

ENVIRONMENTAL POWER CORP

Form 10-K/A

November 15, 2004

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K/A

(Mark one)

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

For the fiscal year ended December 31, 2003

OR

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

For the transition period from _____ to _____

Commission File Number 0-15472

Environmental Power Corporation

(Exact name of registrant as specified in its charter)

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

Delaware
(State or other jurisdiction
of incorporation or organization)

75-3117389
(IRS Employer
Identification No.)

One Cate Street, Fourth Floor, Portsmouth, New Hampshire 03801

(Address of principal executive offices)

(Zip code)

Registrant's telephone number, including area code: (603) 431-1780

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, \$.01 par value

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to the Form 10-K. Yes No

The aggregate market value of voting stock (common stock, \$.01 par value) held by non-affiliates, computed by reference to the closing price of such stock, was \$5,229,907 on June 30, 2003.

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

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the last practicable date: On March 12, 2004 there were 26,741,734 outstanding shares of Common Stock, \$.01 par value, of the registrant.

Table of Contents

EXPLANATORY NOTE

This Annual Report on Form 10-K/A of Environmental Power Corporation (the Company or EPC) for the year ended December 31, 2004, is filed solely for the purposes of (1) integrating, but not amending (other than to delete the reference to Section 21E of the Securities Exchange Act in the section entitled Forward-looking Information), the information set forth in both the Company's Annual Report on Form 10-K for the year ended December 31, 2004 (the Original Report) and the information set forth in the Company's Annual Report on Form 10-K/A as filed on April 30, 2004 with the Securities and Exchange Commission (the Amendment), (2) conforming the signature of Deloitte & Touche LLP on the filed version of its Independent Auditors Report and (3) filing updated certifications pursuant to Item 601(b)(31) of Regulation S-K, which certifications appear as Exhibits 31.01 and 31.02 to this report. Except as described above, no other changes are being made to the Original Report or the Amendment. This Form 10-K/A does not reflect events occurring after the March 30, 2004 filing of the Original Report or modify or update the disclosure contained in the Original Report in any way other than as required to reflect the foregoing.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement to be filed with the Securities and Exchange Commission and delivered to shareholders in connection with the 2004 Annual Meeting of Shareholders are incorporated by reference into Part III of this Annual Report filed on Form 10-K. The portions of the Proxy Statement under the headings Audit Committee Report, Report of the Compensation Committee and the Stock Performance Graph are not incorporated by reference and are not a part of this Annual Report on Form 10-K.

TABLE OF CONTENTS

| | |
|--|----|
| PART I | |
| <u>Item 1. Business</u> | 4 |
| <u>Item 2. Properties</u> | 15 |
| <u>Item 3. Legal Proceedings</u> | 15 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u> | 15 |
| PART II | |
| <u>Item 5. Market for Registrant's Common Equity and Related Shareholder Matters</u> | 15 |
| <u>Item 6. Selected Financial Data</u> | 16 |
| <u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 17 |
| <u>Item 7A. Quantitative and Qualitative Disclosures about Market Risk</u> | 33 |
| <u>Item 8. Financial Statements and Supplementary Data</u> | 33 |
| <u>Item 9. Disagreements on Accounting and Financial Disclosure</u> | 33 |
| <u>Item 9A. Controls and Procedures</u> | 33 |
| PART III | |
| <u>Item 10. Directors and Executive Officers</u> | 34 |
| <u>Item 11. Executive Compensation</u> | 35 |
| <u>Item 12. Security Ownership of Certain Beneficial Owners and Management</u> | 40 |
| <u>Item 13. Certain Relationships and Related Transactions</u> | 42 |
| <u>Item 14. Principal Accountant Fees and Services</u> | 42 |
| PART IV | |
| <u>Item 15. Index to Financial Statements, Exhibits, and Reports on Form 8-K</u> | 43 |
| <u>Signature Page</u> | 48 |

Table of Contents

CERTAIN DEFINITIONS

All references in this Annual Report on Form 10-K to EPC , Company , we , us and our refer to Environmental Power Corporation and its consolidated subsidiaries (unless the context otherwise requires).

FORWARD-LOOKING INFORMATION

This Annual Report on Form 10-K contains forward-looking statements. For this purpose, any statements contained herein that are not statements of historical fact, including without limitation, certain statements under Item 1. Business and Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and located elsewhere herein regarding industry prospects and our results of operations or financial position, may be deemed to be forward-looking statements. Without limiting the foregoing, the words believes, anticipates, plans, expects, and similar expressions are intended to identify forward-looking statements. The important factors discussed below under the caption Certain Factors That May Affect Future Results, among others, could cause actual results to differ materially from those indicated by forward-looking statements made herein and presented elsewhere by management from time to time. Such forward-looking statements represent management's current expectations and are inherently uncertain. Investors are warned that actual results may differ from management's expectations.

Table of Contents

PART I

Item 1. Business

Environmental Power Corporation was incorporated in May 2003 and is 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, and, as its successor, Environmental Power Corporation is currently quoted on the OTC Bulletin Board market (symbol: POWR.OB). The address of our principal executive offices is One Cate Street, Fourth Floor, Portsmouth, New Hampshire 03801 and our telephone number is (603) 431-1780.

The following table outlines the corporate structure of Environmental Power Corporation and its subsidiaries:

| <u>Entity</u> | <u>Relationship</u> |
|---------------------------------|--|
| Environmental Power Corporation | Ultimate parent |
| EPC Corporation | Wholly-owned subsidiary of Environmental Power Corporation |
| Buzzard Power Corporation | Wholly-owned subsidiary of EPC Corporation |
| Microgy Cogeneration Systems | Wholly-owned subsidiary of Environmental Power Corporation |
| Coal Dynamics Corporation | Wholly-owned subsidiary of Environmental Power Corporation, inactive |
| Kaiser Power of Sunnyside, Inc | Wholly-owned subsidiary of Environmental Power Corporation, inactive |
| Kaiser Systems, Inc. | Wholly-owned subsidiary of Environmental Power Corporation, inactive |
| Milesburg Energy, Inc | Wholly-owned subsidiary of Environmental Power Corporation, inactive |
| Sunnyside Power Corporation | Wholly-owned subsidiary of Environmental Power Corporation, inactive |

EPC is an independent developer and owner of electrical generating facilities powered by non-commodity fuels and renewable energy sources. Our power generating facilities use alternative fuels, most of which are wastes, which are generally not subject to the same cost fluctuations as traditional fuels. Our power generating facilities have also been able to exceed air quality emission standards and to assist with the clean-up of wastes that are sources of water pollution. Accordingly, we have realized financial benefits, such as tax-exempt financing and sales of pollution allowances from the pollution control benefits of our facilities.

