POWERSECURE INTERNATIONAL, INC.
Form 10-Q
August 05, 2010

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2010

or

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

For the transition period from __________ to __________

Commission File Number 1-12014

POWERSECURE INTERNATIONAL, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	84-1169358 (I.R.S. Employer Identification No.)
1609 Heritage Commerce Court Wake Forest, North Carolina (Address of principal executive offices)	27587 (Zip code)

(919) 556-3056
(Registrant s telephone number, including area code)

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

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No þ

As of August 2, 2010, 18,687,180 shares of the issuer s Common Stock were outstanding.

POWERSECURE INTERNATIONAL, INC.
FORM 10-Q
For the Quarterly Period Ended June 30, 2010
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PART I.
FINANCIAL INFORMATION

Item 1. Financial Statements

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

	June 30, 2010	December 31, 2009
Assets		
Current Assets:		
Cash and cash equivalents	$ 3,974	$ 20,169
Trade receivables, net of allowance for doubtful accounts of $330 and $299, respectively	37,711	28,332
Inventories	27,334	21,632
Deferred income taxes	2,713	2,713
Prepaid expenses and other current assets	866	1,300
Total current assets	72,598	74,146
Property, plant and equipment:		
Equipment	25,114	22,252
Furniture and fixtures	676	671
Land, building and improvements	4,838	4,802
Total property, plant and equipment, at cost	30,628	27,725
Less accumulated depreciation and amortization	6,484	5,413
Property, plant and equipment, net	24,144	22,312
Other assets:		
Goodwill	13,395	7,256
Restricted annuity contract	2,265	2,220
Intangible rights and capitalized software costs, net of accumulated amortization of $2,117 and $1,890, respectively	1,947	1,320
Investment in unconsolidated affiliate	4,156	3,974
Other assets	191	249
Total other assets	21,954	15,019
Total Assets	$ 118,696	$ 111,477

See accompanying notes to consolidated financial statements.

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

	June 30, 2010	December 31, 2009
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 7,044	$ 4,116
Accrued and other liabilities	20,003	20,379
Restructuring charges payable		325
Current income taxes payable	144	
Current unrecognized tax benefit	327	327
Current portion of capital lease obligations	776	756
Total current liabilities	28,294	25,903
Long-term liabilities:		
Revolving line of credit		
Capital lease obligations, net of current portion	4,052	4,445
Unrecognized tax benefit	1,169	1,169
Deferred compensation	887	721
Total long-term liabilities	6,108	6,335
Commitments and contingencies (Note 9)		
Stockholders Equity:		
PowerSecure International stockholders equity:		
Preferred stock undesignated, $.01 par value; 2,000,000 shares authorized; none issued and outstanding		
Preferred stock Series C, $.01 par value; 500,000 shares authorized; none issued and outstanding		
Common stock, $.01 par value; 25,000,000 shares authorized; 18,329,780 and 17,241,650 shares issued and outstanding, respectively	183	172
Additional paid-in-capital	112,466	110,911
Accumulated deficit	(30,410)	(32,951)
Total PowerSecure International, Inc. stockholders equity	82,239	78,132
Noncontrolling interest	2,055	1,107
Total stockholders equity	84,294	79,239

Total Liabilities and Stockholders Equity	$	118,696	$	111,477

See accompanying notes to consolidated financial statements.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	**2009**	**2010**	**2009**
Revenues	$ 34,314	$ 25,135	$ 58,988	$ 44,855
Cost of sales	22,477	16,880	37,560	30,726
Gross profit	11,837	8,255	21,428	14,129
Operating expenses:				
General and administrative	9,007	6,072	16,333	12,112
Selling, marketing and service	1,387	969	2,440	1,800
Depreciation and amortization	743	563	1,400	1,105
Total operating expenses	11,137	7,604	20,173	15,017
Operating income (loss)	700	651	1,255	(888)
Other income and (expenses):				
Equity income	807	401	1,837	878
Management fees	142	98	296	203
Interest income and other income	24	38	56	91
Interest expense	(139)	(145)	(280)	(319)
Income (loss) before income taxes	1,534	1,043	3,164	(35)
Income tax provision	(250)	(26)	(476)	(50)
Net income (loss)	1,284	1,017	2,688	(85)
Less: Net income attributable to noncontrolling interest	40	(331)	(147)	(365)
Net income (loss) attributable to PowerSecure International, Inc.	$ 1,324	$ 686	$ 2,541	$ (450)
Earnings (loss) per share attributable to PowerSecure International, Inc. common stockholders:				

Basic	$	0.07	$	0.04	$	0.14	$	(0.03)
Diluted	$	0.07	$	0.04	$	0.14	$	(0.03)
Weighted average common shares outstanding:								
Basic		17,933		17,159		17,587		17,127
Diluted		18,566		17,159		18,136		17,127

See accompanying notes to consolidated financial statements.

