ENVIRONMENTAL POWER CORP
Form S-2/A
January 13, 2005
Table of Contents

As filed with the Securities and Exchange Commission on January 13, 2005.

Registration No. 333-121572

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

AMENDMENT NO. 1

TO

FORM S-2

REGISTRATION STATEMENT

UNDER THE SECURITIES ACT OF 1933

ENVIRONMENTAL POWER CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**75-3117389**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

One Cate Street, 4th Floor

Portsmouth, New Hampshire 03801

(603) 431-1780

(Address, including zip code, and telephone number, including area code, of registrant s principal executive offices)

Joseph E. Cresci

Chairman

Environmental Power Corporation

One Cate Street, 4th Floor

Portsmouth, New Hampshire 03801

(603) 431-1780

(Name, address, including zip code, and telephone number, including area code, of agent for service)

Copies to:

Scott E. Pueschel, Esq.	**Alan P. Baden, Esq.**
Pierce Atwood LLP	**Vinson & Elkins L.L.P.**
1 New Hampshire Avenue, Suite 350	**666 Fifth Avenue, 26th Floor**
Portsmouth, New Hampshire 03801	**New York, New York 101030**

Approximate date of commencement of proposed sale to the public: As soon as practicable following the date on which the Registration Statement becomes effective.

If any of the securities being registered on this form are offered as a delayed or continuous basis pursuant to Rule 415 under the Securities Act, check the following box. ¨

If the registrant elects to deliver its latest annual report to security holders, or a complete and legal facsimile thereof pursuant to Item 11(a)(1) of this Form, check the following box. ¨

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If delivery of the prospectus is expected to be made pursuant to Rule 434, check the following box. ¨

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities to be Registered	Amount to Be Registered	Proposed Maximum Aggregate Offering Price	Amount of Registration Fee
Common Stock	2,875,000(2)	$ 16,675,000(1)	$ 1,963.00(1),(3)
Underwriter s warrant	100,000	n/a	(4)
Common Stock issuable upon exercise of the underwriter s warrant	100,000	$ 667,500(5)	$ 80.00(5)

(1) Estimated solely for purposes of calculating the registration fee in accordance with Rule 457(c) and based on the average of the bid and asked prices of the registrant s common stock, as reported on the OTC Bulletin Board on December 20, 2004.
(2) Includes 375,000 shares of common stock issuable upon exercise of the underwriter s over-allotment option.
(3) Previously paid.
(4) Pursuant to Rule 457(g), no registration fee is required for the underwriter s warrant
(5) Estimated solely for purposes of calculating the additional registration fee due in respect of the shares of common stock underlying the underwriter s warrant in accordance with Rule 457(c) and based on the average of the high and low sales prices of the registrant s common stock, as reported on the American Stock Exchange on January 7, 2005.

The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the registration statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

Table of Contents

The information in this prospectus is not complete and may be changed. A registration statement relating to these securities has been filed with the Securities and Exchange Commission. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

SUBJECT TO COMPLETION, DATED JANUARY 13, 2005.

PROSPECTUS

2,500,000 shares of common stock

We are offering 2,500,000 shares of our common stock. Our common stock is listed on the American Stock Exchange under the symbol EPG. The last reported sale price of our common stock on the American Stock Exchange on January 10, 2005 was $6.95 per share.

Investing in our common stock involves certain risks. See Risk Factors commencing on page 6 of this prospectus.

	Per Share	Total
Public Offering Price	$	$
Underwriting Discounts and Commissions(1)	$	$
Proceeds to us, before expenses	$	$

(1) Does not reflect additional compensation to the underwriter in the form of a nonaccountable expense allowance of 1½% of the gross proceeds of the offering and warrants to purchase up to 100,000 shares of common stock at an exercise price equal to 115% of the public offering price. See Underwriting.

The underwriter has a 30-day option to purchase up to an additional 375,000 shares of common stock from us to cover over-allotments.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The underwriter expects to deliver the shares to purchasers on , 2005.

LADENBURG THALMANN & CO. INC.

, 2005.

Table of Contents

Table of Contents

TABLE OF CONTENTS

Our website is located at *www.environmentalpower.com*. We have not incorporated by reference into this prospectus the information on our website and you should not consider it to be a part of this document. Our website address is included as an inactive textual reference only.

You should rely only on the information contained or incorporated by reference in this prospectus. We have not authorized anyone to provide you with information different from that contained or incorporated by reference in this prospectus. Under no circumstances should the delivery to you of this prospectus or any sale made pursuant to this prospectus create any implication that the information contained in this prospectus is correct as of any time after the date of this prospectus.

Table of Contents

PROSPECTUS SUMMARY

The following summary highlights the key information contained elsewhere or incorporated by reference in this prospectus. It does not contain all the information that may be important to you. You should read this entire prospectus carefully, especially the discussion of Risk Factors and our selected consolidated financial statements and related notes, before deciding to invest in shares of our common stock. In this prospectus, when we use phrases such as we, our and us, we are referring to Environmental Power Corporation and its subsidiaries as a whole, except where it is clear from the context that any of these terms refers only to Environmental Power Corporation. Unless otherwise indicated, the information in this prospectus assumes that the underwriters do not exercise their over-allotment option. Unless otherwise noted, all share amounts, share price information and the exercise prices of outstanding options and warrants set forth in this prospectus have been adjusted to give effect to a 1-for-7 reverse split of our common stock that occurred on November 30, 2004.

Environmental Power Corporation

We are a developer, owner and operator of renewable energy production facilities, with the ability to produce energy at a stable, predictable cost that is at or below the cost of most power sources. Our production facilities produce energy from environmentally harmful waste materials, allowing us to generate environmental benefits with significant social and economic value. Our principal operating subsidiary, Microgy Cogeneration Systems, Inc., referred to as Microgy, holds an exclusive license in North America for the development and deployment of a proprietary anaerobic digestion technology for the extraction of methane gas from animal wastes for its use to generate energy. Microgy develops, sells and will own and operate renewable gas facilities based on its anaerobic digestion technology, with the ability to capitalize on the value of the biogas produced by these facilities in a number of ways, including the direct sale of biogas or pipeline-grade methane, the use of gas for thermal energy in a variety of industrial and agricultural processes and for the generation of electricity.

Microgy can generate profitable quantities of marketable, renewable gas from the great volume of animal and food wastes produced at or near large animal feeding operations, or AFOs, which consist primarily of cattle, dairy and swine farms. We license our anaerobic digestion technology from Danish Biogas Technology A/S, referred to as DBT, which has been a leader in the development of this technology, having constructed 28 anaerobic digester facilities in Europe over the past 15 years. We believe that the increasingly stringent environmental regulations concerning the handling of animal waste will significantly increase the demand for anaerobic digesters similar to Microgy s on AFO sites.

Microgy has executed agreements with affiliates of five farms pursuant to its relationship with Dairyland Power Cooperative, referred to as Dairyland, one of the largest generation and transmission cooperatives in the Midwest: Five Star Dairy, Wild Rose Dairy, Norswiss Dairy, Daley Farms Dairy and Bach Farms. These dairy farms will purchase a Microgy digester system to process animal waste produced by their dairy farm operations in Wisconsin and Minnesota and will supply biogas to Dairyland for use in the generation of electricity using equipment sold to it by Microgy. Other facilities that Microgy intends to develop may supply biogas for other applications, such as the operation of drying equipment for feed production, as contemplated by Microgy s project development agreement with The Scoular Company, referred to as Scoular. In addition to the agreements with Dairyland and Scoular, we have signed memoranda of understanding with the Vermont Public Power Supply Authority and, in California, the Lodi Electric Utility, and the Merced Irrigation District and Gallo Farms, to develop projects based on Microgy s proprietary anaerobic digestion technology. Each of these agreements are non-binding, and the actual completion of any projects under these agreements may not occur.

During the quarter ended September 30, 2004, Microgy recognized its first product sales of $1,670,306 from three of the five farms we have signed under the relationship with Dairyland to construct on-site anaerobic digesters. In December 2004, we completed construction of the anaerobic digester system at the Five Star Dairy facility in Elk Mound, Wisconsin, and anticipate completing installation of the generating equipment and producing biogas from that facility in the first quarter of 2005.