Since our founding in 1982, we have partially or fully developed seven hydroelectric plants, two municipal waste projects and three waste-coal fired generating facilities. We sold all but one of these projects as follows:

We sold four hydropower projects during their development phases;

We transferred rights to two municipal waste projects during their development phases;

We sold three hydropower facilities after completion;

We sold, during development, a 43 megawatt (net) waste-coal fired facility located in Pennsylvania known as the Milesburg Project;

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

We sold, after completion in 1994, a 51 megawatt (net) waste-coal fired facility located in Utah known as the Sunnyside Project; and

We sold, during development, an approximate 83 megawatt (net) waste-coal fired facility located in Pennsylvania known as the Scrubgrass plant. Buzzard Power Corporation, referred to as Buzzard, currently owns a 22-year leasehold interest in this project.

In 2001, we acquired all of the common stock of Microgy Cogeneration Systems Inc., a privately held Colorado company, referred to as Microgy. We operate Microgy as a subsidiary. Microgy holds an exclusive license in North America for development and deployment of a proprietary technology for extraction of methane gas from animal wastes and its use to fuel generation of energy. EPC is currently in the process of marketing and developing opportunities for sale and development of this technology.

Our ongoing business activities are discussed further in the following sections.

Buzzard Power Corporation

Buzzard is a subsidiary of our wholly owned subsidiary, EPC Corporation. Buzzard leases the Scrubgrass plant from Scrubgrass Generating Company, L.P. The Scrubgrass plant, located on a 600-acre site in Venango County,

Table of Contents

Pennsylvania, is an approximate 83 megawatt waste coal-fired electric generating station. The following table describes the key participants in the Buzzard plant and their relationship and responsibilities:

| <u>Entity</u> | <u>Relationship</u> |
|--|---|
| EPC Corporation | Owns Buzzard Power Corporation |
| Buzzard Power Corporation | Holds the lease rights to the Scrubgrass plant and all principal project agreements |
| U.S. Operating Services Company | Operates the Scrubgrass plant |
| Pennsylvania Electric Company or Penelec | Purchases energy from Scrubgrass |
| FirstEnergy Group | Parent of Penelec |
| NEGT, Inc | Parent of U.S. Operating Services Company |

Buzzard's lease commenced on June 30, 1994 and provides for a term of 22 years with a renewal option for up to 3 years. Under the lease, Scrubgrass Generating Company assigned to Buzzard all principal project agreements and its rights and obligations under such contracts including the following:

- power purchase agreement;
- management services agreement;
- operating and maintenance agreement;
- limestone supply agreements;
- ground lease agreements;
- fuel agreements;
- transportation; and
- materials handling agreements.

We have pledged Buzzard's common stock to the Scrubgrass Generating Company as security for Buzzard's performance of its obligations as lessee. PG&E National Energy Group, a wholly owned indirect subsidiary of NEG, Inc., which in turn is a wholly owned indirect subsidiary of PG&E Corporation, manages the Scrubgrass plant under a Management Services Agreement.

U.S. Operating Services Company (formerly PG&E Operating Services Company) (the Operator), a wholly owned, indirect subsidiary of NEG, Inc., operates the Facility pursuant to a 15-year operating and maintenance agreement (the O&M). Under the terms of the O&M, the Operator can incur a liability not to exceed its management fee if the Operator does not achieve certain targeted output performance levels.

Buzzard sells all of its electric output to Pennsylvania Electric Company, known as Penelec, a subsidiary of FirstEnergy Group, under a 25-year power sales agreement, which commenced in June 1993. Under this contract, except for amounts sold above certain hourly and annual limits, all power is sold at fixed rates which initially averaged 4.68 cents per kilowatt hour and escalate by 5% annually through 2004. For years 2005 through 2012, the agreement provides for a rate equal to the greater of a scheduled rate, as adjusted to reflect actual inflation during the contract term compared to the prior 5% annual adjustment, or a rate based on the PJM Billing Rate. The PJM Billing Rate is the monthly average of the hourly rates for purchases by the FirstEnergy Group from, or sale to, the Pennsylvania-New Jersey-Maryland Interconnection. For years 2013 through 2015 and 2016 through 2018, if Buzzard exercises the renewal term option, terms of the power purchase agreement applicable during these prospective periods will apply. The agreement provides for a rate equal to the lower of the average monthly PJM Billing Rate or the rate paid for calendar year 2012 adjusted annually by the percentage change in the Gross National Product Deflator less one percent.

Buzzard deposits all revenues earned under the power sales agreement into an account administered by a disbursement agent. Before Buzzard can receive cash from the operation of the Scrubgrass plant, Buzzard must first satisfy all operating expenses, base lease payments, restricted cash deposits, and other subordinated obligations. Buzzard's base lease payments consist of Scrubgrass Generating Company's debt service, equity repayment, base return on equity and related expenses. Buzzard must also pay to Scrubgrass Generating Company additional rent of 50 percent of the net cash flows Buzzard receives from the operation of the Scrubgrass plant. We are not required to fund Buzzard's operating losses, or otherwise invest further from sources outside of the Scrubgrass plant.

