

Energy Recovery, Inc.
Form 10-Q
May 07, 2010

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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 March 31, 2010

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.)**

**1717 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 May 3, 2010, there were 52,416,769 shares of the registrant's common stock outstanding.

ENERGY RECOVERY, INC.
QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED MARCH 31, 2010
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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 and par value)
(unaudited)

| | March 31, 2010 | December 31, 2009 |
|--|---------------------------|----------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 50,511 | \$ 59,115 |
| Restricted cash | 5,183 | 5,271 |
| Accounts receivable, net of allowance for doubtful accounts of \$169 and \$196 at March 31, 2010 and December 31, 2009, respectively | 15,561 | 12,683 |
| Unbilled receivables, current | 6,155 | 5,544 |
| Inventories | 12,695 | 10,359 |
| Deferred tax assets, net | 1,467 | 1,466 |
| Prepaid expenses and other current assets | 2,277 | 1,741 |
| Total current assets | 93,849 | 96,179 |
| Restricted cash, non-current | 5,521 | 5,555 |
| Property and equipment, net | 20,855 | 16,958 |
| Goodwill | 12,790 | 12,790 |
| Other intangible assets, net | 10,303 | 10,987 |
| Deferred tax assets, non-current, net | 447 | 447 |
| Other assets, non-current | 52 | 53 |
| Total assets | \$ 143,817 | \$ 142,969 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 3,005 | \$ 1,952 |
| Accrued expenses and other current liabilities | 7,959 | 9,492 |
| Income taxes payable | 49 | 350 |
| Accrued warranty reserve | 708 | 605 |
| Deferred revenue | 5,537 | 4,628 |
| Current portion of long-term debt | 128 | 265 |
| Current portion of capital lease obligations | 196 | 203 |
| Total current liabilities | 17,582 | 17,495 |
| Long-term debt | 181 | 246 |
| Capital lease obligations, non-current | 325 | 369 |
| Other non-current liabilities | 3,864 | 3,890 |
| Total liabilities | 21,952 | 22,000 |

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; 51,311,892 and 51,215,653 shares issued and outstanding at March 31, 2010 and

| | | |
|--------------------------------------|---------|---------|
| December 31, 2009, respectively | 51 | 51 |
| Additional paid-in capital | 109,397 | 108,626 |
| Notes receivable from stockholders | (36) | (90) |
| Accumulated other comprehensive loss | (63) | (66) |
| Retained earnings | 12,516 | 12,448 |

| | | |
|----------------------------------|---------|---------|
| Total stockholders equity | 121,865 | 120,969 |
|----------------------------------|---------|---------|

| | | |
|--|------------|------------|
| Total liabilities and stockholders equity | \$ 143,817 | \$ 142,969 |
|--|------------|------------|

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

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

| | Three Months Ended March 31, | |
|--|---|-------------|
| | 2010 | 2009 |
| Net revenue | \$ 12,615 | \$ 12,646 |
| Cost of revenue | 5,257 | 4,573 |
| Gross profit | 7,358 | 8,073 |
| Operating expenses: | | |
| General and administrative | 4,416 | 3,154 |
| Sales and marketing | 1,960 | 1,510 |
| Research and development | 828 | 804 |
| Total operating expenses | 7,204 | 5,468 |
| Income from operations | 154 | 2,605 |
| Interest expense | (21) | (14) |
| Other non-operating expense, net | (18) | (88) |
| Income before provision for income taxes | 115 | 2,503 |
| Provision for income taxes | 47 | 949 |
| Net income | \$ 68 | \$ 1,554 |
| Earnings per share: | | |
| Basic | \$ 0.00 | \$ 0.03 |
| Diluted | \$ 0.00 | \$ 0.03 |
| Number of shares used in per share calculations: | | |
| Basic | 51,243 | 50,052 |
| Diluted | 53,652 | 52,580 |

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)

| | Three Months Ended | |
|---|---------------------------|----------------|
| | March 31, | |
| | 2010 | 2009 |
| Cash Flows From Operating Activities | | |
| Net income | \$ 68 | \$ 1,554 |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: | | |
| Depreciation and amortization | 1,126 | 178 |
| Interest accrued on notes receivables from stockholders | (1) | (2) |
| Stock-based compensation | 597 | 195 |
| Net unrealized loss (gain) on foreign currency transactions | 14 | (337) |
| Excess tax benefit from stock-based compensation arrangements | (25) | |
| Provision for doubtful accounts | (28) | 4 |
| Provision for warranty claims | 121 | 28 |
| Valuation adjustments for excess or obsolete inventory | 101 | 74 |
| Amortization of inventory acquisition valuation step-up | 422 | |
| Other non-cash adjustments | (25) | |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (2,844) | 9,369 |
| Unbilled receivables | (618) | 93 |
| Inventories | (2,858) | (1,661) |
| Deferred tax assets, net | (1) | |
| Prepaid and other assets | (534) | (471) |
| Accounts payable | 1,292 | (459) |
| Accrued expenses and other liabilities | (1,929) | (568) |
| Income taxes payable | (275) | (1,463) |
| Deferred revenue | 910 | (1,301) |
| Net cash (used in) provided by operating activities | (4,487) | 5,233 |
| Cash Flows From Investing Activities | | |
| Capital expenditures | (4,199) | (933) |
| Restricted cash | 122 | (8,779) |
| Net cash (used in) investing activities | (4,077) | (9,712) |
| Cash Flows From Financing Activities | | |
| Repayment of long-term debt | (202) | (120) |
| Repayment of capital lease obligation | (51) | (10) |
| Net proceeds from issuance of common stock | 148 | 212 |
| Excess tax benefit from stock-based compensation arrangements | 25 | |
| Repayment of notes receivables from stockholders | 55 | 130 |
| Net cash (used in) provided by financing activities | (25) | 212 |

| | | |
|---|-----------|-----------|
| Effect of exchange rate differences on cash and cash equivalents | (15) | (16) |
| Net change in cash and cash equivalents | (8,604) | (4,283) |
| Cash and cash equivalents, beginning of period | 59,115 | 79,287 |
| Cash and cash equivalents, end of period | \$ 50,511 | \$ 75,004 |
| Supplemental disclosure of cash flow information | | |
| Cash paid for interest | \$ 21 | \$ 14 |
| Cash paid for income taxes | \$ 1,001 | \$ 3,159 |

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 , ERI , we or us) develops, manufactures and sells high-efficiency energy recovery devices for use in seawater desalination. Our products are sold under the trademarks ERI[™], PX[™], PEI[™], Pressure Exchanger[™], PX Pressure Exchanger[™], Pump Engineering[™] and Quadribaric[™]. Our energy recovery devices make desalination affordable by capturing and reusing the otherwise lost pressure energy from the concentrated seawater reject stream of the desalination process. We also manufacture and sell high pressure pumps and circulation pumps which are also for use in seawater desalination. Our products are developed and manufactured in the United States of America (U.S.) at our headquarters in San Leandro, California, and at a facility in New Boston, Michigan. Additionally, the Company has direct sales offices and technical support centers in Madrid, Dubai, and Shanghai.