1

We believe that Microgy s anaerobic digestion facilities provide AFOs with a potentially profitable means of mitigating an existing waste management problem that significantly affects both water and air quality. In addition to providing an animal waste disposal solution to farmers, Microgy s anaerobic digester facilities also provide a renewable source of methane-rich biogas that can be used in a number of ways, including: the generation of electricity; the production of thermal energy for use in a variety of industrial or agricultural processes; or the direct sale of biogas produced, either as is or refined to pipeline-grade methane. We believe that the increased interest in renewable energy sources, green energy, as well as a desire to mitigate the economic effects of fluctuating commodity energy prices, will continue to drive demand for the multiple uses of the biogas produced by Microgy s facilities.

Our objective is to become a leader in the production and marketing of biogas and in the development of biogas resources. Key elements of our strategy include:

- Capitalizing on the increasingly attractive gas market dynamics by providing off-take customers with stable, long-term supplies of renewable gas that are not subject to price fluctuation;

- Aggressively marketing our anaerobic digester facilities, which are a cost-effective tool to assist AFOs in complying with new and more stringent environmental regulations;

- Leveraging the value of our proven anaerobic digester technology, which we believe is superior to competing technologies;

- Pursuing the advantages of our business model, in which we create and manage profitable renewable energy opportunities while alleviating the environmental pressures facing AFOs; and

- Continuing to expand the menu of off-take options for the digester systems we develop.

Our other operating subsidiary, Buzzard Power Corporation, referred to as Buzzard, is the owner of a leasehold interest, which extends through 2016, in an approximately 83 megawatt electrical generating facility, referred to as Scrubgrass. This facility generates electricity from coal mining wastes and has yielded over $50,000,000 in annual revenues to us over each of the last several years. On September 4, 2003, we entered into a financial arrangement with an affiliate of ArcLight Energy Partners Fund I, L.P., referred to as ArcLight, pursuant to which we borrowed $3,700,000, which is repaid from Scrubgrass cash flow. While Buzzard has historically provided us with a reliable source of revenue, we have monetized much of Buzzard s future net revenue stream through the transaction with ArcLight. We are currently focusing most of our corporate resources on advancing Microgy s business.

Risk Factors

Investing in our common stock involves risks. You should carefully consider all of the information included and incorporated by reference in this prospectus. In particular, you should consider carefully the factors discussed under Risk Factors, beginning on page 6, before deciding to invest in our common stock.

Corporate Information

We are a Delaware corporation, incorporated in May 2003, as the successor holding company to our subsidiary, EPC Corporation, which was originally incorporated in Delaware in 1982. EPC Corporation became a publicly traded company in 1986. Our common stock is currently listed on the American Stock Exchange under the symbol EPG. We have made application to list our common stock on the American Stock Exchange. Our principal executive offices are located at One Cate Street, 4th Floor, Portsmouth, New Hampshire 03801 and our telephone number is (603) 431-1780.

2

Table of Contents

THE OFFERING

Common stock offered by us	2,500,000 shares (2,875,000 shares if the over-allotment option granted to the underwriter is exercised in full).
Common stock to be outstanding after this offering	7,372,564 shares (7,747,564 shares if the over-allotment option granted to the underwriter is exercised in full).
Use of proceeds	Working capital and general corporate purposes, including the expansion of the business of Microgy.
American Stock Exchange Symbol	EPG.

The number of shares of our common stock to be outstanding after this offering is based on the number of shares outstanding as of November 1, 2004, after giving effect to a 1-for-7 reverse split of our common stock on November 30, 2004 and excludes (a) options to purchase 1,661,709 shares of common stock outstanding as of November 1, 2004, (b) 431,148 additional shares of common stock available for future issuance under our stock option plans, (c) outstanding warrants to purchase 659,957 shares of common stock and (d) 100,000 shares of common stock issuable upon exercise of a warrant to be granted to the underwriter in connection with this offering.

Table of Contents

SUMMARY FINANCIAL DATA

The following table sets forth summary financial data for our business for the fiscal years ended December 31, 2001, 2002 and 2003, the nine months ended September 30, 2004 and the three months ended September 30, 2004. The financial data for the nine months and three months ended September 30, 2004 have not been audited. You should read this information together with the financial statements and the related notes appearing at the end of this prospectus, as well as the information in the section of this prospectus entitled Management s Discussion and Analysis of Financial Condition and Results of Operations.

	Year Ended December 31,			Nine Months Ended September 30,	Three Months Ended September 30,
	2003	2002	2001	2004	2004
			(in thousands)		
Results of Operations Data: (1)					
Revenues	$ 53,365	$ 54,984	$ 53,518	$ 42,713	$ 16,772
Costs and expenses					
Operating expenses	25,124	24,140	23,681	22,528	7,043
Lease expenses	22,382	25,291	24,706	14,373	4,760
Cost of goods sold (Microgy)				1,670	1,670
General and administrative expenses	5,644	5,605	3,859	4,367	1,491
Non-cash compensation	713	50	114	1,988	(451)
Depreciation and amortization	495	545	441	357	111
Total costs and expenses	54,358	55,631	52,801	45,283	14,624
Operating income (loss)	(993)	(647)	717	(2,570)	2,148
Other income and expense					
Interest income	31	48	78	30	14
Interest expense	(352)	(142)	(185)	(568)	(181)
Sale of NOx emission credits		2,428			
Amortization of deferred gain	308	308	308	231	77
Other income (expense)	2		2,135		
Total other income (expenses)	(11)	2,642	2,336	(307)	(90)
Income (loss) before income taxes	(1,004)	1,995	3,053	(2,877)	2,058
Income tax (expense) benefit	26	(857)	(1,374)	538	305
Net income (loss)	$ (978)	$ 1,138	$ 1,679	$ (2,339)	$ 2,363
Share Data: (2)					
Basic earnings (loss) per common share	$ (0.29)	$ 0.38	$ 0.83	$ (0.54)	$ 0.48
Diluted earnings (loss) per common share	$ (0.29)	$ 0.38	$ 0.79	$ (0.54)	$ 0.45
Weighted average number of common shares outstanding on a diluted basis (000s)	3,376	2,973	2,107	4,367	5,288
Balance Sheet Data:					
Total assets	$ 103,154	$ 92,958	$ 85,566	$ 108,056	$ 108,056
Working capital	3,876	(585)	(1,499)	8,300	8,300
Deferred gain	3,855	4,164	4,472	3,624	3,624
Long-term obligations	79,814	71,244	65,216	80,967	80,967

Shareholders equity (deficit)	6,620	6,186	4,383	11,382	11,382

(1) The Results of Operations Data for 2001 includes Microgy from July 23, 2001 to December 31, 2001.
(2) The share and per share data have been restated to reflect the 1-for-7 reverse stock split that was effective on November 30, 2004.

Table of Contents

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

- uncertainties involving development-stage companies,
- uncertainties regarding project financing,
- the lack of binding commitments and the need to negotiate and execute definitive agreements for the construction and financing of projects,
- financing and cash flow requirements and uncertainties,
- difficulties involved in developing and executing a business plan,
- difficulties and uncertainties regarding acquisitions,
- technological uncertainties, including those relating to competing products and technologies,
- risks relating to managing and integrating acquired businesses,
- unpredictable developments, including plant outages and repair requirements,
- the difficulty of estimating construction, development, repair and maintenance costs and timeframes,
- the uncertainties involved in estimating insurance and implied warranty recoveries, if any,
- the inability to predict the course or outcome of any negotiations with parties involved with our projects,
- uncertainties relating to general economic and industry conditions, and the amount and rate of growth in expenses,

uncertainties relating to government and regulatory policies, the legal environment, intellectual property issues, the competitive environment in which Environmental Power Corporation and its subsidiaries operate

and other factors, including those described in this prospectus under the heading Risk Factors, as well as other filings with the Securities and Exchange Commission. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date that they are made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Table of Contents

RISK FACTORS

An investment in our common stock is speculative and involves a high degree of risk. You should purchase the common stock only if you are sophisticated in financial matters and business investments. You should carefully consider the following factors before purchasing our common stock.