Table of Contents

The debt obligations for Scrubgrass Generating Company and Buzzard are described below:

| | <u>Balance at December 31, 2003</u> | <u>Balance at December 31, 2002</u> | <u>Interest Rate</u> |
|--|---|---|----------------------|
| 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 | 8,700,913 | 7.6725% |
| Variable rate term loan (2004) | 3,687,000 | 7,089,016 | LIBOR + 1.250% |
| Buzzard's debt obligations (maturity): | | | |
| Variable rate term loan (2004) | 389,535 | 837,437 | LIBOR + 1.250% |
| Working capital loan (2008) | 2,433,261 | 517,112 | LIBOR + 1.250% |

Scrubgrass Generating Company or Buzzard pays interest on these obligations at either quoted rates for tax-exempt debt, rates fixed by swap agreements for taxable debt, or rates for taxable debt which are based on the London Interbank Offering Rate, or LIBOR. On December 22, 1995, Scrubgrass Generating Company entered into an interest rate swap arrangement that fixed the LIBOR component for the life of its swap rate term loan at 6.4225%. As a result, the interest rate for the swap rate term loan was fixed at 7.5475% through 2001 and at 7.6725% for its remaining term. This swap rate term loan and the other lease obligations of Buzzard are not debt obligations of Buzzard and are not recorded on our balance sheets.

Under the terms of the loan agreements, Buzzard is subject to various customary financial and operating covenants with the most critical being debt service coverage. It is required to maintain a 1.20 coverage ratio defined as all cash from revenues minus all operating expenses divided by principal and interest payments. As of December 31, 2003 and 2002, we were in compliance with all such covenants.

The Environmental Protection Agency and the Pennsylvania Department of Environmental Protection granted Nitrogen Oxide Ozone Transport Region Budget Allowances, or NOx Credits, to Buzzard based on factors that primarily pertain to the design and operation of the Scrubgrass plant. Buzzard is required annually to maintain NOx Credits that equal or exceed the quantity of its nitrogen oxide emissions during a seasonal period known as an ozone season. If the Scrubgrass plant's nitrogen oxide emissions exceed its available NOx Credits, Buzzard would be subject to fines by such agencies. During 1999, Buzzard installed machinery, costing \$811,568, which has significantly reduced its nitrogen oxide emissions. Accordingly, we anticipate that Buzzard may not require a portion of its future NOx Credits to comply with the applicable regulations. NOx Credits are transferable and marketable. Buzzard has sold and may sell, from time to time, its projected excess NOx Credits or purchase additional NOx credits that are necessary to meet the applicable regulations. To date, we have entered into several agreements to sell and purchase, when necessary, NOx credits. We received net proceeds from these NOx Credit transactions of \$0 in 2003, \$2,428,200 in 2002, and \$0 in 2001, which were reported as other income in our accompanying consolidated financial statements. The sale in 2002 was for NOx emission credits for the 2002 through 2007 ozone seasons.

Our wholly owned subsidiary, EPC Corporation, holds our investment in Buzzard as its sole asset. In September 2003, EPC Corporation obtained a \$3,700,000 loan from ArcLight Capital Partners. This debt is secured by the stock of EPC Corporation. This loan incurs a 20% interest rate. All distributions from Buzzard are required to be used to repay this note. As an incentive fee for providing this note, we have also granted ArcLight a participation right in a portion of the future distributions of Buzzard after the note has been repaid. ArcLight will receive half of the distributions after the note has been repaid in full and after EPC alone receives a total of \$1,400,000 of distributions. This participation right will end on December 31, 2012. We are required to make payments only when we receive distributions. Any unpaid interest by the 15th of any month will be accrued and rolled into the principal. Nevertheless, we are required to make at least one payment of any amount within a 24 month period. As of the date of this filing, we have satisfied this requirement for the next 22 months.

Microgy Cogeneration Systems

Overview

In 2001, we acquired all of the common stock of Microgy Cogeneration Systems Inc., a privately held development-stage company based in Colorado. 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 its use to fuel generation of energy. Microgy's product is expected to provide certain farms, known as concentrated animal feeding operations, or CAFOs, with a potentially profitable means of mitigating an existing waste management problem

Table of Contents

that affects both water and air quality. Federal and State agencies either have or may be in the process of passing regulations that require CAFOs to implement changes to their current waste management practices.

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

Anaerobic Digester License Agreement

The licensor of Microgy's anaerobic digester technology is Danish Biogas Technology A/S (DBT). Anaerobic digestion is a process whereby animal wastes are broken down into different chemical components in an oxygen-free environment. One of the critical components is methane that has fuel value. DBT is 50% owned by Schouw & Co., a Danish public company and 50% by DDH Contractors A/S, a Danish engineering firm. On May 12, 2000, Microgy entered into a revised licensing agreement with DBT which granted Microgy a perpetual and exclusive license in certain territories, specifically North America, for use of certain proprietary technologies, including the anaerobic digestion technology. This agreement superseded previous license agreements. As part of the agreement renegotiated in 2003, DBT will receive fixed payments for engineering work and construction drawings and a licensing fee that is based on a percentage of the total cost for each project facility where the licensed technology is installed and operating.

Proposed Projects

Microgy plans to develop projects based upon the anaerobic digestion technology license. Our present business strategy anticipates the outright sale of facilities; however, we expect that, in some circumstances, we may own some or even a majority of projects. In addition to any ownership position Microgy may have, it presently plans to manage and may operate any such proposed facilities. We anticipate that most of these facilities will deliver renewable energy for supply to the utility grid and will provide certain pollution control benefits to the agricultural markets. In addition, certain facilities may supply biogas for other applications, such as the operation of feed production and drying equipment as contemplated by projects proposed to be developed under Microgy's Project Development Agreement with The Scoular Company. The ultimate opportunity to develop such projects and/or to sell these facilities to others, as well as to manage and/or operate them profitably, depends on factors including the value which can be derived from the energy and agricultural markets discussed below.

Microgy has executed agreements with affiliates of five farms: Wild Rose Dairy, Five Star Dairy, Norswiss Dairy, Daley Farms Dairy, and Bach Farms, LLC. These farms will purchase a Microgy digester system to process manure produced by their dairy operations in Wisconsin and Minnesota. These five farms represent a backlog of over \$12 million in sales from documented transactions to be developed under the agreement with Dairyland Power Cooperative described below.