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

	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Cash flows from operating activities:		
Net income (loss)	$ 2,688	$ (85)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	1,400	1,105
Stock compensation expense	988	787
Distributions to noncontrolling shareholder	(877)	
(Gain) loss on disposal of miscellaneous assets	(1)	30
Equity in income of unconsolidated affiliate	(1,837)	(878)
Distributions from unconsolidated affiliate	1,618	1,093
Changes in operating assets and liabilities, net of effect of acquisitions:		
Trade receivables, net	(9,031)	(1,378)
Inventories	(5,440)	(3,024)
Other current assets and liabilities	578	189
Other noncurrent assets	73	14
Accounts payable	1,952	1,492
Restructuring charges	(325)	(814)
Accrued and other liabilities	(411)	(1,494)
Deferred compensation obligation	166	166
Restricted annuity contract	(46)	(43)
Net cash used in operating activities	(8,505)	(2,840)
Cash flows from investing activities:		
Acquisitions	(4,413)	(800)
Purchases of property, plant and equipment	(2,560)	(1,612)
Additions to intangible rights and software development	(432)	(134)
Proceeds from sale of property, plant and equipment	19	10
Net cash used in investing activities	(7,386)	(2,536)
Cash flows from financing activities:		
Borrowings (payments) on revolving line of credit		
Payments on capital lease obligations	(373)	(353)
Proceeds from stock option and warrant exercises, net of shares tendered	69	274
Net cash used by financing activities	(304)	(79)

NET DECREASE IN CASH AND CASH EQUIVALENTS	(16,195)	(5,455)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	20,169	24,316
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 3,974	$ 18,861

See accompanying notes to consolidated financial statements.

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POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES
Notes to Unaudited Consolidated Financial Statements
As of June 30, 2010 and December 31, 2009 and
For the Three and Six Month Periods Ended June 30, 2010 and 2009
(in thousands, except per share data)

1. Description of Business and Basis of Presentation

Description of Business

PowerSecure International, Inc., headquartered in Wake Forest, North Carolina, is a leading provider of Energy and Smart Grid Solutions to electric utilities, their commercial, institutional and industrial customers, and of Energy Services to oil and natural gas producers. We provide these customers with products and services in four strategic business areas:

Interactive Distributed Generation,

Utility Infrastructure,

Energy Efficiency, and

Energy Services.

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

Our Energy Services segment is operated through our two other principal operating subsidiaries, Southern Flow Companies, Inc., which we refer to as Southern Flow , and WaterSecure Holdings, Inc., which we refer to as WaterSecure . Our Southern Flow business provides oil and natural gas measurement services to customers involved in oil and natural gas production, transportation, and processing, with a focus on the natural gas market. Southern Flow is headquartered in Lafayette, Louisiana, and provides these services through ten division offices located throughout the Gulf of Mexico, Southwest, Midwest and Rocky Mountain regions. WaterSecure owns approximately 40% of the equity interests in an unconsolidated business, Marcum Midstream 1995-2 Business Trust, which we refer to as MM 1995-2 or as our WaterSecure operations . Our WaterSecure operations provide water processing and disposal services for oil and natural gas producers in northeastern Colorado utilizing environmentally responsible technologies and processes.

See Note 11 for more information concerning our reportable segments.

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Basis of Presentation

Organization The accompanying consolidated financial statements include the accounts of PowerSecure International, Inc. and its subsidiaries, primarily, PowerSecure, Inc. (our PowerSecure subsidiary) (and its majority-owned and wholly-owned subsidiaries, UtilityEngineering, Inc., PowerServices, Inc., EnergyLite, Inc., EfficientLights, LLC, Reid s Trailer, Inc., Innovative Electronic Solutions Lighting, LLC and PowerPackages, LLC), Southern Flow Companies, Inc. (Southern Flow), and WaterSecure Holdings, Inc. (WaterSecure).

These consolidated financial statements have been prepared pursuant to rules and regulations of the Securities and Exchange Commission. The accompanying consolidated financial statements and notes thereto should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2009.

In management s opinion, all adjustments (all of which are normal and recurring) have been made which are necessary for a fair presentation of the consolidated financial position of us and our subsidiaries as of June 30, 2010 and the consolidated results of our operations and cash flows for the three and six month periods ended June 30, 2010 and June 30, 2009.

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

Noncontrolling Interest Until April 30, 2010, our PowerSecure subsidiary held a 67% controlling ownership interest in EfficientLights which is consolidated in our financial statements. On April 30, 2010, we acquired the 33% noncontrolling ownership interest in EfficientLights at which time EfficientLights became a wholly-owned subsidiary of our PowerSecure subsidiary. Also, on April 1, 2010, our PowerSecure subsidiary acquired a 67% controlling ownership interest in IES (see Note 4).