The Company was incorporated in Virginia in April 1992 and reincorporated in Delaware in March 2001. Shares of the Company began trading publicly in July 2008. The Company has four wholly owned subsidiaries: Osmotic Power, Inc., Energy Recovery, Inc. International, Energy Recovery Iberia, S.L., and Pump Engineering, Inc. (PEI).

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 stock options, valuation of goodwill and acquired intangible assets, useful lives for depreciation and amortization, valuation adjustments for excess and obsolete inventory, deferred taxes and valuation allowances on deferred tax assets. Actual results could differ materially 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, 2009 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. 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, 2009 included in the Company s Annual Report on Form 10-K filed with the SEC on March 15, 2010.

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, 2009.

In connection with preparing the unaudited condensed consolidated financial statements for the three months ended March 31, 2010, we have evaluated subsequent events for potential recognition and disclosure through the date of this filing.

Recent Accounting Pronouncements

Table of Contents*Revenue Arrangements with Multiple Deliverables*

In October 2009, the FASB issued an amendment to its previously released guidance on revenue arrangements with multiple deliverables. This guidance 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. Additionally, the guidance 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, eliminates the use of the residual value method for determining the allocation of arrangement consideration, and requires expanded disclosures. The guidance becomes effective for the Company for revenue arrangements entered into or materially modified on or after January 1, 2011. Earlier application is permitted with required transition disclosures based on the period of adoption. The Company is currently evaluating the application date and the impact of this standard on its 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

The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share data):

| | Three Months Ended March 31, | |
|--|---|-------------|
| | 2010 | 2009 |
| Numerator: | | |
| Net income | \$ 68 | \$ 1,554 |
| Denominator: | | |
| Weighted average common shares outstanding | 51,243 | 50,052 |
| Effect of dilutive securities: | | |
| Restricted stock units | 4 | |
| Stock options | 500 | 617 |
| Warrants | 1,905 | 1,911 |
| Total shares for purpose of calculating diluted net income per share | 53,652 | 52,580 |
| Earnings per share: | | |
| Basic | \$ 0.00 | \$ 0.03 |
| Diluted | \$ 0.00 | \$ 0.03 |

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):

| | Three Months Ended March 31, | |
|---------------|---|-------------|
| | 2010 | 2009 |
| Stock options | 2,672 | 1,262 |

Note 3 Supplemental Financial Information*Restricted Cash*

The Company has pledged cash in connection with irrevocable standby letters of credit, an equipment promissory note, and contingent payments resulting from a business acquisition. The Company has deposited corresponding amounts into money market and non-interest bearing accounts at two financial institutions for these items as follows

(in thousands):

| | March 31, 2010 | December 31, 2009 |
|---|---------------------------|----------------------------------|
| Contingent and other consideration for acquisition of Pump Engineering, LLC | \$ 5,500 | \$ 5,500 |
| Collateral for irrevocable standby letters of credit | 4,880 | 4,968 |
| Collateral for equipment promissory note | 324 | 358 |
| | \$ 10,704 | \$ 10,826 |

Table of Contents***Inventories***

Inventories consisted of the following (in thousands):

| | March 31, 2010 | December 31, 2009 |
|-----------------|---------------------------|----------------------------------|
| Raw materials | \$ 5,554 | \$ 6,394 |
| Work in process | 3,306 | 1,848 |
| Finished goods | 3,835 | 2,117 |
| | \$ 12,695 | \$ 10,359 |

Property and Equipment

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

| | March 31, 2010 | December 31, 2009 |
|---|---------------------------|----------------------------------|
| Machinery and equipment | \$ 4,630 | \$ 4,508 |
| Office equipment, furniture, and fixtures | 2,004 | 1,943 |
| Automobiles | 40 | 40 |
| Software | 337 | 312 |
| Leasehold improvements | 4,724 | 4,754 |
| Buildings | 2,215 | 2,215 |
| Land | 210 | 210 |
| Construction in progress | 9,724 | 5,567 |
| | 23,884 | 19,549 |
| Less: accumulated depreciation and amortization | (3,029) | (2,591) |
| | \$ 20,855 | \$ 16,958 |

Of the construction in progress costs at March 31, 2010, \$1.4 million related to the construction and installation of specialized testing equipment and \$8.3 million related to the build-out for seismic upgrades and ceramics manufacturing at the Company's new facility in San Leandro, including ceramic manufacturing equipment. As of March 31, 2010, 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.

The Company estimates the costs to complete construction in progress to be approximately \$2.4 million as of March 31, 2010 and expects to complete construction within the next nine months.

Accrued Expenses and Other Current Liabilities

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

| | March 31, 2010 | December 31, 2009 |
|---|-------------------------------|----------------------------------|
| Payroll and commissions payable | \$ 2,083 | \$ 3,166 |
| Contingent consideration and other for acquisition, current portion | 2,500 | 2,500 |
| Capital projects | 1,687 | 1,193 |
| Professional fees | 478 | 770 |

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| | | |
|--|----------|----------|
| Inventory in transit | 52 | 512 |
| Collaboration fees | | 102 |
| Other accrued expenses and current liabilities | 1,159 | 1,249 |
| | \$ 7,959 | \$ 9,492 |

Table of Contents***Non-Current Liabilities***

Non-current liabilities consisted of the following (in thousands):

| | March 31, 2010 | December 31, 2009 |
|---|-------------------------------|----------------------------------|
| Contingent and other consideration for acquisition, non-current | \$ 3,000 | \$ 3,000 |
| Deferred rent expense, non-current | 864 | 890 |
| | \$ 3,864 | \$ 3,890 |

Note 4 Long-Term Debt and Capital Leases***Notes Payable***

As of March 31, 2010, 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):

| | March 31, 2010 |
|------------------------------|---------------------------|
| 2010 (remaining nine months) | \$ 96 |
| 2011 | 128 |
| 2012 | 85 |
| | \$ 309 |

During the first quarter of 2010, the Company paid the remaining balance of two promissory notes for a total of \$148,000, including accrued interest. The promissory notes consisted of a vehicle note payable and an unsecured note payable which the Company had assumed in a business combination in December 2009.