Microgy will act as the general contractor in these projects and pay for licensing fees, construction, permitting, engineering, and other general expenses related to the projects.

Power Sales Agreements

Microgy and/or EPC have also signed memoranda of understanding with Dairyland Power Cooperative, or DPC, Vermont Public Power Supply Authority, or VPPSA, Lodi Electric Utility, or Lodi, and Merced Irrigation District and Gallo Farms to develop projects based on Microgy's proprietary anaerobic digestion technology. The following table outlines these agreements and the associated generating capacity:

| Power Sales Agreement | Location | Generating Capacity (MW) |
|--|----------------------|---------------------------------|
| Dairyland | La Crosse, Wisconsin | 25 |
| Vermont VPSA | Waterbury, Vermont | 15 |
| New York NYSERTA | New York | 5 |
| Lodi Electric Utility | California | 20 |
| Merced Irrigation District and Gallo Farms | California | 4 |
| TOTAL | | 69 |

Table of Contents

All of these agreements are non-binding and the actual completion of any projects under these agreements may not occur.

Commodity Electricity

We expect the near-term market for commodity electricity to remain very price competitive with upward pressure on prices dependent upon increased costs of fuels used for electric generation. If and when the economy becomes more robust and consumption of energy increases, there are likely to be increases in conventional fuel prices as well as geographical areas within the United States that will need increased capacity to service demand. Therefore, we believe prices will likely increase accordingly. If such projections prove to be accurate and commodity electricity prices do increase, the output from any facilities developed by Microgy will be increasingly price competitive and potentially more profitable. Such factors should also make it easier for us to attract and execute new opportunities to develop these projects.

Renewable Peak Period Electricity

Among the facilities that we plan to develop, some will serve the market for renewable energy delivered during peak usage periods. We intend this combination of renewable energy and peak period delivery to position our output into the highest priced segments of the electricity markets. The greatest use and demand for electricity occurs during peak periods. Natural gas is the principal fuel source for generating commodity electricity on a peaking basis. Except for oil, which is now seldom used, generation from most other fuels is not readily adaptable to peak period operation. Microgy's anaerobic digestion technology produces biogas from the processed manure that, like natural gas, can be stored and used to generate power during peak periods. We believe that Microgy's technology offers us a valuable generating capability, namely, the ability to produce renewable, peak energy.

The demand for renewable power in the energy markets is driven largely by consumer desire for such power and by state legislation. These preferences have resulted in green pricing programs in many local energy markets. Many states and local governments have further encouraged the growth of renewables through tax incentives and by requiring utilities to offer customers electricity derived from renewable sources and/or to generate or purchase a small portion of their electricity from renewable energy providers. Presently, the United States Congress is considering proposed legislation that would add significant tax benefits to the generation of electricity produced from biomass involving animal waste. Further, many states and the Federal government require a portion of the power consumed in their own facilities to be provided from renewable generating sources.

Green Tags and Pollution Offset Credits

As a potential producer of renewable energy, we expect to be able to sell separately electricity and green energy credits, also called green tags. Green tags can be defined in many ways. We define them as the marketable bundle of benefits derived from the environmentally friendly generation of power. In many instances, we may include all or some portion of the green tags in wholesale electricity purchase agreements. However, we may also separately trade these green tags or some of their unbundled components in a separate trading market.

Buzzard has been able to sell pollution-offset credits based upon NOx emissions which were discussed previously. We may derive future demand, or increased opportunities, for facility sales by Microgy if our future facilities are able to sell greenhouse gases, and other pollution offset credits in addition to electricity and other green credits. We hope that the market for these and similar credits will grow over the long term, as stricter environmental regulations and emission standards are adopted.

Agricultural Markets

We plan to provide anaerobic digester equipment and services to help control pollution in agricultural markets, specifically concentrated animal feeding operations or CAFOs. Runoff from animal wastes presents significant water pollution problems.

On December 16, 2002, the Environmental Protection Agency issued new rules to regulate manure run-off on farms, one of the nation's leading causes of water pollution. The new rules apply to about 15,500 livestock operations across the country. These CAFOs will need to obtain permits, submit an annual report, and develop and follow a plan that will ensure that measures are instituted to protect America's waters from wastewater and manure. The EPA

Table of Contents

is working with the United States Department of Agriculture to help the agricultural community find solutions to this environmental problem. Effective manure management practices required by the rules will maximize the use of manure as a resource for agriculture while reducing adverse impacts on the environment. The effective date of the rules was April 14, 2003, but the compliance deadlines vary depending upon the classification of a company's operations. For operations that are defined as CAFOs under regulations that were in effect prior to April 14, 2003, the owner or operator was requested to have or seek to obtain coverage under an NPDES permit by April 14, 2003, and comply with all applicable NPDES requirements, including the duty to maintain permit coverage. The compliance deadlines for other operations are phased in over periods ranging from 90 days to three years. In addition, permitted CAFOs must have their nutrient management plans developed and implemented by December 31, 2006.

We believe that the waste management benefits of Microgy's technologies should help CAFOs meet the stricter guidelines and permitting requirements, and, as a result, many farms would be able to address existing pollution problems over time and to increase land application of less-pollutant manure and, in some instances, support a larger herd on the same amount of land. Alternatively, in critical pollution areas, or where uses for residual products can be identified, the land application of manure could be substantially curtailed.

Thermal Energy

We believe that Microgy's technology is readily adaptable to applications other than electric generation and can address markets requiring a reliable supply of high quality biogas for use in producing thermal energy. We believe that this adaptability allows us to operate to economic advantage in markets that do not have favorable power pricing or power marketing dynamics. An example of such an alternative are the projects Microgy intends to develop with The Scoular Company, referred to as Scoular, where biogas produced by Microgy digesters will be used to operate feed production systems, which include a dryer and are dependent upon a reliable, cost-effective, high-quality gas supply. We believe that the application contemplated by the agreement with Scoular is only the first of many possible opportunities to leverage Microgy's technology into diverse applications dependent upon thermal energy. We believe that the volatility of, and general increases in, natural gas prices are propelling this market. Heavy users of thermal energy not only suffer generally when fuel costs increase, but often are unable to protect their profitability from fuel cost volatility when prices for their products are referenced to different market forces. Our biogas prices are expected to be essentially constant.