The noncontrolling ownership interests in the income or losses of our majority-owned subsidiaries is included in our consolidated statements of operations as a reduction or addition to net income (loss) to derive income (loss) attributable to PowerSecure International stockholders. Similarly, the noncontrolling ownership interest in the undistributed equity of our majority-owned subsidiaries is shown as a separate component of stockholders equity in our consolidated balance sheet. Our noncontrolling interest consisted of the noncontrolling interest in EfficientLights only for periods until the three month period ended June 30, 2010. The EfficientLights noncontrolling interest reflected in this period consists of results through April 30, 2010, due to our purchase of this noncontrolling interest on that date. Beginning with this same quarter, our noncontrolling interest also includes the results of IES. Because our acquisition of IES occurred at the start of the quarter, these noncontrolling interest results were reflected for the entire three month period ended June 30, 2010. Accordingly, period-to-period comparisons of the aggregate amount of noncontrolling interests are not necessarily comparable.

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The following is a reconciliation of the amounts attributable to the noncontrolling interest for the six months ended June 30, 2010:

	Noncontrolling Interest		
	EfficientLights	IES	Total
Balance, December 31, 2009	$ 1,107	$	$ 1,107
Capital Contributions		2,188	2,188
Income (loss)	280	(133)	147
Distributions	(877)		(877)
Acquisition of noncontrolling interest	(510)		(510)
Balance, June 30, 2010	$	$ 2,055	$ 2,055

The following is a reconciliation of the amounts attributable to the noncontrolling interest for the six months ended June 30, 2009:

	Noncontrolling Interest		
	EfficientLights	IES	Total
Balance, December 31, 2008	$	$	$
Capital Contributions			
Income (loss)	365		365
Distributions			
Acquisition of noncontrolling interest			
Balance, June 30, 2009	$ 365	$	$ 365

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

Reclassifications Certain 2009 amounts have been reclassified to conform to current year presentation. Such reclassifications had no effect on net income or loss or stockholders equity.

2. Summary of Significant Accounting Policies and Recent Accounting Standards

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

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

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

In all cases where we utilize the percentage-of-completion, revenues and gross profit are adjusted prospectively for revisions in estimated total contract costs and contract values. Estimated losses, if any, are recorded when identified. While a project is in process, amounts billed to customers in excess of revenues recognized to date are classified as current liabilities. Likewise, amounts recognized as revenue in excess of actual billings to date are recorded as unbilled accounts receivable. In the event a contract provides for adjustments to the contract price for actual wire or other raw material usage, we recognize the associated revenue when the actual costs are incurred and the customer is billed.

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

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

Service revenue includes utility transmission and distribution system construction and maintenance services, engineering services, regulatory consulting and rate design services, energy conservation services, chart services, field services, laboratory analysis, data management services, and monitoring and maintenance services. Revenues from these services are recognized when the service is performed and the customer has accepted the work.

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

Sales of certain goods or services sometimes involve the provision of multiple elements. Revenues from contracts with multiple element arrangements are recognized as each element is earned based on the relative fair value of each element and when the delivered elements have value to customers on a standalone basis. Amounts allocated to each element are based on its objectively determined fair value, such as the sales price for the product or service when it is sold separately, or competitor prices for similar products and services.

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

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

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

Warranty Reserve We provide a standard one-year warranty for our distributed generation and switchgear equipment, and a five-year warranty for our EfficientLights lighting product. In addition, we offer extended warranty terms on our distributed generation turn-key and switchgear projects. We reserve for the estimated cost of product warranties when revenue is recognized, and we evaluate our reserve periodically by comparing our warranty repair experience by product. The purchase price for extended warranties or extended warranties included in the contract terms are deferred as a component of our warranty reserve.

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

Pre-tax share-based compensation expense for our stock options and restricted stock awards recognized during the three months ended June 30, 2010 and 2009 was $493 and $433, respectively. Pre-tax share-based compensation expense for our stock options and restricted stock awards recognized during the six months ended June 30, 2010 and 2009 was $988 and $787, respectively. All share-based compensation expense is included in general and administrative expense in the accompanying consolidated statements of operations.

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

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

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

Recent Accounting Pronouncements

Accounting for Transfers of Financial Assets In June 2009, the Financial Accounting Standards Board (FASB) issued new guidance on the accounting for the transfers of financial assets. The new guidance, which is now part of FASB Accounting Standards Classification (ASC) 860, *Transfers and Servicing*, requires additional disclosures for transfers of financial assets, including securitization transactions, and any continuing exposure to the risks related to transferred financial assets. There is no longer a concept of a qualifying special-purpose entity, and the requirements for derecognizing financial assets have changed. The adoption of the new guidance on January 1, 2010 had no effect on our financial position or results of operations or on our financial statement disclosures.