Risks Relating to Microgy

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

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

Microgy has experienced losses to date and we anticipate it will continue to experience losses in 2005.

Microgy had accumulated losses due primarily to expenses of business development of approximately $6,774,211 through September 30, 2004. We expect our Microgy subsidiary to continue to incur losses, reduce our earnings or, as the case may be, add to our earnings deficit as we seek to further develop its business. These ongoing losses will adversely affect our financial condition into 2005.

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

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

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

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

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

There are many companies that offer anaerobic digester systems. We believe that at least 60 companies offer complete systems or components to these systems in the U.S. market. Competition from these companies

Table of Contents

may constrain our market share to a degree that we are not profitable. Although we are unaware of any competitors pursuing a business strategy similar to Microgy s, a number of competitors have more mature businesses and have successfully installed anaerobic digester systems.

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

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

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

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

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

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

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

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

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

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

Table of Contents

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

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

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

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

If our relationship with the licensor of our technology were terminated for any reason, such licensor ceased doing business or we fail to fulfill our obligations under our license agreement, our Microgy subsidiary likely could not continue to operate.

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

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

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

- Site agreements;

Supply contracts;

Design/build or other construction related agreements;

Power sales contracts;

Various co-product sales agreements;

Table of Contents

- Waste disposal agreements;
- Licenses;
- Environmental and other permits;
- Local government approvals; and
- Financing commitments required for the successful completion of development projects.

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

Because all of the cash flow we receive from Buzzard is currently dedicated to the repayment of our loan with ArcLight, we are entirely dependent upon the capital we raise to fund the continuing development of Microgy.

We do not expect to receive cash from the operations of Buzzard, because such cash, if any, will be used to repay interest and principal on our loan from an affiliate of ArcLight. As a result, if we are not able to raise additional capital, including by means of this offering, to fund Microgy s operations and our corporate expenses until Microgy s operations begin to generate positive cash flow, we will not be able to continue to fund Microgy s operations at their current levels, and our business will be materially and adversely affected.

Risks Relating to Buzzard

We currently rely on the Scrubgrass plant for almost all of our operating revenues, and the cash distributions resulting from the Scrubgrass operations have been dedicated to the repayment of the ArcLight loan.

We own a 22-year leasehold interest that commenced in 1994 in our Scrubgrass plant, a waste coal-fired electric generating facility in Pennsylvania. Because almost all of our operating revenue currently results from the Scrubgrass plant, we are dependent on its successful and continued operations. Increased working capital requirements of the Scrubgrass plant, significant unscheduled shutdowns or large increases in interest rates at Scrubgrass would reduce our cash flow. In addition, we will not receive any distributions from Buzzard until our loan from ArcLight is repaid. Thereafter, we will receive the next $1,400,000 of distributions, after which we will share distributions equally with ArcLight through December 31, 2012. As a result, unless we are able to raise additional capital or generate operating income from other sources, we would have to substantially curtail our operations.

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

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

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

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

We have a management services agreement with PG&E National Energy Group to manage the Scrubgrass plant and a 15-year operation and maintenance agreement with PG&E Operating Services to operate the facility.

Table of Contents

These agreements contain provisions that limit our participation in the management and operation of the Scrubgrass plant. Because we do not exercise control over the operation or management of the Scrubgrass plant, decisions may be made, notwithstanding our opposition, which may have an adverse effect on our business.

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

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

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

Our Buzzard and EPC Corporation subsidiaries are leveraged with variable rate and fixed rate debt obligations. Additionally, Buzzard has lease expenses that are based on the principal, interest and fees of the debt obligations of the lessor of our Scrubgrass facility, most of which carries variable rate interest. The following table shows that over 90% of our debt obligations and lease obligations have variable interest rates. Therefore, significant increases in market interest will adversely affect our operating results since we are required to pay the Scrubgrass lessor s debt obligations as a base lease expense. For example, a one percent increase in the London Interbank Offering Rate, referred to as LIBOR, and our quoted bond rates would result in a $1,400,000 increase in our lease expense.

	December 31, 2003	September 30, 2004	Interest Rate
Buzzard s lease obligations (maturity):			
Tax-exempt bonds (2012)	135,600,000	135,600,000	Quoted Bond Rates
Swap rate term loan (2005)	6,268,163	5,031,165	7.6725%
Variable rate term loan (2004)	3,687,000	0	LIBOR + 1.250%
TOTAL LEASE OBLIGATIONS	145,555,163	140,631,165	
EPC Corporation s debt obligations:			
ArcLight Note Payable	$ 3,916,160	$ 3,463,159	20%
Buzzard s debt obligations (maturity):			
Variable rate term loan (2004)	389,535	0	LIBOR + 1.250%
Working capital loan (2008)	2,433,261	2,221,000	LIBOR + 1.250%
TOTAL DEBT	6,738,956	5,684,159	
TOTAL DEBT & LEASE OBLIGATIONS	$ 152,294,119	$ 146,315,324	
% VARIABLE RATE/TOTAL DEBT	94%	95%	

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

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

Table of Contents

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

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

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

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

Risks Relating to Both Microgy and Buzzard

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

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

Furthermore, there are from time to time various legislative proposals that would amend or comprehensively restructure the Public Utility Regulatory Policies Act of 1978, or PURPA, and the electric utility industry. If PURPA is amended or repealed, the statutory requirement that electric utilities purchase electricity from qualifying facilities, or QFs, at full-avoided cost could be repealed or modified. While we expect that existing contracts would be honored, the repeal or modification of these statutory purchase requirements under PURPA in the future could, among other things, increase pressure from electric utilities to renegotiate existing contracts. Should there be changes in statutory purchase requirements under PURPA, and should these changes result in amendments to our current power purchase agreement with Penelec for our Scrubgrass facility that reduce the contract rates, our results of operations and financial position could be negatively impacted.

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

Our Scrubgrass facility produces power for sale to the local electrical grid, as will many of our planned bio-energy projects. The sale of this power may come under the regulations of various state public utility commissions, although such sales are currently exempt. These commissions set the price tariffs under which energy can be sold or purchased and they set the design standards for the interconnection of power producing equipment with the electrical power grid. Many of our power projects where electricity is sold to the grid may come under regulation by these commissions. These regulations may impede or delay the process of approving and implementing our projects. Substantial delays may materially affect our financial condition.

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

Risks Relating to Our Common Stock and This Offering

We have numerous outstanding options and warrants which may adversely affect the price of our common stock.

As of November 30, 2004, after giving effect to a 1-for-7 reverse split of our common stock on November 30, 2004, we had outstanding options, both vested and unvested, and warrants to acquire up to approximately 2,321,666 shares of our common stock at prices ranging from $1.19 to $21.56 per share. For the term of such options and warrants, the holders thereof will have an opportunity to profit from a rise in the market price of our common stock without assuming the risk of ownership. This may have an adverse effect on the price of our common stock and on the terms upon which we could obtain additional capital. It should be expected that the holders of such options and warrants would exercise them at a time when we would be able to obtain equity capital on terms more favorable then those provided by the options and warrants.

The issuance of preferred stock may adversely affect the price of our common stock, which could cause a reduction in the value of your investment.

We are authorized to issue up to 2,000,000 shares of preferred stock. The preferred stock may be issued in series from time to time with such designations, rights, preferences and limitations as our board of directors may determine by resolution without shareholder approval. No shares of preferred stock are currently outstanding. However, we may issue preferred stock which would enjoy dividend and liquidation preferences over our common stock, thereby diminishing the value of our common stock.

The sale of a substantial number of shares could cause the market price of our common stock to decline.

Our sale, or the resale by our stockholders, of shares of our common stock after this offering could cause the market price of our common stock to decline.

A significant portion of our outstanding shares of common stock had been restricted from immediate resale, but are now available for sale in the market pursuant to Rule 144 under the Securities Act of 1933. As of September 30, 2004, we had 2,946,642 shares of restricted common stock outstanding, of which 1,268,954 shares are eligible for resale in accordance with Rule 144.