Other Expected Benefits

While digesting the raw manure and burning the resulting biogas to make electricity does not eliminate the nutrients from the manure slurry, the process does change their chemical makeup. In the anaerobic digestion process, many of the nutrients that were previously bound in organic molecules are mineralized, or reduced to the inorganic forms of the nutrients. These are the forms that are usable by crops. The organic forms in undigested manure must first be broken down before they can be used. Because this usually takes an extended period of time, there are residual nutrients in the soil left over from previous years' manure applications. These residuals must be taken into account when calculating current manure application rates, resulting in less manure being spread on the same amount of cropland. By providing the nutrients in readily usable forms, digested manure has lower potential to produce a residual accumulation of minerals on the land. Therefore, more of it can be spread on an acre of cropland, thus reducing manure-spreading costs.

In addition, further environmental benefits are expected to be achievable by subjecting the digested manure slurry to other nutrient extraction techniques, such as chemical precipitation. By digesting the manure, these nutrients will be in a form that is more easily extracted in such techniques. Digested manure can also be put to other beneficial uses, such as bedding for the animals, and, therefore, would not need to be applied to the land.

Competition

The following sections describe the competition facing our subsidiaries.

Buzzard Power Corporation

Buzzard generates electricity using waste coal, an alternative energy source. Buzzard sells all of its electricity at rates established under a long-term power purchase agreement. With the exception of the risk that Penelec would seek and achieve judicial determination that it has a right to renegotiate the terms of the power purchase agreement,

Table of Contents

the sale of power from our existing facility is not subject to competition during the term of the power purchase agreement.

However, because our contracted rates in the later years of the agreement are determined with reference to the Gross National Product Deflator, or GNPD, and future market conditions at the PJM western hub, the rate at which such power is sold after 2004 is influenced by competitive power rates in the region. Therefore, low wholesale energy rates during the later years of the power purchase agreement would adversely affect our profitability and could affect our results of operations and financial position.

Microgy Cogeneration Systems

Microgy plans to generate revenue from the development, sale, and/or ownership of facilities that market renewable, green energy in addition to providing pollution control features to the agricultural markets. In the energy market, its competitors include traditional regulated utilities, unregulated subsidiaries of regulated utilities, energy brokers and traders, energy service companies in the development and operation of energy-producing projects as well as the marketers of electric energy, equipment suppliers, providers of pollution control products or services, and other non-utility generators like EPC.

Microgy's green competitors include other energy producers using biomass combustion, biomass anaerobic digestion, geothermal, solar, wind, new hydro, and other renewable sources. These companies represent a significant class of competitors because they will compete with Microgy not only for electricity sales but also for sale of green tags and participation in various renewable portfolios and other programs.

In the agricultural markets, Microgy faces many forms of competition from other providers of pollution control. The most significant among these entities may include environmental engineers, providers of pollution control systems, and other developers of anaerobic digesters or plug-flow digesters. Competition includes private companies, public companies, associations, cooperatives, government programs, such as AgStar, foreign companies, and educational pilot programs.

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. 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.

Environmental Regulation

Our present and any future projects are and will be subject to various federal, state and local regulations pertaining to the protection of the environment, primarily in the areas of water and air pollution. Microgy intends to build plants in various states. These facilities will be subject to federal, state and local regulatory requirements in all the locations where they may operate.

In many cases, these regulations require a lengthy and complex process of obtaining and maintaining licenses, permits and approvals from federal, state and local agencies. We also have and will have significant administrative responsibilities to monitor our compliance with the regulations. As regulations are enacted or adopted in any of these jurisdictions, we cannot predict the effect of compliance therewith on our

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

business. Our failure to comply with all the applicable requirements could require modifications to operating facilities. During periods of non-compliance, our operating facilities may be forced to shutdown until the compliance issues are resolved. EPC is responsible for ensuring the compliance of its facilities with all the applicable requirements and, accordingly, attempts to minimize these risks by dealing with reputable contractors and using appropriate technology to measure compliance with the applicable standards. The cost of environmental regulation does and will continue to affect our profitability.

Buzzard Power Corporation

We believe the Scrubgrass plant, our only currently operating project, is currently in compliance with all material applicable environmental regulations. Our Scrubgrass plant is most notably affected by the following environmental regulations:

Table of Contents

Air Quality The Scrubgrass plant is subject to air quality regulations under the federal Clean Air Act of 1970. This Act established National Ambient Air Quality Standards for certain pollutants including ozone, sulfur dioxide, nitrogen dioxide, particulate matter, carbon monoxide and lead. In particular, Title I of the Clean Air Act established the Northeast Ozone Transport Region, which includes 12 northeast states and the District of Columbia, to address the transport of these pollutants which may lead to the non-attainment of the ozone standards in the Northeast. Ozone control is facilitated by the control of pollutant precursors, which are nitrogen oxides, or NOx, and volatile organic compounds. Electric generating facilities that use fossil fuels, including the Scrubgrass plant, are considered major sources of NOx emissions.

In recent years, the Pennsylvania Department of Environmental Protection established regulations that required companies with stationary sources of NOx emissions to establish plans to reduce their NOx emissions. To administer these regulations, the Department began allocating Nitrogen Oxide Ozone Transport Region Budget Allowances, or NOx Credits, to facilities based on numerous factors including the design and operation of each facility. A market-based trading system was established to allow companies with excess NOx Credits to trade with companies that required additional NOx Credits to meet the stricter requirements. More recently, an Ozone Transport Commission established certain inner and outer zones with seasonal NOx emission reductions that required the Scrubgrass plant to achieve certain targeted NOx emission levels beginning on May 1, 1999. Under such requirements, the Scrubgrass plant was also required to achieve reduced emission standards by May 2003. Due to the efficient design of the Scrubgrass plant, the Scrubgrass plant met the new 1999 requirements without any modifications to the facility. However, we made capital improvements of \$811,568 in 1999 to the Scrubgrass plant, which enabled the Scrubgrass plant to meet the stricter standards in 2003. To date, we have sold credits through 2007 in anticipation of meeting the air quality standards for sulfur dioxide, nitrogen dioxide, particulate matter, carbon monoxide and lead during this period. We do not anticipate needing any additional material modifications to the Scrubgrass plant during this time.