Variable Interest Entities In June 2009, the FASB issued revised guidance on the accounting for variable interest entities. The revised guidance, which is now part of ASC 810-10, *Consolidation*, reflects the elimination of the concept of a qualifying special-purpose entity and replaces the quantitative-based risks and rewards calculation of the previous guidance for determining which company, if any, has a controlling financial interest in a variable interest entity. The revised guidance requires an analysis of whether a company has: (1) the power to direct the activities of a variable interest entity that most significantly impact the entity s economic performance and (2) the obligation to absorb the losses that could potentially be significant to the entity or the right to receive benefits from the entity that could potentially be significant to the entity. An entity is required to be re-evaluated as a variable interest entity when the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights to direct the activities that most significantly impact the entity s economic performance. Additional disclosures are required about a company s involvement in variable interest entities and an ongoing assessment of whether a company is the primary beneficiary. The adoption of the new guidance on January 1, 2010 had no effect on our financial position or results of operations or on our financial statement disclosures.

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

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

Multiple Deliverable Revenue Arrangements In October 2009, the FASB issued ASU No. 2009-13 - *Multiple Deliverable Revenue Arrangements A Consensus of the FASB Emerging Issues Task Force*: *(Topic 605) Revenue Recognition*. ASU No. 2009-13 provides application guidance on whether multiple deliverables exist, how the deliverables should be separated and how the consideration should be allocated to one or more units of accounting. This update establishes a selling price hierarchy for determining the selling price of a deliverable. The selling price used for each deliverable will be based on vendor-specific objective evidence, if available, third-party evidence if vendor-specific objective evidence is not available, or estimated selling price if neither vendor-specific or third-party evidence is available. We will be required to apply the new guidance prospectively for revenue arrangements entered into or materially modified after January 1, 2011; however, early application is permitted. We are currently evaluating the effect that this update may have on our financial position or results of operations or on our financial statement disclosures.

Software Elements in Revenue Arrangements In October 2009, the FASB issued ASU No. 2009-14, *Certain Revenue Arrangements That Include Software Elements (Topic 985): Software*. This update provides new standards that amend the scope of previous software revenue guidance by excluding non-software components of tangible products and certain software components of tangible products. These new standards are effective for our fiscal year beginning January 1, 2011; however, early adoption is permitted. We are currently evaluating the effect that this update may have on our financial position or results of operations or on our financial statement disclosures.

3. Earnings (Loss) per Share

Basic earnings (loss) per share is computed by dividing net income (loss) attributable to PowerSecure International, Inc. common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share attributable to PowerSecure International, Inc. common stockholders is computed using the weighted average number of common shares outstanding and, when dilutive, potential common shares from stock options and warrants using the treasury stock method. Diluted earnings per share excludes the impact of potential common shares related to stock options and warrants in periods in which we reported a loss from continuing operations or in which the option or warrant exercise price is greater than the average market price of our common stock during the period because the effect would be antidilutive. A total of 455,000 common shares issuable upon the exercise of in-the-money stock options were excluded from the diluted weighted average number of shares outstanding for the three months ended June 30, 2009 because the net effects of in-the-money stock options, unrecognized stock compensation costs, and tax benefits on nonqualified stock options and time vesting restricted stock awards was antidilutive. A total of 416,000 common shares issuable upon the exercise of in-the-money stock options were excluded from the diluted weighted average number of shares outstanding for the six months ended

June 30, 2009 because their effect was antidilutive to our net loss for the period.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Net income (loss)	$ 1,324	$ 686	$ 2,541	$ (450)
Basic weighted-average common shares outstanding in period	17,933	17,159	17,587	17,127
Add dilutive effects of stock options and warrants	633		549	
Diluted weighted-average common shares outstanding in period	18,566	17,159	18,136	17,127
Basic earnings (loss) per common share:	$ 0.07	$ 0.04	$ 0.14	$ (0.03)
Diluted earnings (loss) per common share:	$ 0.07	$ 0.04	$ 0.14	$ (0.03)

4. Acquisitions

Acquisition of IES On April 1, 2010, we launched an expansion of our LED lighting business through the formation and acquisition of a 67% controlling interest in Innovative Electronic Solutions Lighting, LLC, a Delaware limited liability company (IES), which acquired substantially all of the assets and business of a leading LED lighting development company, Innovative Electronic Solutions, LLC, in order to accelerate the expansion of new LED lighting products and to capitalize on the growing marketplace for LED lighting. The new business will design and manufacture new LED-based lighting products (light emitting diode based products) for commercial, industrial, and retail customers. The business will include turn-key product development, design and manufacturing of solid state LED-based lights and their components, including power drivers, light engines, and thermal management solutions. IES commenced its business and operations by acquiring, on April 1, 2010, substantially all of the assets and business of Innovative Electronic Solutions, LLC, a North Carolina limited liability company. Since 2002, the business acquired by IES has engineered dozens of innovative lighting products for many of the largest and fastest growing LED lighting companies in the marketplace. Among these products is a leading LED street light for utilities. In addition, IES has acquired expertise and market leading technology in the areas of LED power drivers, light engines, and thermal management solutions. This expertise and technology is expected to enable IES to design and manufacture high quality LED lighting products with strong competitive advantages driven by lighting designs that maximize the energy efficiency savings for given light outputs. IES manufacturing operations are located in the Raleigh, North Carolina area.