Furthermore, we have an effective registration statement under the Securities Act of 1933 that permits the resale by certain of our shareholders of up to 1,677,688 shares of our restricted common stock, of which 1,017,712 shares are currently issued and outstanding and 659,976 shares are subject to outstanding warrants that are currently exercisable at a price of $7.70 per share.

As of November 30, 2004, we had outstanding options to acquire up to approximately 1,661,709 shares of our common stock at prices ranging from $1.19 to $21.56 per share. The shares of common stock issuable upon exercise of these options will be freely transferable without restriction, except to the extent that they are held by our affiliates. Any shares held by our affiliates may only be sold in compliance with the volume limitations of Rule 144. These volume limitations restrict the number of shares that may be sold by an affiliate in any three-month period to the greater of 1% of the number of shares then outstanding, which will equal approximately 73,725 shares immediately after this offering, or the average weekly trading volume of our common stock during the four calendar weeks preceding the filing of a notice on Form 144 with respect to the sale.

Table of Contents

The holders of approximately 1,584,873 shares of our outstanding common stock, and options and warrants to acquire approximately 996,250 shares of our common stock, are expected to sign lock-up agreements. Under these lock-up agreements, these stockholders are expected to agree, subject to limited exceptions, not to sell or pledge any shares owned by them, including shares purchased in this offering, for a period ranging from 120 to 180 days after the commencement of this offering, unless they first obtain the written consent of the managing underwriters, which may be granted. Ladenburg Thalmann & Co. Inc. has no pre-established conditions to waiving the terms of the lock-up agreements, and any decision by it to waive those terms would depend on a number of factors, which may include market conditions, the performance of our common stock in the market and our financial condition at that time.

Our management and directors will continue to control our management and affairs.

As of September 30, 2004, management and directors, including Joseph E. Cresci, Donald A. Livingston, Kamlesh R. Tejwani, Robert I. Weisberg, Jessie J. Knight, Jr., John R. Cooper, August Schumacher, Jr. and R. Jeffrey Macartney, beneficially owned approximately 37% of our outstanding common stock. While there are no voting agreements among them, such persons, as a group, may be able to control the outcome of matters submitted for stockholder action, including the election of members to our board of directors and the approval of significant change in control transactions. This may have the effect of delaying or preventing a change in control of our company and, therefore, your opportunity to sell your shares in such a transaction.

The lack of a developed trading market may make it difficult for you to sell your common stock.

Prior to December 27, 2004, our common stock was traded on the OTC Bulletin Board. Trading activity in our common stock has fluctuated and has at times been limited. We cannot guarantee that a consistently active trading market will develop in the future. A holder of our common stock may find it difficult to dispose of our common stock.

The market price for our common stock may be volatile.

The market price for our common stock could be subject to significant fluctuations in response to variations in quarterly operating results, announcements of technological innovations or new projects and products by us or our competitors, or our failure to achieve operating results consistent with any securities analysts projections of our performance.

The stock market has experienced extreme price and volume fluctuations and volatility that have particularly affected the market price of many emerging growth and development stage companies. Such fluctuations and volatility have often been unrelated or disproportionate to the operating performance of such companies.

We will require and are actively seeking significant additional financing, which may result in our issuing a significant number of shares of our common stock or preferred stock, which in turn may dilute your investment.

We require and are seeking corporate and project financing to fund our ongoing operations and growth plans as well as and the cost of any development we may decide to pursue for our anaerobic digester projects. Any such financing could be in the form of debt or equity instruments or a combination of debt and equity instruments. To the extent any such financing involves equity, we may issue a significant number of shares of our common stock or preferred stock, which will dilute your investment in our common stock, and we may issue such shares at prices that may be lower than the price you paid for our common stock. In addition, if we issue shares of our preferred stock, such preferred stock will have rights and preferences that are superior to those of the shares of common stock offered hereby.

Table of Contents

Purchasers in this offering will suffer immediate and substantial dilution.

If you purchase common stock in this offering, the value of your shares based upon our actual book value will immediately be less than the offering price you paid. This reduction in the value of your equity is known as dilution. Based upon the pro forma net tangible book value of our common stock at September 30, 2004 and an assumed public offering price of $6.95 per share, your shares will be worth $3.89 less per share than the price you paid in this offering. If outstanding options and the warrants are exercised, additional dilution is likely to occur. As of November 30, 2004, options and warrants to purchase 2,321,666 shares of common stock at a weighted average exercise price of $7.71 per share were outstanding. In addition, if we raise additional funding by issuing more equity securities, the newly issued shares will further dilute your percentage ownership of our shares and may also reduce the value of your equity.

Table of Contents

USE OF PROCEEDS

We estimate the net proceeds from this offering, after deducting underwriting discounts and commissions and the estimated offering expenses payable by us, will be approximately $15,324,375 (approximately $17,683,031 if the over-allotment option granted to the underwriters is exercised in full). This estimate is based on an assumed offering price of $6.95 per share, the last reported sale price of our common stock on January 10, 2005 on the American Stock Exchange.

We intend to use the net proceeds from this offering primarily for working capital and for general corporate purposes, including the expansion of Microgy s business, as well as the discharge of certain corporate obligations of our parent holding company.

The amounts actually spent by us for any specific purpose may vary significantly and will depend on a number of factors, including the progress of our commercialization and development efforts. Accordingly, our management has broad discretion to allocate the net proceeds. Pending the uses described above, we intend to invest the net proceeds of this offering in short-term, interest-bearing, investment-grade securities.

PRICE RANGE OF COMMON STOCK

Our common stock trades on the American Stock Exchange under the symbol EPG. As of September 30, 2004 there were approximately 335 record holders and approximately 1,560 beneficial holders of our common stock.

The following table shows the quarterly high and low bid prices during 2002, 2003 and 2004 as reported by the OTC Bulletin Board, where our stock traded prior to its listing on the American Stock Exchange on December 27, 2004, and after giving effect to a 1-for-7 reverse split of our common stock on November 30, 2004.

	High	Low
Fiscal Year Ended December 31, 2002		
First Quarter	$ 4.20	$ 3.15
Second Quarter	6.30	2.80
Third Quarter	4.34	2.45
Fourth Quarter	3.01	1.05
Fiscal Year Ended December 31, 2003		
First Quarter	2.10	7.33
Second Quarter	1.96	1.19
Third Quarter	8.05	1.26
Fourth Quarter	7.56	5.60
Fiscal Year Ended December 31, 2004		
First Quarter	10.78	6.16
Second Quarter	8.19	5.95
Third Quarter	7.84	6.44
Fourth Quarter (through December 24, 2004)	8.15	5.60

These over-the-counter quotations reflect inter-dealer prices without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

Table of Contents

The following table shows the quarterly high and low sales prices during the remainder of the fourth quarter of 2004 and the first quarter of 2005 through January 10, 2005 as reported on the American Stock Exchange.

	High	Low
Fiscal Year Ended December 31, 2004		
Fourth Quarter (from December 27, 2004 through December 31, 2004)	$ 7.05	$ 6.85
Fiscal Year Ended December 31, 2005		
First Quarter (through January 10, 2005)	7.00	6.60

DIVIDEND POLICY

Our board of directors has not declared any dividends on our common stock since the last quarter of 2000. Due to our acquisition of Microgy in 2001 and the anticipated continued expansion of our business, our board of directors has determined that available cash flows should be used for operating and investing activities for the foreseeable future.

Table of Contents

CAPITALIZATION

The following table sets forth our capitalization as of September 30, 2004:

- on an actual basis; and
- on an as adjusted basis to reflect the issuance and sale of 2,500,000 shares of our common stock in this offering at an assumed offering price of $6.95 per share, after deducting the underwriting discounts and commissions and the estimated offering expenses payable by us.

This table excludes 2,321,666 shares of our common stock reserved as of September 30, 2004 for issuance upon exercise of outstanding options and warrants. You should read this table together with our financial statements and accompanying notes and with Management s Discussion and Analysis of Financial Condition and Results of Operations appearing elsewhere in this prospectus.