Effective February 2009, the Company entered into a new loan and security agreement with another financial institution. This agreement provides a total available credit line of \$15.0 million. Under this 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%. As of March 31, 2010, there were no advances drawn on this line of credit. This agreement expires in May 2010 and is collateralized by substantially all of the Company's assets. The Company is subject to certain financial and administrative covenants under this agreement. As of March 31, 2010, 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 are collateralized by the Company's credit line or restricted cash and generally terminate within 12 to 36 months from issuance. At March 31, 2010 and December 31, 2009, amounts outstanding on letters of credit collateralized by the Company's line of credit totaled approximately \$6.9 million and \$6.4 million, respectively.

Capital Leases

Future minimum payments under capital leases consist of the following (in thousands):

| | March 31, 2010 |
|------------------------------|---------------------------|
| 2010 (remaining nine months) | \$ 177 |

| | |
|---|--------|
| 2011 | 207 |
| 2012 | 138 |
| 2013 | 65 |
| Total future minimum lease payments | 587 |
| Less: amount representing interest | (66) |
| Present value of net minimum capital lease payments | 521 |
| Less: current portion | (196) |
| Long-term portion | \$ 325 |

Note 5 Income Taxes

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The Company's effective tax rate for the three months ended March 31, 2010 and 2009 was 41% and 38%, 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.

There have been no material changes to the Company's income tax position during the three months ended March 31, 2010.

Note 6 Commitments and Contingencies***Operating Lease Obligations***

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):

| | March 31, 2010 |
|------------------------------|---------------------------|
| 2010 (remaining nine months) | \$ 1,295 |
| 2011 | 1,564 |
| 2012 | 1,535 |
| 2013 | 1,570 |
| 2014 | 1,566 |
| Thereafter | 7,112 |
| | \$ 14,642 |

Product Warranty

The Company sells products with a limited warranty for a period ranging from one to six 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 months ended March 31, 2010 and 2009 (in thousands):

| | Three Months Ended March 31, | |
|---|---|---------------|
| | 2010 | 2009 |
| Balance, beginning of period | \$ 605 | \$ 270 |
| Warranty costs charged to cost of revenue | 121 | 28 |
| Utilization of warranty | (18) | (2) |
| Balance, end of period | \$ 708 | \$ 296 |

Purchase Obligations

The Company entered into purchase order arrangements with its vendors for which it had not received the related goods or services by March 31, 2010. The majority of these purchase order arrangements are related to various key raw materials and components parts and are subject to change based on the Company's sales demand forecasts. The Company has the right to cancel most of these arrangements prior to the date of delivery; however, some arrangements include minimum purchase requirements and are therefore considered noncancelable. At March 31, 2010, the Company had approximately \$10.2 million of open purchase order arrangements related to materials and parts, of which \$4.3 million was cancelable and \$5.9 million was noncancelable.

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 December 31, 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 generally remain in place for periods ranging from 24 to 36 months which relate to the underlying product warranty period. These guarantees are issued under the Company's credit facility or collateralized by restricted cash, as follows (amounts in thousands).

| | March 31, 2010 | December 31, 2009 |
|-----------------------------------|---------------------------|----------------------------------|
| Issued under credit facility | \$ 6,857 | \$ 6,435 |
| Collateralized by restricted cash | 4,717 | 4,779 |
| | \$ 11,574 | \$ 11,214 |

Employee Agreements

In August 2007, the Company entered into an agreement with a senior vice president governing the terms of his employment. The agreement is in place for an indefinite period of time.

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 Stock-based Compensation Expense

For the three months ended March 31, 2010 and 2009, the Company recognized share-based compensation expense related to employees and consultants as follows (in thousands):

| | Three Months Ended March 31, | |
|----------------------------|---|-------------|
| | 2010 | 2009 |
| Cost of revenue | \$ 48 | \$ 24 |
| General and administrative | 412 | 92 |
| Sales and marketing | 128 | 60 |
| Research and development | 9 | 19 |
| | \$ 597 | \$ 195 |

As of March 31, 2010, total unrecognized compensation cost related to non-vested stock-based awards, net of forfeitures, was \$6.6 million, which is expected to be recognized as expense over a weighted-average period of approximately 2.8 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):

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| | Three Months Ended March 31, | |
|-----------------------|---|-------------|
| | 2010 | 2009 |
| Domestic revenue | \$ 1,192 | \$ 709 |
| International revenue | 11,423 | 11,937 |
| Total revenue | \$ 12,615 | \$ 12,646 |
| Revenue by country: | | |
| Australia | 54% | 14% |
| Israel | 3 | 54 |
| Others | 43 | 32 |
| Total | 100% | 100% |

Approximately 99% of the Company's long-lived assets were located in the United States at March 31, 2010 and December 31, 2009, respectively.

Note 9 Concentrations

Two customers, Acciona Agua and U.T.E. Desaladora Tenes, (a Befesa Agua entity), accounted for approximately 36% and 19%, respectively, of the Company's accounts receivable at March 31, 2010. As of December 31, 2009, two customers, Acciona Agua and Southern Seawater JV (a joint venture led by Valoriza Agua and Tecnicas Reunidas) accounted for approximately 27% and 13% of the Company's trade accounts receivable, respectively.

Revenue from customers representing 10% or more of net revenue varies from period to period. For the three months ended March 31, 2010, Thiess Degremont J.V. (a joint venture of Thiess Pty Ltd and Degremont S.A.) and Acciona Agua accounted for approximately 28% and 24% of the Company's net revenue, respectively. For the three months ended March 31, 2009, IDE Technologies, Ltd. accounted for approximately 66% of the Company's net revenue.