Waste Disposal The Scrubgrass plant must also comply with various environmental regulations pertaining to water discharge as well as the handling and disposal of hazardous and non-hazardous wastes. The Pennsylvania Department of Environmental Protection establishes classifications for wastes and requires companies to follow certain handling and disposal procedures for each waste classification. Currently, the Scrubgrass plant employs special handling procedures for the transportation of its fuel, which is classified as a waste, from the waste sites to the Scrubgrass plant. The fuel is burned in the Scrubgrass facility where it is treated with various substances such as limestone during the electric generation process. Ash, which is a byproduct of the waste-coal combustion process, is removed from the Scrubgrass facility and returned to the original waste site, which is reclaimed in part by deposit of the ash along with the soil. Under existing regulations, ash is not classified as a hazardous waste. However, various environmental organizations have recently been lobbying for changes to the applicable regulations for the classification of ash. If there are changes to the waste classification of ash, our ash disposal costs may significantly increase which could have material adverse affect on our results of operations and financial position.

Microgy Cogeneration Systems

Microgy has no projects currently in operation. Depending on the location of each individual plant, state implementation plans of the Clean Air Act and Clean Water Act as described above may apply. The state permitting process could involve lengthy delays and the purchase of offsets in order to counter-balance emissions. Microgy's projects may be subject to the following additional regulations:

Current Regulations The primary Federal law affecting manure management on animal operations is the Clean Water Act, under which the National Pollutant Discharge Elimination System, or NPDES, program covers Concentrated Animal Feeding Operations, or CAFOs. Federal NPDES permits may be issued by EPA or any state authorized by EPA to implement the NPDES program. Forty-three states are certified by the EPA to issue their own NPDES permits. Of note, EPA materials published in 1999 indicated that 32 states have a requirement covering application rates of manure on the land, and 27 states require at least some animal operations to develop and use waste management plans.

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

In addition, each distributed generation site with an installed reciprocating engine and generator is regulated under a state implementation plan (SIP) developed in accordance with the federal Clean Air Act. The engine emissions at each site will be covered under a general statewide permit or a point source permit. The engine emissions are

Table of Contents

considered a minor point source for both the general and specific permit, and no other emission control devices are required.

New Regulations On December 16, 2002, the Environmental Protection Agency issued new rules to regulate manure run-off on farms, one of the nation's leading causes of water pollution. The new rules apply to about 15,500 livestock operations across the country. These CAFOs will need to obtain permits, submit an annual report, and develop and follow a plan which will ensure that measures are instituted to protect America's waters from wastewater and manure. The EPA is working with the United States Department of Agriculture (USDA) to help the agricultural community find solutions to this environmental problem. Effective manure management practices required by the rules are intended to maximize the use of manure as a resource for agriculture while reducing adverse impacts on the environment.

Energy Regulation

PURPA The Public Utility Regulatory Policies Act of 1978, or PURPA, and the regulations under PURPA by the Federal Energy Regulatory Commission, or FERC, have provided incentives for the development of cogeneration facilities and small power production facilities, which are power projects that use renewable fuels and generally have a capacity of less than 80 megawatts. In general, PURPA requires utilities to purchase electricity produced by facilities using alternative fuels or from cogeneration facilities that meet the FERC's requirements for certification as qualifying facilities, or QFs.

In order to obtain QF status under PURPA, any facilities that we might acquire or develop will be required to meet certain size, fuel and ownership requirements and/or co-generate. Specifically, a cogeneration facility must produce not only electricity, but also useful thermal energy for use in an industrial or commercial process for heating or cooling applications in certain proportions to the facility's total energy output and must meet certain energy efficiency standards. A geothermal facility may qualify as a QF if it produces less than 80 megawatts of electricity. With respect to small power production facilities, there is generally no size limit for qualifying solar, wind, or waste facilities. For small power production facilities, the primary energy source of the facility must be biomass; waste, renewable resources, geothermal resources, or any combination thereof, and 75 percent or more of the total energy input must be from these sources. Any primary energy source which, on the basis of its energy content, is 50 percent or more biomass is considered to be biomass. Finally, a QF must not be controlled or more than 50 percent owned by an electric utility or by an electric utility holding company, or a subsidiary of such a utility or holding company or any combination thereof.

PURPA provides two primary benefits to QFs. First, QFs generally are relieved of compliance with extensive federal and state regulations that control the financial structure of an electric generating plant and the prices and terms on which electricity may be sold by the plant. Such regulations include the Public Utility Holding Company Act of 1935, or PUHCA, and the Federal Power Act, or FPA. Second, electric utilities are required to purchase electricity generated by QFs at a price based on the purchasing utility's avoided cost and to sell back-up power to the QFs on a non-discriminatory basis. The term "avoided cost" is defined generally as the price at which the utility could purchase or produce the same amount of power from sources other than the QF. The FERC regulations also permit QFs and utilities to negotiate agreements for utility purchases of power at rates other than the utilities' avoided costs. While public utilities are not explicitly required by PURPA to enter into long-term power sales agreements, PURPA helped to create a regulatory environment in which it has been common for long-term agreements to be negotiated.

Our Scrubgrass plant is certified as a QF by the FERC. We believe that the facilities we would build or develop using Microgy's licensed technology would also meet the qualifications required to be a QF. We endeavor to develop our projects and monitor compliance of existing projects with applicable regulations in a manner which minimizes the risks of any project losing its QF status. Certain factors necessary to maintain QF status are, however, subject to the risk of events which may be outside our control. Upon the occurrence of such an event, we would seek to correct any non-compliance in order to meet PURPA's requirements, but we cannot assure you that such correction would be possible in all instances.