	ACTUAL	AS ADJUSTED
DEBT		
Working capital loan	$ 2,221,000	$ 2,221,000
Secured promissory notes payable and other borrowings	4,046,189	4,046,189
Total Debt	6,267,189	6,267,189
SHAREHOLDERS EQUITY		
Preferred stock (1)		
Preferred stock of subsidiary (2)	100	100
Common stock (3)	49,610	74,610
Additional paid-in capital	14,843,253	30,142,629
Accumulated deficit	(3,709,904)	(3,709,904)
Accumulated other comprehensive loss	(324,815)	(324,815)
Treasury stock (4)	(385,402)	(385,402)
Deferred compensation	1,554,658	1,554,658
Notes receivable from officers and board members	(645,948)	(645,948)
Total Shareholders Equity	$ 11,381,552	$ 26,705,923

(1) $.01 par value; 2,000,000 shares authorized, no shares issued.

(2) Preferred stock of subsidiary, no par value, 10 shares authorized, 10 shares issued as of September 30, 2004 and December 31, 2003, respectively.

(3) $.01 par value; 21,400,000 shares authorized; 4,960,994 issued, 88,430 shares held in treasury and 4,872,564 outstanding as of September 30, 2004; 7,460,994 shares issued, 88,430 shares held in treasury and 7,372,564 shares outstanding, as adjusted, as of September 30, 2004.

(4) 88,430 shares at cost, as of September 30, 2004 and December 31, 2003.

Table of Contents

DILUTION

Our net tangible book value as of September 30, 2004 was approximately $7,200,863, or $1.48 per share. Net tangible book value per share represents our total tangible assets less our total liabilities, divided by the aggregate number of shares of our common stock outstanding. After giving effect to the sale of the 2,500,000 shares of our common stock in this offering, after deducting the estimated underwriting discounts and commissions and the estimated offering expenses payable by us, our net tangible book value at September 30, 2004 would have been approximately $22,525,238 or $3.06 per share. We have assumed a public offering price of $6.95 per share, which was the closing price of our common stock on the American Stock Exchange on January 10, 2005. This represents an immediate increase in net tangible book value per share of $1.58 to existing stockholders and an immediate dilution of $3.89 per share to new investors. Dilution per share represents the difference between the amount per share paid by the new investors in this offering and the net tangible book value per share at September 30, 2004, giving effect to this offering. The following table illustrates this per share dilution to new investors.

Assumed public offering price per share	$ 6.95
Net tangible book value as of September 30, 2004	$ 7,200,863
Increase in net tangible book value attributable to new investors	$ 15,324,375
Net tangible book value after this offering	$ 22,525,239
Dilution per share to new investors	$ 3.89

These calculations assume no exercise of stock options and warrants outstanding as of September 30, 2004. As of September 30, 2004, there were options and warrants outstanding to purchase an aggregate of 2,321,666 shares of our common stock at a weighted average exercise price of $7.71 per share. To the extent all of these options and warrants had been exercised as of September 30, 2004, the dilution to new investors would be greater.

Table of Contents

SELECTED CONSOLIDATED FINANCIAL DATA

The selected consolidated financial data presented below for the fiscal years ended December 31, 1999, 2000, 2001, 2002 and 2003 have been derived from our consolidated financial statements that have been audited by Deloitte & Touche LLP, an independent registered public accounting firm. The selected consolidated financial data for the nine months ended September 30, 2003 and 2004 have been derived from our unaudited consolidated financial statements. In the opinion of our management, such unaudited consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements and include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of our operating results and financial position for such periods and as of such date. Our operating results for the nine months ended September 30, 2004 are not necessarily indicative of the results to be expected for the entire fiscal year ending December 31, 2004. The financial data presented below should be read in conjunction with the other financial information appearing elsewhere in this prospectus.

	Year Ended December 31,					Nine Months Ended September 30,	
	2003	2002	2001(1)	2000	1999	2004	2003
	(in thousands)						
Results of Operations Data:							
Revenues	$ 53,365	$ 54,984	$ 53,518	$ 54,303	$ 48,268	$ 42,713	$ 39,012
Costs and expenses:							
Operating expenses	25,124	24,140	23,681	22,291	21,931	22,528	19,669
Lease expenses	22,382	25,291	24,706	26,416	23,111	14,373	14,439
Cost of goods sold						1,670	
General and administrative expenses	5,644	5,605	3,859	3,603	2,455	4,367	4,438
Non-cash compensation	713	50	114			1,988	515
Depreciation and amortization	495	545	441	415	363	357	371
Total costs and expenses	54,358	55,631	52,801	52,725	47,860	45,283	39,432
Operating (loss) income	(993)	(647)	717	1,578	408	(2,570)	(420)
Other income (expense):							
Interest income	31	48	78	737	111	30	21
Interest expense	(352)	(142)	(185)	(320)	(375)	(568)	(136)
Sale of NOx emission credits		2,428		1,156	607		
Amortization of deferred gain	308	308	308	308	308	231	231
Other income (expense)	2		2,135				2
Total other income (expense)	(11)	2,642	2,336	1,881	651	(307)	118
Income (loss) before income taxes	(1,004)	1,995	3,053	3,459	1,059	(2,877)	(303)
Income tax (expense) benefit	26	(857)	(1,374)	(1,632)	(470)	538	(98)
Income (loss) before cumulative effect of a change in accounting principle	(978)	1,138	1,679	1,827	589	(2,339)	(400)
Cumulative effect of a change in accounting principle(2)					1,189		
Net (loss) income	$ (978)	$ 1,138	$ 1,679	$ 1,827	$ 1,778	$ (2,339)	$ (400)
Basic earnings (loss) per common share(3)	$ (0.29)	$ 0.38	$ 0.83	$ 1.12	$ 1.09	$ (0.53)	$ (0.12)
Diluted earnings (loss) per common share(3)	$ (0.29)	$ 0.38	$ 0.79	$ 1.12	$ 1.09	$ (0.53)	$ (0.12)
	3,376	2,973	2,107	1,630	1,629	4,367	3,238

Weighted average number of common shares outstanding on a diluted basis (in thousands)(3)							
Balance Sheet Data:							
Total assets	$ 103,154	$ 92,958	$ 85,566	$ 69,284	$ 58,782	$ 108,056	$ 101,640
Working capital	3,876	(585)	(1,499)	(1,176)	(2,662)	8,300	4,189
Deferred gain	3,855	4,164	4,472	4,780	5,089	3,624	3,932
Long-term obligations	79,814	71,244	65,216	58,304	51,546	80,967	78,919
Shareholders equity (deficit)	6,620	6,186	4,383	(3,970)	(5,471)	11,382	6,993

(1) The Results of Operations Data for 2001 includes Microgy from July 23, 2001 to December 31, 2001.

(2) Net income in 1999 includes a cumulative effect of a change in accounting principle of $1,188,989 net of $812,440 in income taxes.

(3) The share and per share data have been restated to reflect the 1-for-7 reverse stock split that was effective on November 30, 2004

Table of Contents

MANAGEMENT S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

Our mission is to be a leading company in resource management and energy production technologies that serve multiple socially responsible markets. Since inception, we have been an independent developer and owner of non-commodity, renewable and alternative energy facilities that produce biofuels or electricity by utilizing fuel derived from our agricultural waste management processes or alternative fuel sources such as waste coal. Such fuel sources generally are not subject to the pricing and market fluctuations of commodity fuels and, in some instances, are considered renewable energy fuels. We have developed seven hydroelectric plants, two municipal waste projects, and three waste coal-fired generating facilities. We sold or transferred all of these projects either in development or after completion. We currently have two principal business units, Buzzard Power Corporation and Microgy Cogeneration Systems, Inc., which are described below.

Buzzard Power Corporation

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

Microgy Cogeneration Systems, Inc.

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

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

Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that effect the reported amounts of assets and liabilities at the date of the financial statements, the reported amounts of revenues and expenses during the reporting period, and the disclosure of contingent assets and liabilities at the date of the financial statements. Actual results could differ from those estimates. Our management believes the following critical accounting policies, among others discussed in Note B to our consolidated financial statements, involve more significant judgments and estimates used in the preparation of our consolidated financial statements.