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

Note 10 Fair Value Measurements

The Company follows the authoritative guidance for fair value measurements and disclosures, which among other things, defines fair value, establishes a consistent framework for measuring fair value and expands disclosure for each major asset and liability category measured at fair value on either a recurring or nonrecurring basis. Fair value is defined as an exit price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability.

The framework for measuring fair value provides a hierarchy that prioritizes the inputs to valuation techniques used in measuring fair value as follows

Level 1 Quoted prices (unadjusted) in active markets for identical assets or liabilities;

Level 2 Inputs other than quoted prices included within Level 1 that are either directly or indirectly observable; and

Level 3 Unobservable inputs in which little or no market activity exists, therefore requiring an entity to develop its own assumptions about the assumptions that market participants would use in pricing.

Cash and restricted cash are measured at fair value on a recurring basis using market prices on active markets for identical securities (Level 1). The carrying amounts of accounts receivable, accounts payable and other accrued expenses approximate fair value because of the short maturity of those instruments.

Note 11 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. Purchases under this supply agreement amounted to \$20,000 for the

three months ended March 31, 2010 and \$23,000 for the three months ended March 31, 2009. A balance of \$7,000 was due to this vendor as of March 31, 2010. There were no outstanding payments due to this vendor as of December 31, 2009. 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.

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In 2009, 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 March 31, 2010. Expenses incurred under this consulting agreement during the three months ended March 31, 2009 totaled \$31,000. There were no outstanding payments due to this vendor as of March 31, 2010 and December 31, 2009. 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.

Note 12 Subsequent Events

In April 2010, warrants to purchase 1,104,122 shares of common stock were exercised at a price of \$0.20 per share. Subsequent to the effective date of this exercise, 970,000 warrants remain outstanding at a weighted average exercise price of \$0.88 per share.

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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 belief that our PX and PEI energy recovery devices make seawater reverse osmosis and other fluid processes in which our devices are used a more affordable means of production;

our plan to enhance our existing PX and PEI devices and to develop and manufacture new and enhanced versions of these devices;

our belief that the ceramics components of our PX device are highly durable and corrosion-proof resulting in low life cycle maintenance costs and that our PEI devices have long operating lives;

our objective of finding new applications for our technology outside of desalination and expanding and diversifying our product offerings;

our plan to manufacture a portion of our ceramics components internally and reduce the cost of goods sold for our PX devices;

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

our expectation that we will continue to rely on sales of our PX and PEI energy recovery devices for a substantial portion of our revenue and that the recent acquisition of Pump Engineering, LLC is anticipated to increase revenue derived from sales of energy recovery devices and pumps;

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

our belief that our current facilities will be adequate through 2010;

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;

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; and

our expectation that, as we expand our international sales, a portion of our revenue could continue to be denominated in foreign currencies.

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 May 7, 2010. 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.

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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 15, 2010.

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, in early 1997. As of March 31, 2010, we had shipped approximately 8,200 PX devices to desalination plants worldwide. In December 2009, we acquired Pump Engineering, LLC, which manufactures centrifugal energy recovery devices, known as turbochargers, and high pressure and circulation pumps.

A majority of our net revenue has been generated by sales to large engineering, procurement 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 6 to 16 months. A single large desalination project can generate an order for numerous energy recovery devices and generally represents an opportunity for significant revenue. We also sell our devices to original equipment manufacturers, or OEMs, which commission smaller desalination plants, order fewer energy recovery devices per plant and have shorter sales cycles.

Due to the fact that a single order for our energy recovery devices by a large engineering, procurement 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, procurement 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 customers representing 10% or more of total revenue varies from period to period.

For the three months ended March 31, 2010, two customers accounted for approximately 52% of our net revenue. For the three months ended March 31, 2009, one customer accounted for approximately 66% of our net revenue.

During the three months ended March 31, 2010 and 2009, 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 energy recovery devices. We also derive revenue from the sale of our high pressure and circulation pumps, which we manufacture and sell in connection with our energy recovery devices for use in desalination plants. We also receive incidental revenue from the sale of spare parts and from services, such as product support, that we provide to our customers. The recent acquisition of Pump Engineering, LLC is anticipated to increase revenue derived from sales of energy recovery devices and pumps.

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, and valuation of goodwill and other intangible assets.

First Quarter of 2010 Compared to First Quarter of 2009

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):

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

| | 2010 | | 2009 | | Change Increase /(Decrease) | |
|---|-------------|--------|-------------|--------|--|-------|
| Results of Operations:* | | | | | | |
| Net revenue | \$ 12,615 | 100.0% | \$ 12,646 | 100.0% | \$ (31) | 0% |
| Cost of revenue | 5,257 | 41.7% | 4,573 | 36.2% | 684 | 15% |
| Gross profit | 7,358 | 58.3% | 8,073 | 63.8% | (715) | (9)% |
| Operating expenses: | | | | | | |
| General and administrative | 4,416 | 35.0% | 3,154 | 24.9% | 1,262 | 40% |
| Sales and marketing | 1,960 | 15.5% | 1,510 | 11.9% | 450 | 30% |
| Research and development | 828 | 6.6% | 804 | 6.4% | 24 | 3% |
| Total operating expenses | 7,204 | 57.1% | 5,468 | 43.2% | 1,736 | 32% |
| Income from operations | 154 | 1.2% | 2,605 | 20.6% | (2,451) | (94)% |
| Interest expense | (21) | (0.2)% | (14) | (0.1)% | 7 | 50% |
| Other non-operating expense, net | (18) | (0.1)% | (88) | (0.7)% | (70) | (80)% |
| Income before provision for income taxes | 115 | 0.9% | 2,503 | 19.8% | (2,388) | (95)% |
| Provision for income taxes | 47 | 0.4% | 949 | 7.5% | (902) | (95)% |
| Net income | \$ 68 | 0.5% | \$ 1,554 | 12.3% | \$ (1,486) | (96)% |

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

Our net revenue decreased \$31,000 for the three months ended March 31, 2010 compared to the three months ended March 31, 2009. The decrease in net revenue was primarily due to the timing of larger projects and slow recovery in tourism-related projects, resulting in a decrease of PX devices shipped during the first quarter of 2010 when compared to the first quarter of 2009. The decrease in PX device revenue was partially offset by an increase in net revenue generated from sales of turbochargers and high-pressure and circulation pumps by our recently acquired subsidiary, Pump Engineering, Inc. 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 March 31, 2010, the sales of PX devices and related products and services accounted for approximately 82% of our revenue and sales of turbochargers and pumps accounted for approximately 18%. For the three months ended March 31, 2009, the sales of PX devices and related products and services accounted for approximately 97% of our revenue and sales of pumps accounted for approximately 3%. Turbochargers were not part of our product offerings during the three months ended March 31, 2009.