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Our PowerSecure subsidiary owns 67% of the membership interests in, and controls the management of, IES. Our PowerSecure subsidiary contributed approximately $4.4 million to IES to fund the capitalization of IES and the acquisition by IES of substantially all of the assets and business of the seller as well as the assumption by IES of the seller s current liabilities. In connection with its sale and contribution of substantially all of its asset and business to IES, the seller received the remaining 33% membership interests in IES. The assets acquired and liabilities assumed were allocated, on a preliminary basis, as follows:

Accounts receivable	$	349
Inventory		262
Equipment		427
Deposits		14
Intangible rights		422
Goodwill		6,139
Accounts payable		(977)
Accrued and other liabilities		(35)
Non-controlling interest		(2,188)
Net assets acquired	$	4,413

The operations of IES are included within our Energy and Smart Grid Solutions operating segment commencing from the date of acquisition. Pro forma results of operations for the three and six months ended June 30, 2010 and 2009 have not been included herein as the effects of the acquisition were not material to our results of operations.

Both our PowerSecure subsidiary and the seller are subject to various buy-sell rights and obligations with respect to their equity interests in IES, including various call, put and drag-along rights and obligations. Commencing in 2012, our PowerSecure subsidiary has the right to purchase the minority interest in IES held by the seller and thus increase its ownership of IES to 100%, through the issuance and delivery of shares of our common stock in an amount based on a formula derived from the value of our stock using our E.P.S multiple (or if we do not have positive net income, then our revenue multiple) applied to IES s minority interest, subject to a minimum value of $10 million.

Acquisition of Noncontrolling Interest in EfficientLights On April 30, 2010, our PowerSecure subsidiary, which previously owned two-thirds of the equity interests in EfficientLights, exercised its option and acquired the remaining one-third minority interest in EfficientLights in exchange for 1,025,641 shares of our common stock. The minority interest in EfficientLights was previously owned by the founder, who is also the President of EfficientLights, and five other key employees of EfficientLights. EfficientLights markets and sells LED-based lights that reduce the energy and maintenance costs for refrigerated cases in grocery, drug, and convenience stores, and is in the process of developing other LED-based lighting products, including additional in-store retail lighting, and LED-based parking lot lights, street lights and security lights. As a result of the exercise of our option to purchase the remaining one-third minority interest, EfficientLights has become a wholly-owned subsidiary of our PowerSecure subsidiary and there is no reduction in our net income for net income attributable to the noncontrolling interest in EfficientLights after April 30, 2010.

5. Investment in Unconsolidated Affiliate

Through WaterSecure, we currently own 40.45% of the equity interests in Marcum Midstream 1995-2 Business Trust (MM 1995-2), which we account for under the equity method. MM 95-2 owns and operates five water processing and disposal facilities located in northeastern Colorado. The balance of our equity investment in MM 1995-2 includes approximately $711 and $748 of unamortized purchase premiums we paid on our acquired interests at June 30, 2010 and December 31, 2009, respectively. The premiums are being amortized over a period of 14 years, which represents the weighted average useful life of the underlying assets acquired.

The following table sets forth certain summarized financial information for MM 1995-2 at June 30, 2010 and December 31, 2009 and for the three and six months ended June 30, 2010 and 2009:

	June 30, 2010	December 31, 2009
Total current assets	$ 3,201	$ 2,942
Property, plant and equipment, net	9,074	8,879
Total other assets	5	6
Total assets	$ 12,280	$ 11,827
Total current liabilities	$ 1,765	$ 1,433
Long-term note payable	2,329	2,749
Total shareholders equity	8,186	7,645
Total liabilities and shareholders equity	$ 12,280	$ 11,827

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Total revenues	$ 4,439	$ 2,687	$ 9,331	$ 5,674
Total costs and expenses	2,443	1,696	4,790	3,504
Net income	$ 1,996	$ 991	$ 4,541	$ 2,170

6. Debt

Line of Credit We have an existing credit agreement with Citibank, N.A., as the administrative agent, along with SunTrust Bank and BB&T, providing for a $50.0 million senior, first-priority secured revolving and term credit facility. The credit facility, as amended, is a $50.0 million senior, first-priority secured revolving credit facility that is guaranteed by all of our active subsidiaries and secured by all of our assets and the assets of our active subsidiaries. We may, from time to time, request an increase in the aggregate revolving commitment amount by up to $15.0 million without the prior consent of the lenders provided that each lender has the unilateral right to determine whether it agrees to increase its revolving commitment and that no lender is required to increase its individual pro rata commitment amount without such lender s consent.

