

ENVIRONMENTAL POWER CORP

Form 10-Q/A

November 15, 2004

Table of Contents

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

WASHINGTON, DC 20549

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**FORM 10-Q/A**

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(Mark one)

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

For the quarterly period ended March 31, 2004

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 0-15472

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# Environmental Power Corporation

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**75-3117389**  
(IRS Employer Identification No.)

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

(Address of principal executive offices)

(Zip code)

**(603) 431-1780**

Registrant's telephone number, including area code

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

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

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

Number of shares of Common Stock outstanding

at March 31, 2004 27,363,749 shares

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**Table of Contents**

**EXPLANATORY NOTE**

This Quarterly Report on Form 10-K/A of Environmental Power Corporation (the Company or EPC) for the period ended March 31, 2004, is filed solely for the purposes of (1) integrating, but not amending, the information set forth in both the Company's Quarterly Report on Form 10-Q for the period ended March 31, 2004 (the Original Report) and the information set forth in the Company's Quarterly Report on Form 10-Q/A as filed on May 14, 2004 with the Securities and Exchange Commission (the Amendment) and (2) filing updated certifications pursuant to Item 601(b)(31) of Regulation S-K, which certifications appear as Exhibits 31.01 and 31.02 to this report. Except as described above, no other amendments are being made to the Original Report or the Amendment. This Form 10-Q/A does not reflect events occurring after the May 12, 2004 filing of the Original Report or modify or update the disclosure contained in the Original Report in any way other than as required to reflect the foregoing.

**Table of Contents**

**TABLE OF CONTENTS**

PART I. <u>FINANCIAL INFORMATION</u>	2
ITEM 1. <u>FINANCIAL STATEMENTS</u>	2
<u>Condensed Consolidated Balance Sheets (unaudited) as of March 31, 2004 &amp; December 31, 2003</u>	2
<u>Condensed Consolidated Statements of Operations (unaudited) for the Three Months Ended March 31, 2004 and March 31, 2003</u>	3
<u>Condensed Consolidated Statements of Cash Flows (unaudited) for Three Months Ended March 31, 2004 and March 31, 2003</u>	4
<u>Notes to Condensed Consolidated Financial Statements</u>	5
ITEM 2. <u>MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	7
ITEM 3. <u>QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	17
ITEM 4. <u>CONTROL AND PROCEDURES</u>	17
PART II. <u>OTHER INFORMATION</u>	17
ITEM 6. <u>EXHIBITS AND REPORTS ON FORM 8-K</u>	17
<u>SIGNATURES</u>	18

**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****ENVIRONMENTAL POWER CORPORATION AND SUBSIDIARIES****Condensed Consolidated Balance Sheets (unaudited) as of March 31, 2004 & December 31, 2003**

	March 31, 2004	December 31, 2003
	(unaudited)	(unaudited)
<b>ASSETS</b>		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 275,418	\$ 1,444,870
Restricted cash	1,949,086	1,554,308
Receivable from utility	13,794,598	13,063,529
Fuel inventory	983,278	485,021
Other current assets	125,669	194,104
<b>TOTAL CURRENT ASSETS</b>	<b>17,128,049</b>	<b>16,741,832</b>
PROPERTY, PLANT AND EQUIPMENT, NET	404,063	435,516
LEASE RIGHTS, NET	1,826,244	1,863,495
ACCRUED POWER GENERATION REVENUES	75,850,127	75,314,725
GOODWILL	4,912,866	4,912,866
UNRECOGNIZED PRIOR PENSION SERVICE COST	241,427	241,427
LICENSED TECHNOLOGY RIGHTS, NET	3,210,421	3,256,796
OTHER ASSETS	379,099	387,711
<b>TOTAL ASSETS</b>	<b>\$ 103,952,296</b>	<b>\$ 103,154,368</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	\$ 9,807,083	\$ 10,042,990
Working capital loan	1,490,000	2,433,261
Other current liabilities	207,183	389,535
<b>TOTAL CURRENT LIABILITIES</b>	<b>11,504,266</b>	<b>12,865,786</b>
DEFERRED GAIN, NET	3,778,031	3,855,133
LONG TERM DEBT OBLIGATIONS	4,540,915	4,499,190
ACCRUED LEASE EXPENSES	75,850,127	75,314,725
<b>TOTAL LIABILITIES</b>	<b>95,673,339</b>	<b>96,534,834</b>
SHAREHOLDERS EQUITY:		
Preferred Stock (1)		
Preferred Stock of Subsidiary (2)	100	100
Common Stock (3)	275,770	272,638
Additional paid-in capital	9,478,333	9,071,127

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Retained earnings (accumulated deficit)	59,435	(1,368,166)
Accumulated other comprehensive loss	(324,815)	(324,815)
	<u>9,488,823</u>	<u>7,650,884</u>
Treasury stock (4)	(385,402)	(385,402)
Deferred compensation	(178,516)	
Notes receivable from officers and board members	(645,948)	(645,948)
	<u>8,278,957</u>	<u>6,619,534</u>
<b>TOTAL SHAREHOLDERS EQUITY</b>	<b>8,278,957</b>	<b>6,619,534</b>
	<u>\$ 103,952,296</u>	<u>\$ 103,154,368</u>
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	<b>\$ 103,952,296</b>	<b>\$ 103,154,368</b>

See Notes to Condensed Consolidated Financial Statements.

- (1) \$.01 par value; 2,000,000 shares authorized, no shares issued.
- (2) no voting rights, no par value, 10 shares authorized; 10 shares issued as of March 31, 2004 and December 31, 2003, respectively
- (3) \$.01 par value; 50,000,000 shares authorized; 27,576,963 issued and 26,957,949 outstanding as of March 31, 2004; 27,263,749 issued and 26,644,735 outstanding as of December 31, 2003
- (4) 619,014 shares at cost, as of March 31, 2004 and December 31, 2003

**Table of Contents****ENVIRONMENTAL POWER CORPORATION AND SUBSIDIARIES****Condensed Consolidated Statements of Operations (unaudited) for the Three Months Ended March 31, 2004 and March 31, 2003**

	Three Months Ended	
	March 31, 2004	March 31, 2003
	(unaudited)	(unaudited)
<b>POWER GENERATION REVENUES</b>	<b>\$ 14,338,388</b>	<b>\$ 14,535,334</b>
<b>COSTS AND EXPENSES:</b>		
Operating expenses	6,281,122	5,589,847
Lease expenses	4,796,684	5,039,952
General and administrative	1,554,487	1,445,103
Depreciation and amortization	123,989	123,930
	<b>12,756,282</b>	<b>12,198,832</b>
<b>OPERATING INCOME</b>	<b>1,582,106</b>	<b>2,336,502</b>
<b>OTHER INCOME (EXPENSE):</b>		
Interest income	6,296	6,482
Interest expense	(207,980)	(25,362)
Amortization of deferred gain	77,102	77,103
	<b>(124,582)</b>	<b>58,223</b>
<b>INCOME BEFORE INCOME TAXES</b>	<b>1,457,524</b>	<b>2,394,725</b>
<b>INCOME TAX EXPENSE</b>	<b>28,673</b>	<b>1,245,257</b>
<b>NET INCOME</b>	<b>\$ 1,428,851</b>	<b>\$ 1,149,468</b>
<b>PREFERRED SECURITIES DIVIDEND REQUIREMENTS OF SUBSIDAIRY</b>	<b>(1,250)</b>	<b>(1,250)</b>
<b>INCOME AVAILABLE TO COMMON SHAREHOLDERS</b>	<b>\$ 1,427,601</b>	<b>\$ 1,148,218</b>
<b>WEIGHTED AVERAGE COMMON SHARES OUTSTANDING:</b>		
Basic	26,752,612	21,814,465
Diluted	29,939,390	21,826,499
<b>EARNINGS PER COMMON SHARE</b>		
Basic	<b>\$ 0.05</b>	<b>\$ 0.05</b>
Diluted	<b>\$ 0.05</b>	<b>\$ 0.05</b>

See Notes to Condensed Consolidated Financial Statements.