The following geographic information includes net revenue from 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.

| | Three Months Ended March 31, | |
|-----------------------|---|------------------|
| | 2010 | 2009 |
| Domestic revenue | \$ 1,192 | \$ 709 |
| International revenue | 11,423 | 11,937 |
| Total revenue | \$ 12,615 | \$ 12,646 |
| | | |
| Revenue by country: | | |
| Australia | 54% | 14% |
| Israel | 3 | 54 |
| Others | 43 | 32 |
| Total | 100% | 100% |

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, depreciation expense, 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 March 31, 2010, gross profit as a percentage of net revenue was 58.3%. For the three months ended March 31, 2009, gross profit as a percentage of net revenue was 63.8%. The decrease in gross margin as a percentage of net revenue was largely due to a shift of product sales to turbochargers and high-pressure and circulation pumps as a result of our recent acquisition of Pump Engineering, Inc. in late 2009. The table below reflects the impact of product sales activities to our overall gross margin in the first quarter of 2010 (amounts in thousands):

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| | Three Months Ended March 31, | | | | | |
|-----------------|---|--|--------------|---|----------------------|--------------|
| | 2010 | | | 2009 | | |
| | PX and Related Products and Services | Turbochargers and Pumps | Total | PX and Related Products and Services | Pumps (1) | Total |
| Net revenue | \$ 10,378 | \$ 2,237 | \$ 12,615 | \$ 12,241 | \$ 405 | \$ 12,646 |
| Cost of revenue | 3,701 | 1,556 | 5,257 | 4,270 | 303 | 4,573 |
| Gross margin | 6,677 | 681 | 7,358 | 7,971 | 102 | 8,073 |
| Gross margin % | 64% | 30% | 58% | 65% | 25% | 64% |

(1) Turbochargers were not part of our product offerings during the three months ended March 31, 2009.

In addition to the shift in product sales, additional overhead costs related to our PX devices also served to negatively impact margins in the first quarter of 2010 over the comparable period in the prior year. The increased overhead costs were attributed largely to the underutilization of our newly expanded manufacturing facility. Some of the overhead increase, however, was offset by an overall increase in the average sales price of our PX units given a shift to the higher margin PX-260 product in the first quarter of 2010 relative to the comparable period in the prior year. Lastly, with regard to the turbocharger and pump margins, the amortization of the inventory valuation step-up stemming from our acquisition of Pump Engineering, LLC served to negatively impact gross margin in the first quarter of 2010 over the comparable period in the prior year by \$0.4 million.

Stock compensation expense included in cost of revenue was \$48,000 and \$24,000 for the three months ended March 31, 2010 and March 31, 2009, 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 \$1.3 million, or 40%, to \$4.4 million for the three months ended March 31, 2010 from \$3.1 million for the three months ended March 31, 2009. As a percentage of net revenue, general and administrative expense was 35% for the three months ended March 31, 2010 and 25% for the three months ended March 31, 2009. The increase of general and administrative expense was attributable primarily to the amortization of acquired intangible assets and an increase in headcount and facilities as a result of our acquisition of Pump Engineering, LLC in December 2009. General and administrative average headcount increased to 41 for the first quarter of 2010 from 34 for the first quarter of 2009.

Of the \$1.3 million increase in general and administrative expense, increases of \$676,000 related to amortization of purchased intangible assets, \$184,000 related to compensation and employee-related benefits, \$448,000 related to occupancy costs and \$78,000 related to local taxes, credit risk insurance and other administrative costs. These increases in costs were offset in part by a decrease of \$124,000 related to Value Added Taxes (VAT). Stock-based compensation expense included in general and administrative expense was \$412,000 for the three months ended March 31, 2010 and \$92,000 for the three months ended March 31, 2009.

Sales and Marketing Expense

Sales and marketing expense increased by \$450,000, or 30%, to \$2.0 million for the three months ended March 31, 2010 from \$1.5 million for the three months ended March 31, 2009. This increase was primarily related to an increase in sales and marketing average headcount as a result of the Pump Engineering acquisition in December 2009 and growth of our existing sales force during 2009. Sales and marketing average headcount increased to 27 for the first quarter of 2010 from 21 for the first quarter of 2009.

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As a percentage of our net revenue, sales and marketing expense increased to 16% for the three months ended March 31, 2010 compared to 12% for the three months ended March 31, 2009. The increase was attributable primarily to a slight decline in our net revenue while our sales and marketing expense increased during the first quarter of 2010 compared to the same period last year.

Of the \$450,000 net increase in sales and marketing expense for the three months ended March 31, 2010, \$404,000 related to compensation, employee-related benefits and commissions to outside sales representatives and \$61,000 related to other sales and marketing costs. The increases were partially offset by a decrease of \$15,000 related to occupancy costs. Stock-based compensation expense included in sales and marketing expense was \$128,000 for the three months ended March 31, 2010 and \$60,000 for the three months ended March 31, 2009.

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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 \$24,000, or 3%, to \$828,000 for the three months ended March 31, 2010 from \$804,000 for the three months ended March 31, 2009. Research and development expense as a percentage of our net revenue increased from 6% for the three months ended March 31, 2009 to 7% for the three months ended March 31, 2010, as research and development expense and net revenue did not vary significantly for those periods.

Average headcount in our research and development department increased to 15 for the first quarter of 2010 from 9 for the first quarter of 2009, primarily due to the acquisition of Pump Engineering, LLC in December 2009. Although the increase in average headcount contributed to an increase in employee-related expense in the current period compared to the same period last year, the increase was offset considerably by a reduction in research and development consulting and direct project costs. Stock-based compensation expense included in research and development expense was \$9,000 for three months ended March 31, 2010 and \$19,000 for the three months ended March 31, 2009.