If a facility in which we have an interest should lose its status as a QF, the project would no longer be entitled to the exemptions from PUHCA and the FPA. This could also trigger certain rights of termination under the facility's power sales agreement, could subject the facility to rate regulation as a public utility under the FPA and state law

Table of Contents

and could result in EPC inadvertently becoming an electric utility holding company that would not be exempt under PUHCA. Loss of QF status may also trigger defaults under covenants to maintain QF status in the project's power sales agreement and potentially result in termination, penalties or acceleration of indebtedness under such agreements.

Under the Energy Policy Act of 1992, if a facility can be qualified as an exempt wholesale generator, or EWG, it will be exempt from PUHCA even if it does not qualify as a QF. Generally, an EWG is defined as any person who receives a determination from the FERC that it is engaged directly, or indirectly through one or more affiliates, and exclusively in the business of owning or operating, or both owning and operating, all or part of one or more eligible facilities and selling electric energy at wholesale. As such, another response to the loss or potential loss of QF status would be to apply to have the project qualified as an EWG. However, assuming this changed status would be permissible under the terms of the applicable power sales agreement, rate approval from FERC would be required. To the extent applicable, the facility would also be required to cease selling electricity to any retail customers.

Presently, there are various pending legislative proposals which would amend or comprehensively restructure PURPA and the electric utility industry. If PURPA is amended or repealed, the statutory requirement that electric utilities purchase electricity from QFs at full-avoided cost could be repealed or modified. While existing contracts are expected to 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 for Scrubgrass which reduce the contract rates, our results of operations and financial position could be negatively impacted.

Public Utility Holding Company Act Under PUHCA, any legal entity which owns or controls ten percent or more of the outstanding voting securities of a public utility company or a company which is a holding company for a public utility company is subject to registration with the Securities and Exchange Commission, or SEC, and regulation under PUHCA, unless eligible for an exemption. Generally, a holding company of a public utility company that is subject to registration is required by PUHCA to limit its utility operations to a single integrated utility system and to divest any other operations not functionally related to the operation of that utility system. Approval by the SEC is required for nearly all important financial and business dealings of a registered holding company. Under PURPA, most QFs are not public utility companies under PUHCA.

The Energy Policy Act of 1992, among other things, amends PUHCA to allow electric wholesale generators, or EWGs, under certain circumstances, to own and operate non-QF electric generating facilities without subjecting those producers to registration or regulation under PUHCA. The effect of such amendments has been to enhance the development of non-QFs which do not have to meet the fuel, production and ownership requirements of PURPA. We believe that these amendments benefit us by expanding our ability to own and operate facilities that do not qualify for QF status. However, they have also resulted in increased competition by allowing utilities to develop such facilities which are not subject to the constraints of PUHCA.

Federal Power Act Regulation Under the FPA, FERC is authorized to regulate the transmission of electric energy and the sale of electric energy at wholesale in interstate commerce. Unless otherwise exempt, any person that owns or operates facilities used for such purposes is considered a public utility subject to FERC jurisdiction. FERC regulation under the FPA includes approval of the disposition of utility property, authorization of the issuance of securities by public utilities, regulation of the rates, terms and conditions for the transmission or sale of electric energy at wholesale in interstate commerce, the regulation of interlocking corporate directors, officers, and officials, and a uniform system of accounts and reporting requirements for public utilities.

FERC regulations provide that a QF is exempt from regulation under the foregoing provisions of the FPA. However, QFs remain subject to limited FPA regulation concerning interconnection authority, transmission authority, information requirements, and emergency provisions. An EWG is not exempt from the FPA and therefore an EWG that makes sales of electric energy at wholesale in interstate commerce is subject to

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

FERC regulation as a public utility. However, many of the regulations that customarily apply to traditional public utilities have been waived or relaxed for power marketers, EWGs and other non-traditional public utilities that have demonstrated that they lack market power in the region in which they are located. EWGs that have demonstrated such a lack of market power are regularly granted authorization to charge market-based rates, blanket authority to issue securities, and waivers of

Table of Contents

FERC's requirements pertaining to accounts, reports and interlocking corporate directors, officers, and officials. Such action is intended to implement FERC's policy to foster a more competitive wholesale power market.

Wholesale Electricity Market Restructuring On July 31, 2002, FERC issued a notice of proposed rulemaking which is intended to substantially restructure the nation's wholesale electricity transmission and sales markets. FERC's objectives in this proposed rule are to remedy various discriminatory aspects of the industry and establish a standardized transmission service and wholesale electric market design that will provide a level playing field for all entities that seek to participate in wholesale electric markets. FERC is also seeking in this rulemaking to establish regulatory measures to protect customers against the exercise of market power when structures do not support a competitive market. We do not know when a final FERC rule in this matter will be issued or what changes will be made to the proposed rule once it is issued in final form. We will continue to monitor these regulatory activities to evaluate any impact on the Scrubgrass plant and/or business opportunities for Microgy.

State Regulation State public utility commissions, or PUCs, have historically had broad authority to regulate both the rates charged by, and the financial activities of, electric utilities operating in their states and to promulgate regulations for implementing PURPA. Because a power sales agreement generally is incorporated into a utility's cost structure and its retail rates, power sales agreements with power producers, such as EWGs and QFs, are potentially subject to state regulatory scrutiny, including the process in which the utility has entered into the power sales agreement. Where the state regulatory authority has authorized a utility's process for securing its electric power supply, the regulatory agency is generally inclined to permit the utility to pass through the costs associated with power purchase agreement to its retail customers. However, under certain circumstances, PUCs could disallow full cost recovery for the expenses associated with a power purchase agreement. Independent power producers that are not QFs or EWGs are considered to be public utilities in many states. As such, these entities would be subject to broad regulation by a PUC, ranging from certificates of public convenience and necessity to regulation of organizational structure, accounting, and financial and other matters. States may also assert jurisdiction over the siting and construction of electric generating facilities including that associated with QFs and EWGs. States may further assert jurisdiction, with the exception of QFs, over the issuance of securities and the disposition, sale, or transfer of assets by these electric generation facilities. PUCs, pursuant to state legislative authority, may also have jurisdiction over how new federal initiatives associated with power production are implemented in each state.