The credit facility, as a revolving credit facility, matures and terminates on November 13, 2011. However, we have the option prior to that maturity date to convert a portion of outstanding principal balance, in an amount not to exceed the present value of estimated annual contract revenues receivable under the initial term of contracts for recurring revenue projects executed after December 31, 2007, into a non-revolving term loan for a two year period expiring November 12, 2013, making quarterly payments based upon a four year fully amortized basis.

We intend to use the proceeds available under the credit facility to finance our PowerSecure subsidiary s recurring revenue projects as well as to finance capital expenditures, working capital, acquisitions, and general corporate purposes. Our outstanding borrowings under the credit facility at any time, the proceeds of which were used for working capital purposes and not in connection with recurring revenue projects, cannot exceed $15.0 million. Outstanding balances under the credit facility bear interest, at our discretion, at either the London Interbank Offered Rate for the corresponding deposits of U. S. Dollars plus an applicable margin, which is on a sliding scale ranging from 175 basis points to 300 basis points based upon the our leverage ratio, or at Citibank s alternate base rate plus an applicable margin, on a sliding scale ranging from 0 basis points to 125 basis points based upon our leverage ratio. Our leverage ratio is the ratio of our funded indebtedness as of a given date to our consolidated EBITDA as defined in the credit agreement for the four consecutive quarters ending on such date. Citibank s alternate base rate is equal to the higher of the Federal Funds Rate as published by the Federal Reserve of New York plus 0.50%, and Citibank s prime commercial lending rate.

The credit facility is not subject to any borrowing base computations or limitations, but does contain certain financial covenants. Our maximum leverage ratio cannot exceed 3.25. Our minimum fixed charge coverage ratio must be in excess of 1.50, where the fixed charge coverage ratio is defined as the ratio of the aggregate of our trailing 12 month consolidated EBITDA plus our lease or rent expense minus our taxes based on income and payable in cash, divided by the sum of our consolidated interest charges plus our lease or rent expenses plus our scheduled principal payments and dividends, computed over the previous period. Also, our minimum asset coverage must be in excess of 1.25, where our asset coverage is defined as the summation of 80% of the book value of accounts receivable plus 60% of the book value of inventory plus 50% of the book value of net fixed assets, divided by total funded debt outstanding. In addition, we are required to maintain a minimum consolidated tangible net worth, computed on a quarterly basis, equal to approximately $42.8 million, plus 50% of our net income each year ending after December 31, 2007, with no reduction for any net loss in any year, plus 100% of any equity we raise through the sale of equity interests, less the amount of any non-cash charges or losses. Finally, our debt to worth ratio, which is the ratio of our total consolidated indebtedness to our consolidated tangible net worth, cannot exceed 1.5 to 1.0 at the end of any quarter. At June 30, 2010, we were in compliance with these financial covenants.

Under the credit facility, our cumulative capital expenditures beginning in 2008 cannot exceed the sum of $5.0 million plus $1.25 million per quarter, on a cumulative basis, plus an allowance for our PowerSecure subsidiary recurring revenue projects generated after December 31, 2007. The credit facility contains other representations and warranties and affirmative and negative covenants, including restrictions with respect to liens, indebtedness, loans and investments, material changes in our business, asset sales or leases or transfers of assets, restricted payments such as distributions and dividends, mergers or consolidations and transactions with affiliates.

Upon the sale of any of our assets or the assets of our subsidiaries other than in the ordinary course of business or the public or private sale of any of our equity or debt or the equity or debt of our subsidiaries other than equity issuances where the aggregate net equity proceeds do not exceed $10,000, we are required to use the net proceeds thereof to repay any indebtedness then outstanding under the credit facility, except for certain reinvestment provisions.

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

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

At June 30, 2010 and December 31, 2009, there were no balances outstanding under the credit facility and we had $50.0 million available to borrow. As of August 5, 2010, we had a balance of $10.0 million outstanding under the credit facility, leaving us with $40.0 million available to borrow. However, the availability of this capital under our credit facility includes restrictions on the use of proceeds, and is dependent upon our ability to satisfy certain financial and operating covenants, as described above.

7. Capital Lease Obligations

We have a capital lease with SunTrust Equipment Finance and Leasing, an affiliate of SunTrust Bank, from the sale and leaseback of distributed generation equipment placed in service at customer locations. We received $5.9 million from the sale of the equipment in December 2008 which we are repaying under the terms of the lease with monthly principal and interest payments of $85 over a period of 84 months. At the expiration of the term of the lease in December 2016, we have the option to purchase the equipment for $1, assuming no default under the lease by us has occurred and is then continuing. The lease is guaranteed by us under an equipment lease guaranty. The lease and the lease guaranty constitute permitted indebtedness under our current credit agreement, under which an affiliate of the lessor is one of the lenders.