Of the \$24,000 increase, increases of \$64,000 related to compensation and employee-related benefits and \$98,000 related to occupancy and other miscellaneous costs were partially offset by decreases of \$78,000 related to research and development direct project costs and \$60,000 related to consulting and professional service.

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

Non-operating Expense, Net

Non-operating expense, net, decreased \$63,000 to \$39,000 for the three months ended March 31, 2010 from \$102,000 for the three months ended March 31, 2009. The decrease was primarily due to a favorable change of \$111,000 related to net foreign currency losses. Our foreign currency denominated contracts decreased and foreign currency rates changed favorably for the three months ended March 31, 2010 compared to the three months ended March 31, 2009. The decrease was partially offset by a decrease in interest income of \$41,000 as a result of lower interest rates and lower cash balances during the first quarter of 2010 compared to the first quarter of 2009 and an increase in interest expense of \$7,000 as a result of additional capital leases and debt acquired in a business combination in December 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 March 31, 2010, we issued common stock for aggregate net proceeds of \$83.4 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 March 31, 2010, our principal sources of liquidity consisted of cash and cash equivalents of \$50.5 million, which are invested primarily in money market funds, and accounts receivable of \$15.6 million.

Under a February 2009 credit agreement, as amended, 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%. As of March 31, 2010, there were no advances drawn under this line of credit. The credit agreement expires in May 2010 and is collateralized by substantially all of the company's assets. We expect to renew this credit agreement in the normal course of business. As of March 31, 2010, we were in compliance with all financial and administrative covenants under this 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 line of credit. The letters of credit generally terminate within 12 to 36 months from

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issuance. As of March 31, 2010, the amounts outstanding on irrevocable letters of credit collateralized under our credit agreement totaled approximately \$6.9 million.

Cash Flows from Operating Activities

Net cash (used in) provided by operating activities was \$(4.5) million and \$5.2 million for the three months ended March 31, 2010 and 2009, respectively. For the three months ended March 31, 2010, net income of \$0.1 million was adjusted to \$2.4 million by non-cash items totaling \$2.3 million. For the three months ended March 31, 2009, net income of \$1.6 million was adjusted to \$1.7 million by non-cash items totaling \$0.1 million. Non-cash items primarily include depreciation, amortization, unrealized gains and losses on foreign exchange, stock-based compensation, provisions for doubtful accounts and warranty reserves, and adjustments for excess and obsolete inventory. Changes in assets and liabilities created a net cash outflow effect of approximately \$(6.9) million and a net cash inflow effect of approximately \$3.5 million for the three months ended March 31, 2010 and 2009, respectively. Net changes in assets and liabilities are primarily attributable to changes in inventory as a result of the timing of order processing and product shipments, changes in accounts receivable and unbilled receivables as a result of timing of invoices and collections for large projects, and changes in prepaid expenses and accrued liabilities as a result of the timing of payments to employees, vendors and other third parties.

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) investing activities was \$(4.1) million and \$(9.7) million for the three months ended March 31, 2010 and 2009, respectively. The decrease of \$5.6 million in net cash used for the three months ended March 31, 2010 compared to the three months ended March 31, 2009 was primarily due to the release of approximately \$8.9 million in restricted cash that had been used to collateralize standby letters of credit and an equipment loan. The favorable variance was partially offset by an increase of \$3.3 million in cash used for capital expenditures during the first three months of 2010 compared to the first three months of 2009 to support seismic upgrades and the build-out of ceramics manufacturing capabilities at our primary manufacturing facility.

Cash Flows from Financing Activities

Net cash (used in) provided by financing activities was \$(25,000) and \$212,000 for the three months ended March 31, 2010 and 2009, respectively. The decrease in net cash flows from financing activities is due to an increase of \$123,000 in debt and capital lease payments a result of assuming additional notes payable and capital leases in a December 2009 business combination and a decrease of \$139,000 in stock option exercises and repayments of promissory notes by stockholders for the current period compared to the prior period. The decrease in cash flows (used in) provided by financing activities is slightly offset by excess tax benefits related to stock-based compensation arrangements of \$25,000.

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 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 March 31, 2010 is \$14.6 million. For additional information, see Note 6 Commitments and Contingencies to the unaudited Condensed Consolidated Financial Statements.

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We have entered into purchase commitments with multiple vendors for seismic upgrades and the build-out of a ceramics facility at one of our manufacturing facilities. Amounts remaining under these purchase commitments total approximately \$2.4 million as of March 31, 2010.

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. As of March 31, 2010, these open purchase orders totaled approximately \$10.2 million.

We have agreements with guarantees or indemnity provisions that we have entered into with customers and others in the ordinary course of business. Based on our historical experience and information known to us as of March 31, 2010, we believe that our exposure related to these guarantees and indemnities as of March 31, 2010 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 Disclosure About Market Risk, in our Annual Report on Form 10-K for the year ended December 31, 2009.

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 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 March 31, 2010, we had cash and cash equivalents totaling \$61.2 million, including restricted cash of \$10.7 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

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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.

(a) *Evaluation of disclosure 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.

(b) *Changes in internal controls.* There were no changes in our internal control over financial reporting during the quarter ended March 31, 2010 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

Almost all of our revenue is derived from sales of energy recovery devices used in reverse osmosis desalination; a decline in demand for desalination or the reverse osmosis method of desalination will reduce demand for our products and will cause our sales and revenue to decline.

Our isobaric and turbine energy recovery devices have historically accounted for a high percentage of our revenue. We expect that the revenue from these products will continue to account for most of our revenue in the foreseeable future. Any factors adversely affecting the demand for desalination, including changes in weather patterns, increased precipitation in areas of high human population density, new technology for producing fresh water, increased water conservation or reuse, political changes, changes in the global economy, or changes in industry or local regulations, would reduce the demand for our energy recovery products and services and would cause a significant decline in our revenue. Similarly, any factors adversely affecting the demand for energy recovery products in reverse osmosis desalination, including, new energy technology or reduced energy costs, new methods of desalination that reduce pressure and energy requirements, improvements in membrane technology would reduce the demand for our energy recovery devices and would 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.

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 that could affect the number and capacity of desalination plants built or the timing of their completion include: the availability of required engineering and design resources, the current weak global economy, shortage in the supply of credit and other forms of financing, changes in government regulations, permitting requirements or priorities, or reduced capital spending for desalination. Each of these factors could result in reduced or uneven demand for our products. Pronounced variability or delays in the construction of desalination plants or reductions in spending for desalination could negatively impact our sales and revenue and make it difficult for us to accurately forecast our future sales and revenue, which could lead to increased spending by us unmatched by equivalent or higher revenue.