**Table of Contents****ENVIRONMENTAL POWER CORPORATION AND SUBSIDIARIES****Condensed Consolidated Statements of Cash Flows (unaudited) for Three Months Ended March 31, 2004 and March 31, 2003**

	Three Months Ended	
	March 31, 2004	March 31, 2003
	(unaudited)	(unaudited)
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 1,428,851	\$ 1,149,468
<i>Adjustments to reconcile net income to net cash provided by (used for) operating activities:</i>		
Depreciation and amortization	123,989	123,930
Amortization of deferred gain	(77,102)	(77,103)
Interest expense, accrued and added to balance of borrowing	79,363	
Non-cash, stock based compensation expense	231,822	
Accrued power generation revenues	(535,402)	(1,280,433)
Accrued lease expenses	535,402	1,280,433
<i>Changes in operating assets and liabilities:</i>		
Increase in receivable from utility	(731,069)	(635,918)
(Increase) decrease in other current assets	(429,822)	24,484
(Increase) decrease in other assets	(298)	827
Decrease in accounts payable and accrued expenses	(235,907)	(695,384)
Net cash provided by (used for) operating activities	389,827	(109,696)
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Increase in restricted cash	(394,778)	(226,130)
Property, plant and equipment expenditures		(1,750)
Net cash used for investing activities	(394,778)	(227,880)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Dividend payments on preferred stock of subsidiary	(1,250)	(1,250)
Repayments under secured promissory note payable	(37,638)	
Repurchase of Treasury stock		(21,274)
Net (borrowings) repayments under working capital loan	(1,125,613)	79,875
Net cash (used for) provided by financing activities	(1,164,501)	57,351
DECREASE IN CASH AND CASH EQUIVALENTS	\$ (1,169,452)	\$ (280,225)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	1,444,870	734,743
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 275,418	\$ 454,518

See Notes to Condensed Consolidated Financial Statements.



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

The accompanying unaudited condensed consolidated financial statements of Environmental Power Corporation ( EPC ) and its subsidiaries (collectively the Company ) have been prepared in accordance with the instructions to Form 10-Q and do not include all of the information and footnotes required by generally accepted accounting principles for annual financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The results of operations for the three months ended March 31, 2004 are not necessarily indicative of results to be expected for the year ending December 31, 2004. For further information, refer to the consolidated financial statements and footnotes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2003.

**NOTE B EARNINGS PER COMMON SHARE**

We compute basic earnings per share by dividing net income for the period by the weighted average number of shares of common stock outstanding during the period. We compute our diluted earnings per common share using the treasury stock method. For purposes of calculating diluted earnings per share, we consider our shares issuable in connection with stock options to be dilutive common stock equivalents when the exercise price is less than the average market price of our common stock for the period. We excluded 701,962, and 1,701,962 antidilutive common stock equivalents from the calculation of diluted earnings per share, for the periods ended March 31, 2004 and 2003, respectively. The following table outlines the calculation of basic earnings per share and diluted earnings per share for the three months ended March 31, 2004 and 2003.

	Income	Shares	Per Share
	(Numerator)	(Denominator)	Amounts
<b>Three Months Ended March 31, 2004</b>			
Net income	\$ 1,428,851	26,752,612	\$ 0.05
Effect of dividends to preferred stockholders of subsidiary	(1,250)		
Basic EPS - Income available to shareholders	\$ 1,427,601	26,752,612	\$ 0.05
Assumed exercise of dilutive stock options		3,186,778	
Diluted EPS - Income available to shareholders	\$ 1,427,601	29,939,390	\$ 0.05
<b>Three Months Ended March 31, 2003</b>			
Net income	\$ 1,149,468	21,814,465	\$ 0.05
Effect of dividends to preferred stockholders of subsidiary	(1,250)		
Basic EPS - Income available to shareholders	\$ 1,148,218	21,814,465	\$ 0.05
Assumed exercise of dilutive stock options		12,034	
Diluted EPS - Income available to shareholders	\$ 1,148,218	21,826,499	\$ 0.05

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

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The Company has elected to account for stock options in accordance with Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees, which uses the intrinsic value method of accounting. Accordingly, the Company has not recognized compensation expense for the fair value of its stock-based awards in its condensed consolidated statements of operations. The following table reflects pro forma net income and earnings per share had the Company elected to record expense for employee stock options under Statement of Financial Accounting Standards ( SFAS ) No. 123, Accounting for Stock Based Compensation.

During the three months ended March 31, 2004, we issued 10,000 options under the 2001 Stock Incentive Plan and 2,000,000 options outside of any plan. As part of their executive compensation packages, Joseph Cresci, Chairman, and Andy Livingston, Executive Vice President, reduced their base salaries to \$225,000 each and received 1,000,000 performance-based options each. These options will vest upon the successful completion of specific milestones related to the development of our Microgy subsidiary. Additionally, we reduced the number of options granted to Kam Tejwani, Chief Executive Officer, by 1,000,000. His remaining options were also adjusted to vest upon successful completion of specific corporate goals, including raising additional equity. There was no compensation expense related to these options this quarter.

During the three months ended March 31, 2003, we did not issue any options.

We recorded \$231,822 of stock-based compensation expense in the period ended March 31, 2004 under ABP Opinion No. 25. Of this amount, \$4,848 was recorded in connection with restricted stock grants made to employees, and \$226,974 was recorded in connection with both stock and option grants, which were originally granted in July 2003 for services rendered through January 2004, made to non-employees. The expense is being recorded over the period the grants and options are earned.

**Table of Contents**

During the quarter, we issued to employees 213,214 shares of restricted stock that vest through 2006. In connection with this issuance, \$4,848 was recorded as stock compensation expense, as noted above, and \$178,516 was recorded as deferred compensation, a component of shareholders' equity on the condensed consolidated balance sheet. This deferred compensation will be expensed over the vesting period through 2006.

