or the incurrence of debt, any of which could harm our business, operating results and financial condition.

***Insiders will continue to have substantial control over us and will be able to influence corporate matters.***

Our directors and executive officers and their affiliates beneficially own, in the aggregate, approximately 13% of our outstanding common stock as of September 30, 2009. As a result, these stockholders will be able to exercise significant influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, such as a merger or other sale of our company or its assets.

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

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



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bylaws include provisions that:

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

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

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

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

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

provide that our directors may be removed only for cause;

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

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

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

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

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

*(a) Sales of Unregistered Securities*

None.

*(b) Use of Proceeds from Public Offering of Common Stock*

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

As a result of the offering, we received net proceeds of approximately \$76.7 million, after deducting underwriting discounts and commissions of \$6.1 million and additional offering-related expenses of approximately \$3.7 million. No payments for such expenses were made directly or indirectly to (i) any of our officers or directors or their associates, (ii) any persons owning 10% or more of any class of our equity securities, or (iii) any of our affiliates. During the first quarter of 2009, we pledged \$9.1 million of the net proceeds as collateral to facilitate the early termination of a credit facility with a financial institution. During the nine months ended September 30, 2009, \$3.6 million of the restricted cash was released and we did not use additional net proceeds from the IPO. We anticipate that we will use the remaining net proceeds from our IPO for working capital and other general corporate purposes, including to finance our growth, develop new products, fund capital expenditures, or to expand our existing business through acquisitions of other businesses, products or technologies. Pending such uses, we have deposited a substantial amount of the net proceeds in a U.S. Treasury based money market fund as of September 30, 2009. There has been no material change

in the planned use of proceeds from our IPO from that described in the final prospectus filed with the SEC pursuant to Rule 424(b).

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*(c) Purchases of Equity Securities by the Issuer and Affiliated Purchasers*

None.

**Item 3. Defaults Upon Senior Securities**

Not applicable.

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

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

<b>Exhibit No.</b>	<b>Description</b>
31.1	Certification of Principal Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d 14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002.
31.2	Certification of Principal Financial Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d 14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002.
32.1	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURES**

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

Registrant: Energy Recovery, Inc.

By:

/s/ G. G. PIQUE

President and Chief Executive Officer  
(Principal Executive Officer)

November 6, 2009

**G. G. Pique**

/s/ THOMAS D. WILLARDSON

Chief Financial Officer  
(Principal Financial Officer)

November 6, 2009

**Thomas D. Willardson**

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