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 membrane 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. Water shortages and demand for desalination can also be adversely affected by water conservation and water reuse initiatives.

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 postponed due to delays in, or failure to obtain, approval, financing or permitting for plant construction because of political factors, adverse and increasingly uncertain financial conditions or other factors, especially in countries with political unrest. Even though we may have a signed contract to provide a certain number of energy recovery devices by a certain date, we may delay shipments at the request of customers. Such shipping delays negatively impact our results of operations and revenue. 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.

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

There are a limited number of large engineering, procurement and construction firms in the desalination industry and these customers account for a substantial portion of our net revenue. One or more of these customers represents 10% or more of our total revenue each year and the customers in this category vary from year to year. See Note 9

Concentrations to the unaudited condensed consolidated financial statements regarding the impact of customer concentrations on our condensed consolidated financial statements. Since we do not have long-term contracts with these large customers but sell to them on a purchase order or project basis, these orders may be postponed or delayed on short or no notice. If any of these customers reduces or delays its purchases, cancels a project, decides not to specify our products for future projects, fails to attract and retain qualified engineers and other staff, fails to pay amounts due us, experiences financial difficulties or reduced demand for its services, we may not be able to replace that lost business and our projected revenue may significantly decrease, which will adversely affect our financial condition and future growth.

We face competition from a number of companies that offer competing energy recovery and pump 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 and pumps for desalination plants is competitive and evolving. We expect competition, especially competition on price, to persist and intensify as the desalination market grows, and new competitors may enter the market. Some of our current and potential competitors may have significantly greater financial, technical, marketing and other resources than we do, longer operating histories or greater name recognition. They may also be able to devote greater resources to the development, promotion, sale and support of their products and respond more quickly to new technology. These companies may also have more extensive customer bases, broader customer relationships across product lines, or long-standing or exclusive relationships with our current or potential customers. They may also have more extensive products and product lines that would enable them to offer multi-product or packaged solutions or competing products at lower prices. As a result, our ability to penetrate the market or sustain our market share may be adversely impacted, which would affect our business, operating results and

financial condition. In addition, if another one of our competitors were to merge or partner with another company, the change in the competitive landscape could adversely affect our continuing ability to compete effectively.

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

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Current economic conditions may continue to negatively impact our business and make forecasting future operating results more difficult and uncertain. A weak global economy may cause our customers to delay product orders or shipments, or delay or cancel planned or new desalination projects, including 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 or shipment 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. 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. Since a single order for our energy recovery devices 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, sales cycles and pricing levels for our products and services;

the cyclical nature of equipment purchasing for planned reverse osmosis desalination plants, which typically results in increased product shipments 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 timely ship new products and product enhancements that meet customer demand and contractual and technical requirements, including scheduled delivery dates, performance tests and product certifications;

the ability of our customers to obtain other key plant components 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;

our ability to maintain efficient factory throughput in our new facility and minimize overhead;

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;

our ability to purchase key components, including 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.

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

Our contracts with large engineering, procurement and construction firms generally contain holdback provisions that delay final installment payments up to 24 months after the product has been shipped 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 is subject to such holdback provisions and are accounted for as unbilled receivables until we deliver invoices for payment. Such holdbacks can result in relatively high current and non-current unbilled receivables. If we are unable to invoice and collect these performance holdbacks or if our customers fail to make these payments when due under the 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 for certain positions with industry-specific experience. Given the relative recent growth in the reverse osmosis desalination industry, the supply of qualified candidates for certain positions is limited. Our ability to grow depends on recruiting and retaining skilled employees with relevant experience, competing with larger, often better known companies and offering competitive total compensation packages. Our failure to retain existing or attract future talented and experienced key personnel could harm our business.

The success of our business depends in part on our ability to enhance and scale our existing products for desalination, find new applications for our technology outside of desalination and diversify our product offerings by developing or acquiring new technology.

Our future success depends in part on our ability to enhance and scale existing products for desalination, to find new applications for existing products and services and to develop or acquire new products and services for new markets. While new or enhanced products and services have the potential to meet specified needs of new or existing markets, their pricing may not meet customer expectations and they may not compete favorably with products and services of current or potential competitors. The release of new products may also be delayed if the products do not meet specifications, performance requirements or quality standards. We may have difficulty finding new markets for our existing technology or developing or acquiring new products for new markets. Potential markets may not accept or be slow to adopt our products and services and may be costly to penetrate. In addition, we may not be able to offer our products and services at prices that meet customer expectations without increasing our costs and eroding our margins. If we are unable to develop competitive new products and open new cost-effective markets, 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 to a limited number of ceramic vendors. To diversify our supply of ceramics and retain more control over our intellectual property, we are continuing our efforts to develop a portion of our ceramic 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 complete our new ceramics manufacturing plant on schedule, unable to begin 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 and our business and financial results, including our cost of goods sold and margins may be adversely affected. During the ramp-up phase of bringing our ceramics facility on line, we expect our cost of goods sold to be negatively affected until we optimize production throughput.

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 been installed for a limited number of 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.

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Our sales efforts involve substantial education of our current and prospective customers about the use and benefits of our energy recovery 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, procurement 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, procurement 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 and 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 PX 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 PX products. 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 a limited number of suppliers for some of our components. If our suppliers are not able to meet our demand and/or requirements, our business could be harmed.