Using the fair value criteria required by SFAS No. 123 to calculate compensation expense, pro forma net income and earnings per share would be as follows:

	Three Months Ended	
	March 31, 2004	March 31, 2003
Income available to common shareholders	\$ 1,427,601	\$ 1,149,468
Additional Compensation Expense under SFAS 123, net of taxes	(130,954)	(12,974)
Income available to common shareholders under SFAS 123	\$ 1,296,647	\$ 1,136,494
Basic EPS, as reported	\$ 0.05	\$ 0.05
Basic EPS, under SFAS 123	\$ 0.05	\$ 0.05
Diluted EPS, as reported	\$ 0.05	\$ 0.05
Diluted EPS, under SFAS 123	\$ 0.04	\$ 0.05
<i>Assumptions for options issued in the period</i>		
Fair Market Per Share	\$ 0.00	NA
Risk-free rate of return	3.78%	NA
Volatility	82%	NA
Expected Annual Dividend Yield	0%	NA
Option Life (years)	10	NA

**NOTE D GOODWILL AND INTANGIBLE ASSETS**

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

Accumulated amortization of licensed technology rights was \$499,579 as of March 31, 2004 and \$453,204 as of December 31, 2003. Amortization expense for licensed technology rights was \$46,375 for the three months ended March 31, 2004 and 2003. The future estimated amortization expense for licensed technology rights is as follows:

2004	2005	2006	2007	2008	Thereafter	Total
\$139,125	185,500	185,500	185,500	185,500	2,329,296	\$ 3,210,421

**NOTE E RECENT ACCOUNTING PRONOUNCEMENTS**

In January and December 2003, the FASB issued FASB Interpretation No. 46 (FIN 46) and No. 46, revised (FIN 46R), Consolidation of Variable Interest Entities. These statements, which address perceived weaknesses in accounting for entities commonly known as special-purpose or off-balance-sheet, require consolidation of certain interests or arrangements by virtue of holding a controlling financial interest in such entities. On January 1, 2004 we adopted FIN 46R. Adoption of this new method of accounting for variable interest entities did not and is not expected to have a material impact on our consolidated results of operations and financial position.

**NOTE F RETIREMENT PLAN**

**Net Periodic Benefit Costs** - Our net periodic pension costs are comprised of the following components:

	<u>Three Months Ended</u>	<u>Three Months Ended</u>
	<u>March 31, 2004</u>	<u>March 31, 2003</u>
<b><u>Net Periodic Pension Cost</u></b>		
Service cost	\$ 48,034	\$ 38,295
Interest cost	29,716	31,770
Expected return on assets	(27,732)	(18,551)
Amortization of prior service cost	4,025	4,025
Amortization of actuarial loss	4,896	5,123
	<u>58,938</u>	<u>60,662</u>
Net periodic pension cost	58,938	60,662

**Table of Contents**

**Plan Assets** Pension costs and cash funding requirements are expected to increase in future years. The following table sets out the market value of our retirement plan as of March 31, 2004 and December 31, 2003.

Pension Assets	March 31, 2004	December 31, 2003
Equity securities	\$ 943,691	\$ 892,632
Fixed Income securities	394,122	382,239
Cash	78,986	110,725
Total	\$ 1,416,799	\$ 1,386,596

**Employer Contributions** We made no contributions to the pension plan in the first quarter of 2004

**NOTE G SEGMENT INFORMATION**

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

SEGMENT INFORMATION	Scrubgrass Project	Microgy	All Other Segments	Consolidated
<b>Three Months Ended March 31, 2004</b>				
Power generation revenues	\$ 14,338,388	\$	\$	\$ 14,338,388
Pre-tax income (loss)	2,525,520	(533,719)	(534,277)	1,457,524
Identifiable Assets	95,215,016	8,595,029	142,251	103,952,296
<b>Three Months Ended March 31, 2003</b>				
Power generation revenues	\$ 14,535,334	\$	\$	\$ 14,535,334
Pre-tax income (loss)	3,000,256	(466,971)	(138,560)	2,394,725
Identifiable Assets	85,154,501	8,722,065	796,098	94,672,664

**NOTE H SUBSEQUENT EVENTS**

On March 17, 2004, we announced that we were conducting a private placement of our equity securities. As of the date of this filing, we have completed two initial closings of the private placement, raising \$3,432,000. The private placement is still in effect and we have received subscription agreements for the remaining full amount of the offering. We expect to issue over 7,500,000 shares of stock and over 3,750,000 warrants to purchase stock as a result of this private placement.

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

*Overview of the Company*

We are an independent developer and, in some cases, owner of facilities that extract and/or utilize energy from non-commodity fuels and renewable energy sources. These alternative fuels, most of which are wastes, which are generally not subject to the same cost fluctuations as traditional fuels can be used to generate electricity or thermal energy and to power other industrial applications. Our power generating facilities have also been able to exceed air quality emission standards and to assist with the clean-up of wastes that are sources of water pollution. Accordingly, we have realized financial benefits, such as tax-exempt financing and sales of pollution allowances from the pollution control benefits of our facilities. Our two primary business units are described below.

**Buzzard Power Corporation**

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

**Microgy Cogeneration Systems**

Microgy holds an exclusive license in North America for the development and deployment of a proprietary technology for the extraction of methane gas from animal wastes. This biogas can be used to generate electricity or it can be used in other industrial applications. Microgy's product is expected to provide certain farms, known as concentrated animal feeding operations, or CAFOs, with a potentially profitable means of mitigating an existing waste management problem that affects both water and air quality. Federal and State agencies either have or may be in the process of passing regulations that require CAFOs to implement changes to their current waste management practices.

## **Table of Contents**

While Microgy is seeking to help farmers meet their waste management needs, we are also seeking to put the biogas produced to use in the generation of electricity or other valuable applications. Many states have either passed or may be in the process of promulgating legislation requiring utilities to obtain a certain percentage of their power from renewable sources. This positions Microgy as a potentially profitable solution to farmers' waste management problems, while at the same time providing a new renewable energy source for utilities. We believe that Microgy represents a substantial portion of the future potential growth of Environmental Power and, as such, we are investing substantially all our available resources, including both our financial and human capital, to take advantage of Microgy's potential.

The following Management's Discussion and Analysis of Financial Condition and Results of Operations compares the Company's results of operations for the three months ended March 31, 2004 with the results of operations for the three months ended March 31, 2003. Unless otherwise indicated, all references to 2004 pertain to the three months ended March 31, 2004 and all references to 2003 pertain to the three months ended March 31, 2003. Historical results and trends that might appear should not be taken as indicative of future operations.

### ***Cautionary Statement***

This Quarterly Report on Form 10-Q contains forward-looking statements, as defined by the Private Securities Litigation Reform Act of 1995, in order to provide investors with prospective information about us. For this purpose, any statements that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, the words believes, anticipates, plans, expects and similar expressions are intended to identify forward-looking statements. There are a number of important factors that could cause our actual results and events to differ materially from those indicated by the forward-looking statements. These factors include, without limitation, those set forth below under the caption Certain Factors That May Affect Future Results. Such forward-looking statements represent management's current expectations and are inherently uncertain. Investors are warned that actual results may differ from management's expectations.

### ***Results of Operations***

For the three months ended March 31, 2004, net income increased 24% to \$1,428,851, or \$0.05 per common share, compared to a net income of \$1,149,468 for the three months ended March 31, 2003, or \$0.05 per common share. The increase in net income was primarily attributable to decrease in income tax expense. This difference has been partially offset by increases in operating expenses, general and administrative expenses, and interest expense.

Power generation revenues, all attributable to Scrubgrass, decreased slightly to \$14,338,388 for the three months ended March 31, 2004 from \$14,535,334 for the three months ended March 31, 2003. This decrease is due to the 58% or \$745,031 decrease in accrued power generation revenues and a decrease in our capacity factor. In 2004, the capacity factor at Scrubgrass was 95.2% compared to a capacity factor of 97.3% for the three months ended March 31, 2003. This decrease was offset by a 4% or \$548,458 increase in power generation revenues as a result of a 5% increase in power rates in the power purchase agreement with Penelec.