Table of Contents

Sale and Lease-Back Accounting

Our 1990 sale of Scrubgrass Power Corporation, the original developer of the Scrubgrass facility, was not treated as a sale for financial accounting purposes, due to the existence of an option which enabled us to reacquire Buzzard, then a wholly owned subsidiary of Scrubgrass Power Corporation and owner of the right to lease the Scrubgrass facility, for a substantial portion of its commercial operation. We exercised our option and reacquired Buzzard in 1991 so that we would have the right to lease the Scrubgrass facility. The then-proposed lease provided Buzzard with a fair market value purchase option to acquire the Scrubgrass facility at the end of the lease. This option meant that we had retained substantial risks or rewards of ownership of Scrubgrass. Therefore, we were not permitted to recognize the sale until 1993, when we agreed to a modification to the proposed form of lease and relinquished the fair market value purchase option. Accordingly, we removed from our consolidated financial statements the gross assets and liabilities of the Scrubgrass facility and reported a gain of $6,785,035 arising from the sale of Scrubgrass. However, due to our anticipated involvement with the lease, we were required to defer our gain over the 22-year minimum lease term, which commenced on June 30, 1994. In connection with the operating lease, we incurred aggregate costs of $3,279,060 to reacquire Buzzard, the lessee of Scrubgrass, and capitalized these costs as the value of our lease rights. The value of our lease rights is also being amortized over the 22-year minimum lease term, which commenced on June 30, 1994.

Lease Expense Recognition

We have a long-term lease agreement for Scrubgrass, which commenced on June 30, 1994, and continues for a 22-year minimum lease term. Under the terms of the lease, Buzzard, as lessee, is required to pay the lessor a specified base rent, which consists of all of the lessor s debt service, scheduled equity repayment, base return on equity and related expenses. Buzzard is also required to pay the lessor an additional rent of 50 percent of the net cash flows Buzzard receives from the operation of Scrubgrass. The lessor s specified base rent increases over time and is based on a schedule which follows the expected receipt of revenues. In accordance with accounting principles generally accepted in the United States of America, we are required to aggregate the estimated lease payments over the life of the lease and recognize them on a straight-line basis over the 22-year lease term. As such, during the earlier years of the lease agreement, a portion of our lease expenses will be paid in cash and a portion will be recorded to a liability. As of December 31, 2003, we have a deferred lease expense of $75,314,725 recorded on our consolidated balance sheet. This liability represents accumulated lease expenses recorded on a straight-line basis in previous years which have not been paid to the lessor. In the later years of the lease, we expect that our cash payments to the lessor will exceed the lease expenses recorded on a straight-line basis and the accrued lease expense will be decreased and reach zero by the end of the lease term. This straight-line accounting treatment of certain lease expenses under the Scrubgrass lease resulted in non-cash lease expense of $5,121,732, $6,543,998, and $7,460,852 for the years ended December 31, 2003, 2002, and 2001, respectively and $1,606,228 for the nine months ended September 30, 2004. Additional rents are not part of this straight-line basis and are recorded as incurred. Environmental Power Corporation, which indirectly owns 100% of Buzzard s common stock, is not liable for future lease rental payments. Buzzard s stock is pledged as security, and Buzzard is only liable for future lease rental payments to the extent Buzzard receives cash receipts from future power generation revenues.

As of September 30, 2004, without regard to straight-line lease accounting, we estimate the future minimum lease payments over the remaining base term of the Scrubgrass lease are as follows:

2004	2005	2006	2007	2008	Thereafter	Total
$4,925,750	21,715,000	26,058,000	28,910,000	29,390,000	219,850,000	$330,848,750

Our lease expense components, which are discussed in the following paragraphs, consist of:

specified base rent payments calculated on a straight-line basis; and

additional rent.

Table of Contents

As noted above, Buzzard, as lessee, is required to pay the lessor a specified base rent, which consists of all of the lessor s debt service, scheduled equity repayment, base return on equity and related expenses. The lessor s debt service largely consists of debt obligations with variable interest rates. Therefore, in order to calculate future minimum lease payments, we estimate an average interest rate which will be payable in the future for each variable rate debt obligation. Because actual interest rates will differ from these estimates, our actual lease expense reported in future periods will differ from these estimates and the differences may be material.

In order to calculate the straight-line lease expense, we take the total estimated future minimum lease payments over the lease term and divide it by the lease term to get an annual lease expense. The annual lease expense is then compared to the total amount projected to be billed by the lessor in each period, and the difference is reported as a straight-line lease expense in our consolidated financial statements. Any differences between actual lease billings and projected lease billings, which principally result from variances between actual interest rates and projected interest rates, are reported as a lease expense in the current period.

We are also required to pay the lessor an additional rent, in addition to the specified base rent, which additional rent represents 50 percent of the net cash flows Buzzard receives from the operation of Scrubgrass. We estimate and accrue additional rent in the accounting period when earned. However, because additional rent is based on cash flows and not earnings, it is more subjective to determine when the cash flows were generated from operations. Lease expenses may also cause large fluctuations between accounting periods in our reported earnings since the specified base rent and additional rent are not directly related to our earnings. Additional rent is not part of the straight-line lease expense calculation.

Revenue Recognition

We record power generation revenues when electricity is transmitted to the utility under the terms of the underlying power sales agreement. However, under the terms of our long-term power purchase agreement, or PPA, with Penelec, the same annual generation of electricity is expected to result in significant increases in revenues over the life of this agreement. For various reasons, including the requirement that all the power generated by the Scrubgrass facility be sold to one customer, we account for power generation revenues under the lease accounting rules as if the power sales agreement was a sublease to this customer. In accordance with accounting principles generally accepted in the United States of America, we are therefore required to aggregate the expected revenue to be received over the life of the power sales agreement and recognize it on a straight-line basis over the 22-year lease term. As such, during the early years of the power sales agreement with Penelec, a portion of our power generation revenues will be received in cash and a portion will be recorded to an asset. However, because we cannot predict whether revenues would be collected over the entire life of the power sales agreement, and absent revenues, whether Buzzard would be able to perform under the lease, the recognition of revenue on a straight-line basis was limited to the recognition of lease expense on a straight-line basis. As a result, net income is not affected by straight-line lease and revenue accounting. As of December 31, 2003, we have accrued power generation revenue of $75,314,725 recorded on our consolidated balance sheet which is equal in amount to the accrued lease expense. This asset represents accumulated revenue recorded on a straight-line basis in previous years that has not been collected from Penelec. This straight-line accounting treatment of power generation revenue under the power sales agreement with Penelec resulted in non-cash revenues of $5,121,732, $6,543,998, and $7,460,852 for the years ended December 31, 2003, 2002, and 2001, respectively. In the later years of the power sales agreement, we expect that our cash receipts from Penelec will exceed the revenues recorded on a straight-line basis and the accrued power generation revenue will be decreased and reach zero by the end of the lease term. Future cash collections from power generation revenue may vary from the projections used to aggregate the expected revenue to be received over the life of the power sales agreement, which we recognize on a straight-line basis over the 22-year lease term.

We are recognizing revenues associated with the construction of three of the five farm projects that we signed under the Dairyland agreement using the percentage of completion method. However, due to our relative inexperience with the construction of projects of this kind, we are currently limiting our revenue recognition to

22

an amount equal to our cost of construction, thereby not recognizing any gross profit until the project sale process is complete. Once we have a proven track record of successfully completing projects of this kind, we intend to move to the standard percentage of completion method of revenue recognition and recognize a prorated share of gross profit each period we record revenue.

Accounting for Income Taxes

As part of the process of preparing our consolidated financial statements we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves us estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as our deferred gain and lease rights, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period, we must include an expense within the tax provision in the consolidated statement of operations.

Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our deferred tax assets. As of December 31, 2003, we recorded a deferred income tax asset of $645,840 and a valuation allowance of $645,840 against our gross deferred income tax assets; due to uncertainties related to our ability to utilize some of our net operating loss carry forwards before they expire. The valuation allowance is based on our estimates of taxable income by jurisdiction in which we operate and the period over which our deferred tax assets will be recoverable. In the event that actual results differ from these estimates or we adjust these estimates in future periods we may need to establish an additional valuation allowance which could materially impact our financial position and results of operations.