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

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

Under the lease guaranty, we have unconditionally guaranteed the obligations of our PowerSecure subsidiary under the lease for the benefit of the lessor. The balance of our capital lease obligations shown in the consolidated balance sheet at June 30, 2010 and December 31, 2009 consist primarily of our obligations under the equipment lease described above.

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8. Share-Based Compensation

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

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

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

Stock Options Net income for the three months ended June 30, 2010 and 2009 includes $103 and $168, respectively, of pre-tax compensation costs related to outstanding stock options. Net income (loss) for the six months ended June 30, 2010 and 2009 includes $207 and $257, respectively, of pre-tax compensation costs related to outstanding stock options. All of the stock option compensation expense is included in general and administrative expenses in the accompanying consolidated statements of operations.

A summary of option activity for the six months ended June 30, 2010 is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Balance, December 31, 2009	1,627	$ 5.18		
Granted	60	9.73		
Exercised	(62)	4.01		
Expired	(5)	17.38		
Forfeited				
Balance, June 30, 2010	1,620	$ 5.35	4.79	$ 3.74
Exercisable, June 30, 2010	1,315	$ 5.12	3.94	$ 3.97

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A summary of option activity for the six months ended June 30, 2009 is as follows:

	Shares		Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)		Aggregate Intrinsic Value
Balance, December 31, 2008	1,708	$	5.21			
Granted	20		4.57			
Exercised	(33)		1.62			
Expired	(6)		6.88			
Forfeited	(49)		11.19			
Balance, June 30, 2009	1,640	$	5.09	5.27	$	(0.83)
Exercisable, June 30, 2009	1,311	$	4.79	4.46	$	(0.53)

The weighted average grant date fair value of the options granted during the six months ended June 30, 2010 and 2009 was $4.34 and $2.25, respectively. In each case, the fair value was measured using the Black-Scholes valuation model with the following assumptions:

		June 30, 2010		June 30, 2009
Expected stock price volatility		48.8%		54.3%
Risk Free interest rate		2.15%		2.65%
Annual dividends	$		$	
Expected life employee options		5 years		5 years
Expected life director options		na		na

The fair value of stock option grants are amortized over their respective service periods using the straight-line method and assuming a forfeiture rate of 5%. As of June 30, 2010 and December 31, 2009, there was $860 and $820, respectively, of total unrecognized compensation costs related to stock options. These costs at June 30, 2010 are expected to be recognized over a weighted average period of approximately 1.8 years.

During the three months ended June 30, 2010 and 2009, the total intrinsic value of stock options exercised was $349 and $2, respectively. Cash received from stock option exercises for the three months ended June 30, 2010 and 2009 was $241 and $8, respectively. The total grant date fair value of stock options vested during the three months ended June 30, 2010 and 2009 was $211 and $253, respectively.

During the six months ended June 30, 2010 and 2009, the total intrinsic value of stock options exercised was $351 and $68, respectively. Cash received from stock option exercises for the six months ended June 30, 2010 and 2009 was $250 and $53, respectively. The total grant date fair value of stock options vested during the six months ended June 30, 2010 and 2009 was $374 and $436, respectively.

Restricted Stock Awards Net income for the three months ended June 30, 2010 and 2009 includes $390 and $265, respectively, of pre-tax compensation costs related to outstanding restricted stock awards granted to directors, certain officers and our employees. Net income (loss) for the six months ended June 30, 2010 and 2009 includes $780 and $530, respectively, of pre-tax compensation costs related to outstanding restricted stock awards. All of the restricted stock award compensation expense during the three and six months ended June 30, 2010 and 2009 is included in general and administrative expenses in the accompanying consolidated statements of operations.

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A summary of restricted stock award activity for the six months ended June 30, 2010 is as follows:

	Unvested Restricted Shares	Weighted Average Grant Date Fair Value
Balance, December 31, 2009	561	$ 10.36
Granted	21	9.56
Vested	(88)	7.16
Forfeited		
Balance, June 30, 2010	494	$ 10.89

A summary of restricted stock award activity for the six months ended June 30, 2009 is as follows:

	Unvested Restricted Shares	Weighted Average Grant Date Fair Value
Balance, December 31, 2008	628	$ 12.06
Granted	43	4.65
Vested	(76)	11.90
Forfeited		
Balance, June 30, 2009	595	$ 11.54

Restricted shares are subject to forfeiture and cannot be sold or otherwise transferred until they vest. If the holder of the restricted shares leaves us before the restricted shares vest, other than due to termination by us without cause, then any unvested restricted shares will be forfeited and returned to us. The restricted shares granted to directors vest in equal amounts over a period of one or three years, depending on the nature of the grant. The restricted shares granted to employees other than officers vest in equal annual amounts over five years. A total of 322,500 unvested restricted shares granted to our officers cliff vest in 2012, and a total of 129,000 restricted shares vest in 2011 and 2012 based on certain performance goals being met. All restricted and unvested shares will automatically vest upon a change in control.