Total cost and expenses increased 5% to \$12,756,282 for the three months ended March 31, 2004 from \$12,198,832 for the three months ended March 31, 2003. This increase is primarily attributable to a 12% or \$691,275 increase in operating expenses and a 8% or \$109,384 increase in general and administrative expenses. These increases were partially offset by a 5% or \$243,268 decrease in lease expenses expense.

The increase in operating expenses was primarily due to:

higher fuel expense for Scrubgrass of \$430,962 from cost escalations and transportation adjustments in certain fuel supply agreements for waste handling and transportation; and

an increase in maintenance expenses for Scrubgrass totaling \$134,508, primarily from fuel supply-related maintenance.

The increase in general and administrative expenses was primarily due to:

stock-based compensation expenses of \$231,822 for the first quarter 2004 compared to none in the first quarter 2003; and

an increase of \$56,428 in project expenses related to Microgy.

For the three months ended March 31, 2004, we had other expense of \$124,582 compared to other income of \$58,223 for the three months ended March 31, 2003. This decrease is attributable to increase in interest expense to \$207,980 from \$25,362 for 2004 and 2003 periods, respectively. This increase is primarily attributable to \$199,846 of interest expense related to the long-term debt at our subsidiary, EPC Corporation, and we will incur similar levels of interest expense while the debt is outstanding.



## **Table of Contents**

Income tax expense decreased to \$28,673 from \$1,245,257 for the three months ended March 31, 2004 and 2003, respectively. These changes are primarily attributable to a decrease in our pre-tax earnings and a decrease in the effective tax rate from 52% for the 2003 period to 2% in the 2004 period. Our tax rate is based upon forecasts for a full year of operations. Currently, we expect to have a federal tax benefit and a state tax obligation, resulting in a combined tax expense of \$114,692 for the full year.

For the three months ended March 31, 2004, we had earnings per common share of \$0.05 compared to earnings per common share of \$0.05 for the three months ended March 31, 2003. The increase in net income was partially offset by the increase in the weighted average common shares outstanding due to the issuance of additional shares of common stock in connection with the 2003 Incentive Compensation Plan.

## ***2004 Outlook***

The following forward-looking information concerning our results of operations for 2004 is being compared to our historical results of operations for 2003:

Power generation revenues are expected to increase in 2004 primarily due to a 5% increase in rates billed to Penelec under the Scrubgrass power sales agreement. This increase is expected to be partially offset by a decrease in revenue recorded as a result of the straight-line accounting treatment of revenue under the power sales agreement. We also expect to operate the facility at a capacity factor of 90% or greater. Due to the ArcLight loan (see *EPC Corporation Debt Obligations* below), all distributions from Buzzard are required to repay the loan. Therefore, performance at Buzzard will not have an effect on our liquidity in 2004. See *Cash Flow Outlook* for more information.

We expect to generate revenues from our Microgy subsidiary in 2004. We have signed Digester Purchase and Management Agreements with 5 farms under our relationship with Dairyland Power Cooperative. These agreements represent backlog of approximately \$12 million. We expect to be able to record some of or all the backlog as revenue in 2004, depending on receipt of all necessary permits and approvals and the pace of construction. On May 5, 2004 we started construction on one of these facilities.

Operating expenses for the full year of 2004 are expected to increase primarily due to:

an escalation in rates for fuel supply cost for Scrubgrass resulting in approximately \$200,000 of additional fuel costs;

an escalation in operator fees under the terms of the operations and maintenance agreement, resulting in approximately \$3,000,000 of non-fuel operating expenses for Scrubgrass; and

the addition of \$7,000,000 to \$9,000,000 of construction, engineering, and licensing costs associated with the Microgy facilities.

Lease expenses for the full year of 2004 are expected to decrease by approximately \$1,450,000 primarily due to:

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lower interest expense as we repay principal; and

lowered straight-line lease expenses recorded under FASB 13.

General and administrative expenses for the full year of 2004 are expected to increase by approximately \$1,800,000 primarily because we plan to increase expenses to further implement Microgy's business plan. These expenses would include:

the addition of marketing, sales, engineering, accounting and finance personnel;

the use of consultants for technical, financial, legal, marketing, public and investor relations and other strategic advice; and

the increase of related corporate expenses such as insurance, office supplies, rent, legal, and travel.

Interest expense is expected to increase for the full year of 2004 because we will pay and accrue interest on the ArcLight loan.

We expect our weighted average common shares outstanding to increase in 2004 as result of additional private placements and issuances of stock compensation and stock awards. In 2003, we issued 4,853,456 new shares and expect to issue as more shares in 2004. In our 2004 Private Placement, we expect to issue over 7,500,000 of new shares and 3,750,000 of warrants to purchase additional shares.

## **Table of Contents**

### ***Liquidity and Capital Resources***

#### **Operating Activities**

For the three months ending March 31, 2004, cash provided by operating activities was \$389,827 compared to cash used in operations of \$109,696 for the 2003 period. During these periods, our only source of cash from operations was cash flow generated by Scrubgrass.

We reported net income of \$1,428,851 for the three months ended March 31, 2004. The following adjustments need to be considered in order to reconcile our net income for the period to our net cash used for operating activities:

*Depreciation and amortization* Depreciation and amortization for the three month period was \$123,989. This included \$46,375 from technology rights, \$37,251 from lease rights, \$8,910 from refinancing costs and \$31,453 from property, plant and equipment.

*Amortization of deferred gain* Our deferred gain, net, amounted to \$3,778,301 as of March 31, 2004 as compared to \$3,855,133 as of December 31, 2003. The decline of \$77,102 is due to the amortization of the deferred gain related to the Scrubgrass project, which is being amortized on a straight-line basis over 22 years, and is a non-cash credit to income.

*Accrued interest* We accrued \$79,363 of interest related to the ArcLight loan and added it to the principal balance.

*Non-cash stock-based compensation* Our net income includes the effect of non-cash stock-based compensation totaling \$231,822 for the three months ending March 31, 2004.

*Receivables from utility* Receivables from utility increased by 6% or \$731,069 because of increased power generation revenues at Scrubgrass.

*Other current assets* Other current assets increased to \$1,108,947 on March 31, 2004 from \$679,125 on December 31, 2003, or 63% due increases in fuel inventories at Scrubgrass.

*Other assets* Other assets decreased to \$379,099 from \$387,711 for the periods ending March 31, 2004 and December 31, 2003, respectively due to an increase in other receivables at Scrubgrass.

*Accounts payable and other current liabilities* Accounts payable, accrued expenses, and other current liabilities decreased by \$1,361,520 or 11%. This decrease is due to a decrease in the working capital loan balance.

#### ***Investing Activities***

Our cash used for investing activities was \$394,778 and \$227,880 for the three months ending March 31, 2004 and 2003, respectively. Our investing activities were concentrated primarily in the following areas:

*Restricted cash* Our restricted cash balance increased by \$394,778. We are contractually required to make scheduled deposits to a restricted maintenance fund for Scrubgrass to ensure that funds are available in the future for scheduled major equipment overhauls. We are allowed to use restricted cash for major equipment overhauls subject to certain restrictions. We are required to make deposits to the restricted major maintenance fund of \$91,520 per month through April 2005. The required monthly payment is subject to possible recalculation after each annual maintenance outage to ensure that funds are sufficient to cover the long-term schedule of major equipment overhauls.