Intangible Assets

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 142, Goodwill and Other Intangible Assets. The most significant changes made by SFAS No. 142 are:

- goodwill and indefinite-lived intangible assets will be tested for impairment at least annually;
- goodwill and indefinite-lived intangible assets will no longer be amortized to income; and
- the amortization period of intangible assets with finite lives will no longer be limited to forty years.

The provisions of SFAS 142 were applied to the goodwill and intangible assets of $4,912,866 acquired in the Microgy acquisition. We did not have goodwill or intangible assets recorded on our balance sheet prior to the Microgy acquisition. We adopted SFAS 142 on January 1, 2002 and completed the transitional impairment testing in June 2002 and required annual testing at December 31, 2002 and 2003. We assessed the implied fair value of the reporting unit by using a discounted cash flow analysis. In consideration of these factors, we concluded that the fair value of the reporting unit exceeded the carrying amount of its net assets and, thus, goodwill was not impaired as of January 1, 2002, December 31, 2002, and December 31, 2003.

Results of Operations

Comparison of the Nine Months and Three Months ended September 30, 2004 and 2003

For the nine months ended September 30, 2004, we had a net loss of $2,341,738, or a loss of $0.53 per common share, compared to a net loss of $404,633, or a loss of $0.12 per common share, for the nine months ended September 30, 2003. The decrease in net income was primarily attributable to a $1,730,706 pre-tax loss in

Table of Contents

Microgy and a $2,786,853 pre-tax loss in All Other Segments, which is comprised of corporate items that are not directly tied to either Microgy or Buzzard, for the nine months ended September 30, 2004, as compared to pre-tax losses in the same period in 2003 of $1,233,585 and $1,044,928, respectively. These decreases were due to increased operating expenses at Microgy and at the home office that are tied to the construction of the first three Microgy plants. Buzzard provided pre-tax income of $1,641,987 for the nine months ended September 30, 2004, compared to pre-tax income $1,975,975 for the nine months ended September 30, 2003. This decrease was due primarily to increased operating and maintenance expenses. The decrease in earnings per common share was partially offset by the increase in the weighted average common shares outstanding due to the issuance of additional shares of common stock in connection with our private placement concluded in the second quarter of this year, referred to as the 2004 Private Placement. In the 2004 Private Placement, we issued 1,007,142 shares of common stock and 503,571 warrants to purchase common resulting in net proceeds of $5,068,019.

For the three months ended September 30, 2004, we had net income of $2,363,144, or $0.48 per common share and $0.44 per diluted share, compared to net loss of $749,642, or a loss of $0.22 per common share on a basic and diluted basis, for the same period in 2003. The increase in net income was primarily attributable to pre-tax income of $2,706,555 at Buzzard, an increase from a pre-tax loss of $46,189 for the three months ended September 30, 2003. The increase was due to increased operating capacity. In 2003, there was an unexpected outage that sharply reduced operating capacity. Pre-tax losses at Microgy increased to $725,726 from $427,720 for the third quarters of 2004 and 2003, respectively, due to increased project-related costs. Pre-tax income for All Other segments was $77,121, compared to a pre-tax loss of $727,164 for the three months ending September 30, 2004 and 2003, respectively, due to the variable accounting of performance based stock options for key executives, described in *Note C Stock Options and Stock-Based Compensation* to our financial statements. Offsetting the increase in earnings per common share was an the increase in the weighted average common shares outstanding due to the issuance of additional shares of common stock in connection with the 2004 Private Placement.

Revenues increased 9% to $42,713,408 from $39,012,266 for the nine months ending September 30, 2004 and 2003, respectively. For the three months ending September 30, 2004, revenues increased 41% to $16,772,134 from $11,923,173 in the same period in 2003. For both periods, the increases were due to increases in revenues at both Buzzard and Microgy. At Buzzard, operating capacity increased due to the absence of any unexpected outages as had occurred in 2003. In addition, Microgy recognized its first revenues in the sale of the first three projects, based upon the percentage completion method, as discussed in more detail below.

Costs and expenses increased by 15% and 12% for the nine and three months ended September 30, 2004 compared to the same periods in 2003. These increases were primarily attributable to operating expenses at Buzzard and Microgy. Buzzard expenses increased due primarily to increased maintenance expenses. Microgy expenses increased as a result of the growth of the business and construction of its first projects. Furthermore, we recorded an additional $1,472,327 in non-cash compensation expense in 2004 related to non-employee stock and option grants and employee options that are subject to variable accounting treatment.

We had other expenses of $306,125 for the nine months in 2004 compared to other income of $117,926 in 2003. For the three months ended September 30, 2004 and 2003, other expenses increased to $89,939 from $3,943. These decreases are primarily due to increased interest expenses related to the ArcLight loan, described in *Note G Long Term Liabilities and Commitments* to our financial statements.

For the nine months ended September 30, 2004, we reported a tax benefit of $537,584 compared to an expense of $98,345 for the same period in 2003. For the three months ended September 30, 2004 and 2003, we recorded a tax benefit of $305,195 and $452,681, respectively. Our tax rate is based upon forecasts for a full year of operations. Currently, we expect to have a federal tax benefit and a state tax obligation, resulting in a combined tax benefit of $716,779 for the full year. However, we have not recognized any deferred taxes and the benefit that has been and will be recorded is only related to realized carry-backs.

Table of Contents

The results of operations for the business segments are discussed below.

Microgy

Pre-tax losses at Microgy increased to $1,730,706 for the nine months ended September 30, 2004, compared to a pre-tax loss of $1,233,585 for the nine months ended September 30, 2003. For the three months ended September 30, 2004, pre-tax losses increased to $725,726 from $427,720 for the same period in 2003. These increases resulted from increases in operating expenses associated with the growth of our Microgy subsidiary and beginning construction on three plants.

For the nine and three months ended September 30, 2004, Microgy recognized its first revenues of $1,670,306. We are recognizing revenues associated with the construction of three of the five farms projects that we signed under the Dairyland agreement, Five Star, Wild Rose, and Norswiss, using the percentage of completion method. However, due to the uncertainty of the projects, we are currently limiting our percentage complete revenue recognition to an amount equal to our cost of construction, thereby not recognizing any gross profit until the project sale process is complete. Once we have a proven track record of successfully completing projects of this kind, we will move to the standard percentage of completion revenue recognition and recognize a prorated share of gross profit each period we record revenue. We began billing Dairyland for construction costs on these farms in August 2004.

For the nine and three months ended September 30, 2004, we recognized $1,670,306 in costs of construction. There were no such expenses for the same periods in 2003.

Operating expenses for the nine months ended September 30, 2004 increased to $2,377,136 from $1,088,666 for the nine months ended September 30, 2003. The increase is primarily attributed to increases in project expenses of $764,138, payroll expenses of $354,543, insurance expenses of $28,448, and professional services of $27,963. Operating expenses for the three months ended September 30, 2004 increased to $1,454,772 from $379,174 for the same period in 2003. This increase is attributed to increases in project-related expenses of $775,283, payroll of $197,469, and travel and entertainment expenses of $9,941. The increase in operating expenses for both periods is due to the growth of Microgy and to the expenses related to the construction of its first facilities.

Buzzard

Pre-tax income at Buzzard decreased to $1,641,987 for the nine months ended September 30, 2004 compared to $1,975,975 for the nine months ended September 30, 2003. This decrease was primarily attributable to an increase in operating and maintenance expenses and was offset by an increase in operating capacity this period, leading to a 12% increase in total energy sales. Buzzard provided pre-tax income of $2,706,555 for the three months ended September 30, 2004, up from pre-tax loss of $46,189 for the same period in 2003. This increase was attributable to increased power generation revenues for the third quarter 2004.

For the nine months ended September 30, 2004, power generation revenues increased to $41,043,102 from $39,012,266 in the same period last year. This increase is principally due to a 5% increase in billable rates to Penelec, the purchaser of power from this facility. Directly contributing to the increase in power generation revenues was an increase in operating capacity to 90% for the nine months ended September 30, 2004 from 84% for the same period in 2003 when we suffered an unexpected outage caused by an electrical storm. For the three months ended September 30, 2004 and 2003, power revenues increased 27% to $15,101,828 from $11,923,173 due to an increase in operating capacity from 75% to 99%

and the 5% increase in billable rates.