We rely on a limited number of suppliers to produce vessel housings and stainless steel castings for our PX devices and castings for our PEI turbochargers and pumps. Our reliance on a limited number of 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 long term supply agreements with these suppliers and instead secure manufacturing availability on a purchase order 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 their commitments with us or fail to meet 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 PX and PEI brand products for a period of one to two years and provide up to a 6 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, or will replicate the harsh, corrosive and varied conditions of the desalination plants and other plants in which they are installed. In addition, certain components of our PEI turbochargers and pumps are custom-made and

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may not scale or perform as expected in production environments. 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 only offered up to a six year warranty on the ceramic components of our PX products in new sales agreements executed after August 7, 2007, and we have only offered PEI products since December 2009 when we acquired Pump Engineering, LLC. Accordingly, we cannot quantify the error rate of our PEI products and the ceramic components of our PX 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 a limited number of United States patents and patents outside the U.S. that are counterparts to several of the U.S. patents and when their terms expire, we could become more vulnerable to increased competition. We do not hold issued patents in many of the countries into which we sell our products though we do have pending applications in 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 our 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 or our customers 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 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 in one or more jurisdictions, 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. In November 2009, we relocated to a new office and manufacturing facility in San Leandro, California, in which the company also plans to house its ceramics manufacturing operations. That space is still being built out and ceramic

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throughput capacity will be available in 2011. If the build-out is delayed, our ceramics 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 constructed and maintained with local, regional or national government guarantees and subsidies, including tax-free bonds. The rate of construction of desalination plants depends on each governing entity's willingness and ability to obtain and allocate funds for such projects, which capabilities may be affected by the current weak global financial system and credit market 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 the necessary funding for such projects and may cancel the projects or divert funds allocated for them to other projects. Political unrest, coups or changes in government administrations may also result in policy or priority changes that may also cause governments to cancel, delay or re-contract planned or ongoing projects. Government embargoes may also prohibit sales into certain countries. As a result, the demand for our products could decline and negatively affect our revenue base, our overall profitability and pace of our expected growth. For example, in late 2009, the Algerian government increased the percentage of required government ownership in desalination plants, which led to the cancellation of the government's contract with a large U.K. engineering, procurement and construction firm and the cancellation or delay in sales of our products.

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 some of the components of our turbochargers and pumps are custom-made. 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 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 or for reasons of good long-term customer relations, we may not be willing to enforce. 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 that use our energy recovery products are outside the United States. Many of these projects are located in emerging growth countries with relatively young or unstable market economies or changing political environments. These countries may be affected

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significantly by the current weak global economy and unstable credit markets. We also rely on sales and technical support personnel stationed in Spain, Asia and the Middle East and we expect to continue to add personnel in other countries. Governmental changes, political unrest or reforms, or other disruptions or changes in the business, regulatory or political environments of the countries in which we sell our products or have staff 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.

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 are 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 is 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. Our acquisition of Pump Engineering, LLC and possible future acquisitions may increase this risk by expanding the scope and nature of operations over which we must develop and maintain internal control over financial reporting. If there are material weaknesses or deficiencies in our internal control, we will not be able to

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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.

Our past acquisition and future acquisitions could disrupt our business, impact our margins, cause dilution to our stockholders or harm our financial condition and operating results.

In December 2009, we acquired privately-held competitor Pump Engineering, LLC and, in the future, we may invest in other companies, technologies or assets. We may not realize the expected benefits from our past or future acquisitions. We may not be able to find other 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 that they will ultimately strengthen our competitive or financial position or that they will not be viewed negatively by customers, financial markets, investors or the media. Acquisitions could also result in shareholder dilution or significant acquisition-related charges for restructuring, stock-based compensation and the amortization of purchased technology and intangible assets. Amortization expenses resulting from impairment of acquired goodwill, intangible assets and purchased technology could also increase over time if the fair value of those assets decreases. A future change in our market conditions, a downturn in our business, or a long-term decline in the quoted market price of our stock may result in a reduction of the fair value of acquisition-related assets. Any such impairment of goodwill or intangible assets could harm our operating results and financial condition. In addition, when we make an acquisition, we may have to assume some or all of that entity's liabilities which may include liabilities that are not fully known at the time of the acquisition. Future acquisitions may reduce our cash available for operations and other uses. If we continue to make acquisitions, we may require additional cash or use shares of our common stock as payment, which would cause dilution for our existing stockholders.

Any acquisitions that we make, including our 2009 acquisition of Pump Engineering, LLC, entail a number of risks that could harm our ability to achieve their anticipated benefits. We could have difficulties integrating and retaining key management and other personnel, aligning product plans and sales strategies, coordinating research and development efforts, supporting customer relationships, aligning operations and integrating accounting, order processing, purchasing and other support services. Since acquired companies have different accounting and other operational practices, we may have difficulty harmonizing order processing, accounting, billing, resource management, information technology and other systems company-wide. We may also have to invest more than anticipated in product or process improvements. Especially with acquisitions of privately held or non-US companies, we may face challenges developing and maintaining internal controls consistent with the requirements of the Sarbanes-Oxley Act and US public accounting standards. Acquisitions may also disrupt our ongoing operations, divert management from day-to-day responsibilities and disrupt other strategic, research and development, marketing or sales efforts. Geographic and time zone differences and disparate corporate cultures may increase the difficulties and risks of an acquisition. If integration of our acquired businesses or assets is not successful or disrupts our ongoing operations, acquisitions may increase our expenses, harm our competitive position, adversely impact our operating

results and financial condition and fail to achieve anticipated revenue, cost, competitive or other objectives.

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 April 15, 2010. As a result, these stockholders will be able to exercise significant influence over all matters

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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 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

In April 2010, warrants to purchase 1,104,122 shares of common stock were exercised at a price of \$0.20 per share. See Note 12 Subsequent Events of Notes to the Condensed Consolidated Financial Statements. The issuance of these shares was exempt from registration under the Securities Act of 1933, as amended, by reason of Section 4(2) of that Act and SEC Rule 506.

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

On July 1, 2009, 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, 2009 with respect to the primary shares and on July 11, 2009 with respect to the over-allotment shares. The managing underwriters were Citigroup Global Markets Inc. and Credit Suisse Securities (USA) LLC.

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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.

In December 2009, we used approximately \$20.0 million, including amounts held in escrow, for the acquisition of Pump Engineering, LLC.

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 remaining net proceeds in a U.S. Treasury based money market fund. 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).

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

None.

Item 6. Exhibits

| Exhibit No. | Description |
|--------------------|---|
| 10.22 | Employment agreement dated August 1, 2007 between the Company and Borja Sanchez-Blanco. |
| 10.22.1 | Wage structure change agreement dated December 30, 2009 between the Company and Borja Sanchez-Blanco. |
| 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 | May 7, 2010 |
| | G. G. Pique | (Principal Executive Officer) | |
| | /s/ THOMAS D. WILLARDSON | Chief Financial Officer | May 7, 2010 |
| | Thomas D. Willardson | (Principal Financial Officer) | |

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|--------------------|---|
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