*Property, plant and equipment* We had no plant and equipment expenditures for the three months ended March 31, 2004 compared to \$1,750 for the three months ended March 31, 2003.

### **Financing Activities**

Our cash used in financing activities was \$1,164,501 for 2004 compared to cash provided by financing of \$57,351 for 2003. We offer the following information concerning the financing activities for our business:

*Dividend payments to preferred stock of subsidiary-Buzzard* paid dividends of \$1,250 to its preferred stockholder during the first quarters of 2004 and 2003.

*Debt repayments* We repaid \$37,638 of accrued interest added to the principal balance related to the ArcLight loan for the three months ended March 31, 2004 (see *EPC Corporation Debt Obligations* below).

*Working capital loan for Scrubgrass-Buzzard* may borrow up to \$4 million under a Lessee Working Capital Loan Agreement with the lessor of Scrubgrass for ongoing working capital requirements of this project. The outstanding borrowings under this loan were \$1,490,000 as of March 31, 2004 and \$2,433,261 as of December 31, 2003. Under the existing terms of this loan, we were required to pay the outstanding balance to zero for a minimum of twenty days during 2004 and 2003. We have met the pay down requirement for this loan for 2004 and 2003.

### **Long Term Liabilities**

The following table shows all of our future contractual obligations:

<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>Thereafter</b>	<b>Total</b>
<b>Non-cancelable operating leases</b>						
\$82,889	97,671	93,716	13,411	0	0	\$ 287,686
<b>ArcLight loan (1)</b>						
\$			1	1	3,975,883	\$ 3,975,885
<b>Scrubgrass facility lease</b>						
\$14,777,250	21,715,000	26,058,000	28,910,000	29,390,000	219,850,000	\$ 340,700,250
<b>Non-cancelable fuel agreements</b>						
\$1,824,750	2,513,000	2,599,000	2,687,000	2,385,000	8,687,000	\$ 20,695,750
<b>TOTAL</b>						
\$16,684,889	24,325,672	28,750,717	31,610,412	31,775,001	232,236,996	\$ 365,383,686

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- (1) All distributions from Scrubgrass will be used to repay the loan. We are only required to make principal repayments when we receive distributions. However, we are required to make at least one principal payment in any 24-month period. We have satisfied this requirement for the next 24 months.

**Table of Contents**

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

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

Distributions from Scrubgrass are held by an agent bank, J.P. Morgan. Payments are made first to any outstanding interest, second to fees to the agent bank, third to the management fee to us, and fourth to the outstanding principal.

The following table describes our debt obligations as of March 31, 2004 and December 31, 2003:

	<b>March 31, 2004</b>	<b>December 31, 2003</b>
<b>Long Term Debt Obligations</b>		
Sunnyside plant obligations	\$ 583,030	\$ 583,030
ArcLight Note Payable	3,975,885	3,916,160
<b>TOTAL</b>	<b>\$ 4,540,915</b>	<b>\$ 4,499,190</b>

**Scrubgrass Debt Obligations** Buzzard and the lessor have various debt obligations related to Scrubgrass. Under the terms of the Scrubgrass lease, Buzzard is required to pay the principal, interest and fees for the lessor's debt obligations as a base lease payment. As such, Buzzard is committed to pay all of the Scrubgrass debt obligations as either a debt or lease obligation. Scrubgrass had the following debt obligations as of December 31, 2003 and 2002:

	<b>Balance at March 31, 2004</b>	<b>Balance at December 31, 2003</b>	<b>Interest Rate</b>
<b>Buzzard's lease obligations (maturity):</b>			
Tax-exempt bonds (2012)	\$ 135,600,000	\$ 135,600,000	Quoted Bond Rates
Swap rate term loan (2005)	5,443,499	6,268,163	7.6725%
Variable rate term loan (2004)	1,055,441	3,687,000	LIBOR + 1.250%
<b>Buzzard's debt obligations (maturity):</b>			
Variable rate term loan (2004)	\$ 207,183	\$ 389,535	LIBOR + 1.250%
Working capital loan (2008)	1,490,000	2,433,261	LIBOR + 1.250%

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

*Notes Receivable from Officers* We have outstanding notes receivable from officers and directors for shares purchased in connection with stock option plans which amounted to \$645,948 as of March 31, 2004 and December 31, 2003. These notes, secured by the underlying shares of stock, are payable upon demand and bear interest at a floating rate which is payable monthly. In accordance with company policy and applicable law, we no longer make loans to our officers or directors.

*Sunnyside Contingent Obligations* We had contingent obligations of \$1,218,078 on our consolidated balance sheet as of December 31, 2000. The contingent obligations were principally expenses for the sale of Sunnyside which were payable

## **Table of Contents**

upon collection of certain obligations from the purchasers of Sunnyside. On April 10, 2001, we received aggregate proceeds of \$1,500,000 from the purchasers of Sunnyside and resolved litigation by executing a Binding Settlement Agreement. In this agreement, we were formally released from contingent obligations of \$177,962. We have also been released by the statute of limitations or the terms of the underlying agreements from additional contingent obligations of \$457,086. We reported the settlement proceeds of \$1,500,000 and the released liabilities of \$635,048 as other income in our consolidated financial statements for 2001.

Because of the terms of this settlement agreement, which terms represented a substantial compromise of our previous claims against the purchasers of Sunnyside, we are presently considering our rights and obligations with respect to the remaining contingent obligations of \$583,030. The unsettled contingent obligations will remain recorded in our consolidated financial statements until the statute of limitations for any legal action runs out after 2004.

## ***Cash Flow Outlook***

During 2004, we expect to fund our business activities principally from available cash balances, investment earnings, equity funding, raising additional debt at Microgy, and the sale of the first products based upon Microgy's technology. We do not expect to receive cash from the operations of Buzzard (because such cash, if any, will be used to repay interest and principal on the ArcLight loan), nor proceeds from the sale of NOx emission credits, nor from any pending litigation, as we have in the past. These sources of cash will be sufficient to cover all of our operating expenses and current contractual obligations for 2004.

On March 17, 2004 we announced that we were conducting a private placement of our equity securities. As of the date of this filing, we have completed initial closings of the private placement, raising \$3,432,000, and have received subscription agreements for the remaining full amount of the offering. After commissions and fees, the proceeds from this private placement are sufficient to cover all of our operating expenses and current contractual obligations for 2004. Additionally, we will be able to finance the construction of some of the Microgy projects that are in our sales backlog.

On March 31, 2004, our unrestricted cash balance was \$275,418 as compared to \$1,444,870 as of December 31, 2003. Our restricted cash balances were \$1,949,086 and \$1,554,308 at the respective dates. As discussed further under investing activities, we are allowed to spend restricted cash to fund the cost of major equipment overhauls at Scrubgrass subject to certain restrictions.

During the three months ended March 31, 2004, we received distributions of \$157,750 from Scrubgrass which is less than our distributions of \$1,211,250 during the same period in 2003. This decrease is due to the repayment of working capital at Scrubgrass. All of the distributions, managed by J.P. Morgan, have been used to repay interest of \$120,483 and principal of \$37,638 on the ArcLight loan, described above. We expect that all distributions in 2004 will be used to satisfy the same debt obligation.