The fair value of the cliff vesting restricted shares is being amortized on a straight-line basis over the vesting period. The fair value of the performance vesting shares is expensed as the achievement of the performance criteria becomes probable and the related service period conditions are met. At June 30, 2010, the balance of unrecognized compensation cost related to unvested restricted shares was $2,779, which, assuming all future performance criteria will be met, will be recognized over a weighted average period of approximately 1.9 years.

9. Commitments and Contingencies

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

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

We estimate that from time to time we have performance issues related to component parts which have a cost basis of approximately 5-20% of our estimated annual revenues, although not necessarily limited to this amount, which are installed in equipment we own and have sold to various customers across our business lines, and additional performance issues could arise in the future. In addition, the failure or inadequate performance of these components pose potential material and adverse effects on our business, operations, reputation and financial results, including reduced revenues for projects in process or future projects, reduced revenues for recurring revenue contracts dependent on the performance of the affected equipment, additional expenses and capital cost to repair or replace the affected equipment, inventory write-offs for defective components held in inventory, asset write-offs for company-owned systems which have been deployed, the cancellation or deferral of contracts by our customers, or claims made by our customers for damages as a result of performance issues. As of the date of this report, we have experienced performance issues with two types of component parts, in particular, which we are working to resolve: 1) an instance of a supplier of a substantial distributed generation system component that has indicated it s warranty does not cover performance issues related to a different component from another supplier which has been incorporated into many of the distributed generation systems deployed for our customers, and 2) generators from a certain supplier which have had performance issues in a distributed generation system we own, and for which we have a performance-based recurring revenue contract that is dependent on the system s positive operating performance. In both of these instances, we are actively working to assess and correct the performance issues, and when possible, we have sought the assistance of the suppliers in resolving these issues. Given that we are in the early stage of assessing these performance issues, the uncertainty regarding the assistance we may or may not receive from our suppliers, our track record of repairing many of these types of issues as well as the inherent uncertainty in addressing technical issues specifically and disputes generally, as of the date of this report we are unable to estimate the potential negative impacts from these particular items, if any, in addition to other component part performance issues discussed above.

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

10. Income Taxes

The tax provision recorded at June 30, 2010 is our best estimate of our tax expense taking into consideration our expectation of future earnings, federal alternative minimum tax, state income tax for state jurisdictions in which we expect taxable income, potential effects of adverse outcomes on tax positions we have taken, true-up effects of prior tax provision estimates compared to actual tax returns, and our net operating loss carryforwards and valuation allowance.

11. Segment Information

Our operating segments represent components of our business for which discrete financial information is available and are reviewed regularly by the chief operating decision-maker, or decision-making group, to evaluate performance and make operating decisions. We conduct our operations through two operating segments: Energy and Smart Grid Solutions, and Energy Services. Our reportable segments are strategic business units that offer different products and services and serve different customer bases. They are managed separately because each business requires different technology and marketing strategies.

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

Energy Services Through our Southern Flow and WaterSecure subsidiaries we serve customers in the oil and natural gas production business with our measurement services and products, and water processing and disposal services. Southern Flow s services include on-site field services, chart processing and analysis, laboratory analysis, and data management and reporting. These services are provided principally to customers involved in natural gas production, gathering, transportation and processing. WaterSecure, through its equity investment in MM 1995-2, provides water processing and disposal for oil and natural gas producers.

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The accounting policies of the reportable segments are the same as those described in Note 1 of the Notes to Consolidated Financial Statements. We evaluate the performance of our operating segments based on income (loss) before income taxes. Intersegment sales are not significant.

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

	Three Months Ended June 30, 2010			
	Energy and Smart Grid Solutions	Energy Services	Unallocated Corporate Costs	Total
Revenues	$ 29,733	$ 4,581	$	$ 34,314
Cost of sales	19,133	3,344		22,477
Gross profit	10,600	1,237		11,837
Operating expenses:				
General and administrative	6,817	813	1,377	9,007
Selling, marketing and service	1,348	39		1,387
Depreciation and amortization	651	91	1	743
Total operating expenses	8,816	943	1,378	11,137
Operating income (loss)	1,784	294	(1,378)	700
Other income and (expenses):				
Equity income		807		807
Management fees		142		142
Interest income and other income			24	24
Interest expense	(68)		(71)	(139)
Income (loss) before income taxes	$ 1,716	$ 1,243	$ (1,425)	$ 1,534
Total capital expenditures	$ 1,534	$ 42	$ 1	$ 1,577