Accrued power generation revenues decreased to $1,606,228 from $3,841,299 and to $535,413 from $1,280,433 for the nine and three months ended September 30, 2004 and 2003, respectively. The decreases result from the FASB 13 accounting treatment of the Scrubgrass lease. In accordance with accounting principles generally accepted in the United States, we are required to treat the power sales agreement as a lease, aggregate the minimum lease payments expected to be received over its life, and recognize it on a straight-line basis over

Table of Contents

the 22-year lease term. However, we have limited the recognition of accrued power revenues to the recognition of the deemed minimum payments of the facility lease so that we do not recognize any profits early related to executory costs or payment for goods and services other than solely for the right to use the facility. This minimum lease payment component is higher in the early years, decreases in the subsequent years, and reverses itself in the later years of the power purchase agreement. This adjustment has no effect on pre-tax income because it is completely offset by an accrued lease expense.

Total operating expenses for 2004 increased 15% to $22,527,867 from $19,699,118 for 2003. The increase is primarily attributed to a 19% increase in total maintenance expense to $5,418,433 for the nine months ended September 30, 2004 from $4,555,847 for the same period in 2003. This increase was related to major maintenance items that will increase the length of time between major maintenances. Further contributing to the increase in total operating expenses was a 26% increase in fuel expense to $8,316,086 for the nine months ended September 30, 2004, up from $6,606,639 for the nine months ended September 30, 2003. The increase in the capacity factor directly contributed to the increase in operating expenses. Because the plant was online 6% longer for the nine months ended September 30, 2004 as compared to the same period in 2003, the plant required more fuel and greater maintenance in the nine months ended September 30, 2004.

Operating expenses for the three months ended September 30, 2004 increased 17% to $7,042,739 as compared to $6,020,393 for the same period in 2003. The increase was due primarily to increased fuel expenses of $1,002,370 and labor expenses of $93,955. These increases were partially offset by decreases in plant maintenance of $162,032.

Lease expenses for 2004 decreased by $66,227 to $14,373,121 for the nine months ended September 30, 2004 as compared to $14,439,348 for the same period in 2003. This decrease was primarily due to decreases in senior debt principal repayments and senior debt interest that were offset by an increase in equity rents to $4,256,838 from $1,382,322. For the three months ended September 30, 2004, lease expenses increased to $4,759,718 from $4,755,928 in the same period in 2003. The increase was due to a $1,300,678 increase in equity rents that was offset by decreases in senior debt principal and interest payments. All of the increases in equity rents are due to scheduled payments.

All Other Segments

All other segments are comprised of corporate expenses and non-current business segments. For the nine months ended September 30, 2004, we had a pre-tax loss of $2,786,853 compared to a pre-tax loss of $1,044,928 for the same period in 2003. Pre-tax income increased to $77,121 from a pre-tax loss of $727,164 for the three months ending September 30, 2004 and 2003, respectively. These losses are all attributable to general and administrative expenses at our corporate offices (see discussion below). We do not have any revenues in these segments.

General and administrative expenses increased to $2,483,309 for the nine months ended September 30, 2004 from $1,170,957 for the same period 2003. This increase is primarily due to a $1,472,327 increase in non-cash stock compensation. These expenses are related to stock and options granted to non-employees for services rendered and to the variable accounting of performance based stock options for key executives. Please see *Note C Stock Options and Stock-Based Compensation* to our financial statements for more information.

For the three months ended September 30, 2004, we had general and administrative income of $167,220 compared to an expense of $732,162 for the same period in 2003. The change in expenses was due primarily to the variable accounting of performance-based stock options for key executives, described in *Note C*. This decrease was primarily a result in the change in the price of our common stock from $7.49 per share to $6.44 per share on June 30, 2004 and September 30, 2004, the respective measurement dates.

We had other expenses of $289,074 and $85,382 for the nine and three months ended September 30, 2004 compared to other income of $139,551 and $17,682 in same periods in 2003. These decreases are primarily due to increased interest expenses related to the ArcLight loan, described in *Note G Long Term Liabilities and Commitments* to our financial statements.

Table of Contents

Comparison of the Years ended December 31, 2003 and 2002

For 2003, we had a net loss of $978,159 compared to net income of $1,138,383 in 2002. The decrease in net income was primarily due to the absence of sales for nitrogen oxide emission credits, or NOx credits. In 2002, we recorded $2,428,000 of such sales. These differences were partially offset by decreases in additional lease expenses and higher operating revenues at Scrubgrass prior to the transformer failure, as discussed below.

We had a basic and diluted loss per common share of $0.29 in 2003 compared to basic and diluted earnings per common share of $0.38 in 2002. The weighted average common shares outstanding increased in 2003 due to the issuance of additional shares as stock compensation, totaling 115,493 shares, the exercise of 10,000 options and the issuance of 567,857 shares in a private placement in the summer of 2003.

Power generation revenues were $53,364,615 in 2003 and $54,983,934 in 2002, a decrease of approximately 3%. In August 2003, we experienced an unexpected shut down of the Scrubgrass plant. This shut down, caused by a blown transformer during a severe electrical storm, reduced revenues by approximately $2,000,000. However, a 5% increase in power rates in 2003 and improved production capacity before and after the outage helped mitigate these losses. A key performance metric at the Scrubgrass plant is capacity factor. This metric is defined as the number of kilowatt hours of generation divided by the maximum kilowatt hours of generation possible. We operated at an 86.6% capacity factor in 2003 as compared to 91.3% capacity factor in 2002 due to the unexpected shutdown.

This decrease in overall power generation revenues was also attributable to a decrease in the component of power generation revenues recorded as a result of the straight-line accounting treatment of revenues under the power sales agreement which amounted to $5,121,732 in 2003 and $6,543,998 in 2002.

Operating expenses increased to $25,123,425 for 2003 from $24,139,819 for 2002 and all pertained to Scrubgrass. The increase in operating expenses was primarily due to:

- higher repair and maintenance costs due to the August outage of $814,950;
- higher fuel expense from cost escalations in certain fuel supply agreements of $322,509;
- increased NOx reduction expenses of $153,731; and
- higher labor and labor-related costs of $51,202.

These increases were partially offset by decreases in operating bonuses, repairing rather than replacing a Buzzard plant component, and improvements in fuel quality that reduced ash costs.

Lease expenses decreased to $22,382,152 for 2003 from $25,291,293 for 2002. The decrease was primarily due to a decrease of $2,408,824 in additional rent paid to the lessor, which amounts to 50% of the net available cash flows from Scrubgrass, and to a decrease in interest expense.

The average rate on the lessor s outstanding bonds dropped to 1.04% in 2003 from 1.49% in 2002 resulting in a decrease of $963,819 in interest and fees. These decreases in lease expenses were partially offset by an increase in scheduled principal payments for the Scrubgrass debt of $2,702,253 which were billed to us under the terms of the lease and a decrease in lease expenses recorded as a result of the straight-line accounting treatment of lease expenses under the Scrubgrass lease, which amounted to $5,121,732 in 2003 and $6,543,998 in 2002.

General and administrative expenses, excluding non-cash compensation, increased to $5,644,084 for 2003 from $5,605,500 for 2002. The increase was primarily due to increases in our labor expenses of $828,363, as a result of hiring relating to the development of Microgy.

Interest expense increased to $351,755 for 2003 from $141,526 for 2002. The increase was due primarily to the $216,160 of interest related to the ArcLight loan of $3,700,000 that is secured by the future cash flows from the Scrubgrass plant.

We earned net proceeds of $2,428,200 from the sale of NOx credits in 2002. Our NOx credits are discussed further under Liquidity and Capital Resources. No such sales occurred in 2003.

For 2003, we had an income tax benefit of $25,925 compared to income tax expense of $857,274 for 2002. The decrease was primarily due to a decrease in income before taxes in 2003, offset by a $418,717 increase in the valuation allowance for deferred tax assets.