On May 5, 2004, we began construction on the first facility based upon the Microgy technology. We have four other facilities in our sales backlog. These five facilities represent approximately \$12 million in gross revenues. We expect to receive cash from these sales in 2004 after paying for development, construction, and licensing costs.

Our present business strategy generally anticipates the outright sale of facilities; however, in some circumstances, we expect that Microgy may own projects. We anticipate that, to the extent Microgy is the owner of projects, project financing may be obtained in the form of a credit facility



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with one or more lenders, the sale of tax exempt or taxable bonds to investors or equity or other financing. We cannot assure you that Microgy or any other prospective project owner will be able to secure project financing in the amount required to fulfill any development or construction requirements, that project financing will be obtained in time to meet such requirements, or that any such proposed project financing, if obtained, will be on terms acceptable to Microgy or any other prospective project owner. However, to the extent Microgy is the owner of projects, Microgy will need to obtain financing to allow it to develop and construct such projects.

*Sale of NOx Credits* Under applicable environmental laws and regulations, Scrubgrass needed to achieve certain seasonal nitrogen oxide emission levels beginning on May 1, 1999, and was also required to achieve reduced emission standards by May 2002. Due to the efficient design of the Scrubgrass facility, Scrubgrass met the 1999 requirements without any modifications to the facility. During 1999, we made capital improvements of \$811,568 to the Scrubgrass facility, which enabled Scrubgrass to meet the stricter standards in 2002. By making improvements to the facility before 2002, we anticipated that we would not require a portion of our future NOx Credits to maintain our compliance with the applicable regulations. Consequently, we sold our anticipated excess NOx Credits in recent years and used the proceeds to finance the capital improvements and generate additional cash flows for operations. We expect to comply with all material environmental regulations for the foreseeable future without any additional material modifications to the Scrubgrass facility. Recently, we received our next award of NOx Credits for the ozone seasons in 2002 through 2007. Similar to prior years, we expected that we may not require a portion of these future NOx Credits to maintain our compliance with the applicable regulations and sold the anticipated excess NOx Credits in 2002 for \$2,428,200. We did not have such sales in 2003 and do not anticipate the sale of NOx Credits in 2004.

## **Table of Contents**

*Loss of Status as a QF Facility* The Scrubgrass plant operates as a qualifying facility or QF. The loss of the QF status could trigger defaults in the project's power sales agreement. Therefore, Buzzard would most likely have to sell power at the prevailing market rates that are much lower than the rate outlined in the power sales agreement. This event would not affect our liquidity in 2004 since all of the distributions in 2004 will be required to repay the ArcLight loan. However, it would have an effect on future years. Nevertheless, our exposure would be limited to the assets of EPC Corporation, our wholly-owned subsidiary, and its subsidiary, Buzzard Power.

## **CERTAIN FACTORS THAT MAY AFFECT FUTURE RESULTS**

The following important factors, among others, could cause actual results to differ materially from those indicated by forward-looking statements made in this Annual Report on Form 10-K.

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

Microgy was formed in 1999 and is still in the development stage. Microgy intends to develop facilities that use environmentally friendly anaerobic digestion and other technologies to produce bio-energy from animal and organic wastes. Because a large part of our future business is expected to involve Microgy's anaerobic digester projects and Microgy is an unproven enterprise with very little operating history, we are unable to determine whether our investment in Microgy will prove to be profitable.

*Microgy has experienced losses to date and we anticipate it will continue to experience losses in 2004.*

Microgy had accumulated losses due primarily to expenses of business development of approximately \$6,000,000 through December 31, 2003. We expect our Microgy subsidiary to continue to incur losses, reduce our earnings or, as the case may be, add to our earnings deficit as we seek to further develop its business. These ongoing losses would adversely affect our financial condition into 2004.

*The marketplace for Microgy's anaerobic digester technology is complex, still developing and subject to change and, therefore, we cannot predict how all projects will be developed, what Microgy's costs will be or, consequently, Microgy's outlook for profitability.*

Microgy markets its anaerobic digester technology in a complicated and changing environment. Due to the many possible applications for Microgy's technology, and the many possible ways in which projects deploying Microgy's technology might be structured, Microgy may decide to develop and own facilities, sell and operate facilities or some combination of the foregoing, either alone or in conjunction with others. These determinations are expected to be made on a case-by-case basis. As a result, despite the revenue potential, we are unable to project with certainty Microgy's organizational, structural, staffing or other overhead costs, or whether any facility, or Microgy as a whole, will generate a profit. If Microgy fails to generate a profit, your investment in our common stock will be adversely affected.

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

We are seeking and will require corporate, project or group financing to fund the cost of any development we may decide to pursue for our anaerobic digester projects. This financing may be difficult or impossible for us to obtain. If we are unable to obtain such financing, the value of our Microgy investment may be reduced significantly, and we may be required to substantially curtail our business or close any anaerobic digester projects. This financing will depend on prospective lenders or investors' review of our financial capabilities as well as specific projects and other factors, including assessment of our ability to successfully construct and manage each project.

***The market for anaerobic digester technology is crowded, and our market share may not be sufficient to be profitable.***

There are many companies that offer anaerobic digester systems. We believe that at least 60 companies offer complete systems or components to these systems in the U.S. market. Competition from these companies may constrain our market share to a degree that we are not profitable. Although we are unaware of any competitors pursuing a business strategy similar to Microgy's, a number of competitors have more mature businesses and have successfully installed anaerobic digester systems.

***We currently rely on the Scrubgrass plant for all of our operating revenues.***

We own a 22-year leasehold interest that commenced in 1994 in our Scrubgrass plant, a waste coal fired electric generating facility in Pennsylvania. Because all of our operating revenue currently results from the Scrubgrass plant, we are dependent on its successful and continued operations. Increased working capital requirements of the Scrubgrass plant, significant unscheduled shutdowns or large increases in interest rates at Scrubgrass would reduce our cash flow. This may necessitate a substantial curtailment of our operations and require the termination of any anaerobic digester projects and would have an adverse effect on our results of operations.

## **Table of Contents**

On September 4, 2003, we entered into a Note Purchase Agreement with Crystal Creek Coalpower Funding, LLC, an affiliate of ArcLight Energy Partners Fund I, L.P., referred to as ArcLight, pursuant to which our subsidiary, EPC Corporation, which holds as its sole asset the stock of Buzzard, agreed to issue and sell to ArcLight up to \$5,400,000 original principal amount of its 20.0% Senior Secured Notes due December 31, 2012, consisting of Note A in the original principal amount of \$3,700,000 and Note B in the original principal amount of \$1,700,000. ArcLight purchased Note A on September 4, 2003, as a result of which EPC Corporation received gross proceeds of \$3.7 million. We do not expect to satisfy the conditions to the purchase of Note B. The aggregate minimum principal and interest to be paid by EPC Corporation on Note A over the term of Note A is \$4.8 million. Distributions from Scrubgrass are required to be used to repay Note A. After it is paid in full, we will keep the next \$1.4 million of distributions. Thereafter, future distributions will be shared equally through December 31, 2012.

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

Our loan from ArcLight is secured by a pledge of all of the outstanding stock of our subsidiary, EPC Corporation, which in turn holds our interest in Buzzard Power Corporation as its sole asset, the entity that maintains the Scrubgrass facility. If we were to default in our obligations under our agreements with ArcLight, ArcLight would have the right to foreclose on this pledge and take ownership of EPC Corporation, as a result of which we would lose our interest in the Scrubgrass facility, which is currently our most significant operating asset and revenue source.

The events of default are narrowly defined. The most significant would be related to non-payment. We are only required to make payments when there is a distribution from Scrubgrass. Nevertheless, if we do not make any payments in a 24-month period, it would trigger a default.

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

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

*Our current power generation revenue is derived from only one customer, the loss of which would severely harm our financial condition and the value of your investment.*

Our current Scrubgrass plant power generation revenue is earned under a long-term power purchase agreement for all output with one customer, Pennsylvania Electric Company, or Penelec, a subsidiary of FirstEnergy Corporation. This concentration of our revenue with this customer will continue for the foreseeable future. If this customer goes out of business or defaults on its payments to us, our financial condition will be adversely affected.

*A large increase in interest rates may adversely affect our operating results.*

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Our Buzzard subsidiary is leveraged with mostly variable rate and some fixed rate debt obligations. Should market interest rates rise significantly, our operating results will be adversely impacted.

***Our Scrubgrass plant's long-term power purchase agreement is subject to a change in rates in 2005 and market conditions in its later years that may affect our profitability.***

The Scrubgrass plant generates electricity that is sold at rates established under a long-term power purchase agreement with Penelec, approved by the Pennsylvania Public Utility Commission. For years 2005 through 2012, the agreement provides for a rate determined based on a scheduled rate adjusted for actual inflation during prior contract years compared to the automatic 5% adjustment in such prior years. Contracted rates in the later years of the agreement are determined with reference to then existing market conditions. Therefore, the existence of inflation less than 5% in years prior to 2005 will negatively impact our revenue. Low wholesale energy rates during the later years of the power purchase agreement would also negatively impact our profitability and could adversely affect our financial position.

***We are a small company and the entrance of large companies into the alternative fuels and renewable energy business will likely harm our business.***

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

## **Table of Contents**

***If we are unable to obtain sufficient waste resources for our Microgy renewable energy technologies, Microgy will not likely operate profitably.***

The performance of our renewable energy technologies is dependent on the availability of animal or other organic waste resources to produce the raw energy and meet performance standards in the generation of power or bio-fuel. Lack of these waste resources or adverse changes in the nature or quality of such waste resources would seriously affect our ability to develop and finance projects and to operate efficiently and generate income. As a result, our revenue and financial condition would be materially and negatively affected. We cannot assure you that waste resources will be available in the future for free or at a price that makes them affordable for our waste-to-energy technologies.

***Because we have not filed patents to protect Microgy's intellectual property, we might not be able to prevent others from employing competing products. Conversely, others who have filed for patent or other protection might be able to prevent us from employing our products.***

Neither we nor, it is believed, our licensor have filed any patent applications on the intellectual property Microgy plans to use. Should we or our licensor decide to file patent applications, we cannot assure you that any patent applications relating to our existing or future products or technologies will result in patents being issued, that any issued patents will afford adequate protection to us, or that such patents will not be challenged, invalidated, infringed or circumvented. Furthermore, we cannot assure you that others have not developed, or will not develop, similar products or technologies that will compete with our products without infringing upon, or which do not infringe upon, our intellectual property rights.

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

We rely heavily on confidentiality agreements and licensing agreements to maintain the proprietary nature of our base of technologies relating to currently licensed technologies. To compete effectively, we may have to defend the rights to our intellectual property from time to time. Such defense costs may be significant. As a result, we may lack the financial resources to adequately defend our intellectual property.

***We rely on a third party license for our technology and continued support.***

Microgy licenses its anaerobic digester technology from Danish Biogas Technology, A.S., referred to as DBT, a Danish company. The license agreement grants to Microgy a perpetual, exclusive license to develop projects based on this technology in North America. Pursuant to the license agreement, Microgy is required to pay royalties and engineering and design fees to DBT in connection with the development of projects. Microgy relies upon DBT for technical advice and engineering assistance. Therefore, if DBT were to cease doing business, Microgy's business may be materially and negatively impacted. Microgy entered into an amendment to the license agreement with DBT for modifications deemed favorable to Microgy. However, in order to maintain these more favorable provisions, Microgy must initiate construction on at least five facilities prior to April 14, 2005. If Microgy fails to satisfy this condition, then DBT will have the option to terminate the more favorable provisions and revert to the original license terms. While Microgy expects to be able to satisfy this condition this year, if it were unable to do so, its business could be materially adversely affected.

*The large number of tasks that need to be accomplished for the development of power projects and other projects based on our anaerobic digester technology increases the possibility that such projects will incur costly delays.*

In our development of power projects and other projects based on our anaerobic digester technology for ourselves or on behalf of our customers, we are required to enter into or obtain some or all of the following:

Site agreements;

Supply contracts;

Design/build or other construction related agreements;

Power sales contracts;

Various co-product sales agreements;

Waste disposal agreements;

Licenses;

Environmental and other permits;

Local government approvals; and

Financing commitments required for the successful completion of development projects.

## **Table of Contents**

Our failure to accomplish any of these objectives could materially increase the cost or prevent the successful completion of development projects and incur the loss of any investment made. These events could adversely affect our business and results of operations.

*We rely on third party subcontractors to build significant portions of our facilities.*

Microgy intends to rely on third party subcontractors to construct significant portions of its anaerobic digester facilities. The failure of these subcontractors to complete their work in a timely fashion, and any errors or omissions in such work, could result in significant additional costs or delays or liability to Microgy, which could have a material adverse effect on Microgy's business.

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

For our Scrubgrass facility, we obtain waste coal primarily from coal mining companies on a long-term basis because waste coal is plentiful and generally creates environmental hazards, such as acid drainage, when not disposed of properly. The waste coal is burned in the Scrubgrass facility using a circulating fluidized bed combustion system. During the circulating fluidized bed combustion process, the waste coal is treated with other substances such as limestone. Depending on the quality of the waste coal and the limestone, the facility operator may need to add additional waste coal or other substances to create the appropriate balance of substances which would result in the best fuel or sorbent consistency for power generation and compliance with air quality standards. Therefore, the cost of generating power is directly impacted by the quality of the waste coal, which supplies the Scrubgrass power generation facility. Certain conditions, such as poor weather, can create situations where the facility operator has less control over the quality of the waste coal. Poor fuel quality may impact our future operating results.

*The composition of effluents from our anaerobic digester facilities is not certain and may expose us to liability.*

In some cases, we may be responsible for handling the wastes that will be produced by some of our anaerobic digester facilities. We do not have experience in handling or disposing of such wastes. Handling and disposing of such wastes could result in unpredictable regulatory compliance costs, related liabilities and unwanted materials in waste effluents and co-products, all of which could harm our financial condition.

*Our products and services involve long sales cycles that result in high costs and uncertainty.*

The negotiation of the large number of agreements necessary to sell, develop, install, operate and manage any of our facilities, as well as to market the energy and other co-products and to provide necessary related resources and services, involves a long sales cycle and decision-making process. Delays in the parties' decision-making process are outside of our control and may have a negative impact on our cost of sales, receipt of revenue and sales projections. We expect that, in some cases, it may take nine months to a year or more to obtain decisions and to negotiate and close these complex agreements.

*Because the market for renewable energy and waste management is unproven, it is possible that we may expend large sums of money to bring our offerings to market and the revenue that we derive may be insufficient to fund our operations.*



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

***If we violate performance guarantees granted to Penelec we will be required to provide them with an incentive payment.***

Our agreement for the sale of power to Penelec contains a provision that requires our Scrubgrass facility to provide Penelec with a minimum output of 85% based on a rolling 3-year average. If we do not comply with this performance guarantee, we will be required to compensate Penelec with an incentive payment. The payment of an incentive payment would have an adverse effect on our financial condition.

***Our products and services may be subject to numerous governmental regulations.***

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

***Our power producing activities could be subject to costly regulations and tariffs.***

Our Scrubgrass facility produces power for sale to the local electrical grid, as will many of our planned bio-energy projects. The sale of this power may come under the regulations of various state public utility commissions, although such sales are

## **Table of Contents**

currently exempt. These commissions set the price tariffs under which energy can be sold or purchased and they set the design standards for the interconnection of power producing equipment with the electrical power grid. Many of our power projects where electricity is sold to the grid may come under regulation by these commissions. These regulations may impede or delay the process of approving and implementing our projects. Substantial delays may materially affect our financial condition.

Government regulations can be burdensome and may result in delays and expense. In addition, modifications to regulations could adversely affect our ability to sell power or to implement our chosen strategy for the sale of power. Subsequent changes in the applicable regulations could also affect our ability to sell or install new facilities or develop and install facilities in an efficient manner or at all. Failure to comply with applicable regulatory requirements can result in, among other things, operating restrictions and fines that could harm our financial condition.

### ***ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK***

Our most significant market risk exposure is changing interest rates which may affect our short-term investments, debt and certain of our lease expenses. We offer the following information about these market risks:

**Short-term investments** We invest cash balances which are in excess of our normal operating requirements in short term investments generally with maturities of 3 months or less. Because of the short duration of these investments, we do not believe our short-term investments are subject to material market risk.

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

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

As of March 31, 2004, the aggregate outstanding balance of our variable rate debt obligations was \$1,601,508 and the aggregate outstanding balance of the lessor's variable rate debt obligations, which are passed along to us as a lease expense, was \$136,655,441. Based on these balances, an immediate change of one percent for the variable interest rates would cause a change in interest expense of \$16,015 and lease expense of \$1,366,554. Our objective in maintaining these variable rate borrowings is to achieve a lower overall cost when compared to fixed-rate borrowings. We believe the lessor has the same objective for maintaining their variable rate borrowings.

### ***ITEM 4. CONTROL AND PROCEDURES***

*(a) Evaluation of disclosure controls and procedures.*

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-14(c) and 15d-14(c) under the Exchange Act) as of a date (the Evaluation Date ) within 90 days prior to the filing date of this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the Evaluation Date, our disclosure controls and procedures are effective in timely alerting them to the material information relating to us (or our consolidated subsidiaries) required to be included in our periodic SEC filings.

*(b) Changes in internal controls.*

There were no significant changes made in our internal controls during the period covered by this report or, to our knowledge, in other factors that could significantly affect these controls subsequent to the date of their evaluation.

**PART II. OTHER INFORMATION**

**ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

a) Exhibits

<u>Exhibit No.</u>	<u>Description</u>	<u>Reference</u>
2.01	Agreement and Plan of Merger dated as of June 2, 2003, among Environmental Power Corporation, EPC Holdings 1, Inc. and EPC Merger Sub, Inc.	A
3.01	Restated Certificate of Incorporation of the Company	A
3.02	Restated Bylaws of the Company	A
4.01	2001 Stock Incentive Plan	B
4.02	Amended and Restated 2002 Director Stock Option Plan	C
4.03	Amended and Restated 2003 Incentive Compensation Plan	D
4.04	Option Agreement dated as of May 2, 2001 between the Company and Robert I. Weisberg	B
4.05	Option Agreement dated as of September 14, 2001 between the Company and Robert I. Weisberg	B
10.1	Option Agreement dated as of March 29, 2004 between the Company and Joseph E. Cresci	D
10.2	Option Agreement dated as of March 29, 2004 between the Company and Donald A. Livingston	D
31.1	Section 302 Certificate of Chief Executive Officer	E
31.2	Section 302 Certificate of Chief Financial Officer	E
32.1	Certificate of Chief Executive Officer pursuant to 18 U.S.C. §1350	E
32.2	Certificate of Chief Financial Officer pursuant to 18 U.S.C. §1350	E

A Previously filed as an exhibit to our Current Report on Form 8-K/A dated June 2, 2003, as filed on June 10, 2003 (Commission File No. 0-15472).

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- B Previously filed as an exhibit to our Registration Statement on Form S-8 filed August 22, 2002 (Commission File No. 333-98559).
- C Previously filed as an appendix to the definitive Schedule 14A relating to the Proxy Statement for our 2003 Annual Meeting of Stockholders (Commission File No. 0-15472).
- D Previously filed with the Quarterly Report on Form 10-Q/A for the period ended March 31, 2004 to which this Amendment relates.
- E Filed herewith.

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**Table of Contents**

b) Reports on Form 8-K

- i) Current Report on Form 8-K, dated January 16, 2004, reporting pursuant to Item 9 (Regulation FD Disclosure) that the Company had executed additional agreements for the construction and sale of digester project with Five Star Dairy.
- ii) Current Report on Form 8-K, dated January 20, 2004, reporting pursuant to Item 9 (Regulation FD Disclosure) that the Company had executed additional agreements for the construction and sale of digester project with Norswiss Dairy.
- iii) Current Report on Form 8-K, dated January 23, 2004, reporting pursuant to Item 9 (Regulation FD Disclosure) that the Company had signed a Memorandum of Understanding with Merced Irrigation District and Gallo Cattle Company to explore the development of two projects based upon the Microgy technology.
- iv) Current Report on Form 8-K, dated January 30, 2004, reporting pursuant to Item 9 (Regulation FD Disclosure) that the Company had executed additional agreements for the construction and sale of digester project with Daley Farms Dairy and increased its sales backlog to \$8.7 million.
- v) Current Report on Form 8-K, dated February 25, 2004, reporting pursuant to Item 9 (Regulation FD Disclosure) that the Company had executed additional agreements for the construction and sale of digester project with Bach Farms and increased its sales backlog to \$12 million.
- vi) Current Report on Form 8-K, dated March 16, 2004, reporting pursuant to Item 9 (Regulation FD Disclosure) that the Company had entered into a Project Development Agreement with an expected value of up to \$200 million with The Scoular Company.
- vii) Current Report on Form 8-K, dated March 16, 2004, reporting pursuant to Item 9 (Regulation FD Disclosure) that the Company had updated its sales pipeline and projections.
- viii) Current Report on Form 8-K, dated March 18, 2004, reporting pursuant to Item 9 (Regulation FD Disclosure) that the Company plans to conduct a private placement of securities.
- ix) Current Report on Form 8-K, dated March 30, 2003, the Registrant disclosed pursuant to Item 9 (Regulation FD Disclosure) an earnings release of Environmental Power Corporation ( POWR ), dated March 30, 2004.

***SIGNATURES***

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

**ENVIRONMENTAL POWER CORPORATION**

November 15, 2004

/s/ R. Jeffrey Macartney

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R. Jeffrey Macartney  
Treasurer and Chief Financial Officer  
(principal accounting officer and authorized officer)