The actual scope of jurisdiction over independent power projects by state public utility regulatory commissions varies from state to state. Presently, through its power purchase agreement with Penelec, the Scrubgrass plant is affected by state legislation in Pennsylvania.

On December 3, 1996, in response to changes in the electric industry, Pennsylvania passed legislation known as the Electricity Generation Customer Choice & Competition Act, or Customer Choice Act, which became effective on January 1, 1997. The Customer Choice Act regulates the generation portion of the electric business by permitting all Pennsylvania retail electric customers to choose their electric generation supplier over a phase-in period which expired December 1, 2000. The Customer Choice Act required that all electric utilities file restructuring plans with the PUC. Penelec filed its proposed restructuring plan during 1997. The plan was subsequently litigated by numerous parties, and later settled by an agreement which was approved by the PUC on October 20, 1998. The settlement agreement set forth a comprehensive plan for restructuring Penelec's service and for ensuring there would be competition for electric generation for all of Penelec's customers beginning on January 1, 1999. The approved restructuring plan provided for Penelec to maintain a separate non-utility generator cost recovery mechanism for accounting purposes. The restructuring plan is designed to enable Penelec to recover all of its costs from non-utility generators, such as the Scrubgrass facility, and should serve to decrease the pressure on Penelec to renegotiate existing power contracts with non-utility generators.

Presently, except as discussed above, neither the Customer Choice Act nor Penelec's restructuring plan directly impacts Environmental Power, since the legislation and restructuring plan pertain to the retail market or new contracts in the wholesale market. Nevertheless, we continue to monitor regulatory developments in order to evaluate any impact on the Scrubgrass plant and possible new business opportunities for Microgy.

Table of Contents

Employees

At the time of this filing, we have thirteen employees, including executive officers and other marketing, finance, engineering and administrative personnel. Our employees are not represented by a collective bargaining agreement and we consider relations with our employees to be good.

Item 2. Properties

Buzzard leases the Scrubgrass facility, which is an approximately 83 megawatt waste coal-fired electric generating facility located on approximately 600 acres in Venango County, Pennsylvania. The payment terms of the lease are described in Item 1.

We lease 2,818 square feet of office space for our corporate headquarters in Portsmouth, New Hampshire under a five-year lease with monthly payments of \$5,520.

Microgy is a tenant-at-will for office space located in Colorado and Wisconsin with aggregate rents of \$1,545 per month.

Item 3. Legal Proceedings

We are currently not involved in any legal proceedings.

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

No matters were submitted to a vote of our stockholders during the fourth quarter of 2003.

PART II

Item 5. Market for Registrant's Common Equity and Related Shareholder Matters

Stock Market Trading:

Our common stock trades on the OTC Bulletin Board under the symbol **POWR**. As of March 3, 2004 there were approximately 231 record holders and approximately 900 beneficial holders of our common stock.

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

The following table shows the quarterly high and low bid prices during 2003 and 2002 as reported by the OTC Bulletin Board:

| <u>Year</u> | <u>Period</u> | <u>High</u> | <u>Low</u> | <u>Year</u> | <u>Period</u> | <u>High</u> | <u>Low</u> |
|-------------|----------------|-------------|------------|-------------|----------------|-------------|------------|
| 2003 | First Quarter | \$0.30 | \$0.19 | 2002 | First Quarter | \$0.60 | \$0.45 |
| | Second Quarter | \$0.28 | \$0.17 | | Second Quarter | \$0.90 | \$0.40 |
| | Third Quarter | \$1.15 | \$0.18 | | Third Quarter | \$0.62 | \$0.35 |
| | Fourth Quarter | \$1.08 | \$0.80 | | Fourth Quarter | \$0.43 | \$0.15 |

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

Dividends:

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

Equity Compensation Plan Information:

The following table sets forth the following information, as of December 31, 2003, with respect to compensation plans (including individual compensation arrangements) under which equity securities of EPC are authorized for issuance; the number of securities to be issued upon the exercise of outstanding options, warrants and rights; the weighted-average exercise price of such options, warrants and rights; and, other than the securities to be issued upon the exercise of such options, warrants and rights, the number of securities remaining available for future issuance under the plans.

Table of Contents

| Plan Category | Shares Issued (1) | Exercise Price (2) | Shares Remaining (3) |
|--|----------------------|-----------------------|-------------------------|
| Equity compensation plans approved by security holders | 2,711,962 | 0.92 | 2,693,038 |
| Equity compensation plans not approved by security holders | 5,600,000 | 0.74 | |
| Total | 8,311,962 | 0.80 | 2,693,038 |

(1) Number of securities to be issued upon exercise of outstanding options, warrants and rights
(2) Weighted average exercise price of outstanding options, warrants and rights
(3) Number of Securities remaining available for future insurance under equity compensation plans

The options, warrants and rights to purchase 5,600,000 shares issued under compensation arrangements not approved by security holders consist of:

Options for 450,000 shares and warrants for 50,000 shares issued in 2001 and options for 100,000 shares issued in 2002 referred to in Note L and described in Note O to our Consolidated Financial Statements; and

5,000,000 options exercisable at an average price of \$0.75 per share issued to Kamlesh Tejwani on July 3, 2003 as part of his overall compensation package.

Item 6. Selected Financial Data

The following selected financial data for the five years ended December 31, 2003 are derived from our audited consolidated financial statements. The data should be read in conjunction with the consolidated financial statements and other financial information included elsewhere herein. Dollars are shown in thousands except per share data.

| | Year Ended December 31 | | | | |
|-------------------------------------|------------------------|---------------|-------------------|---------------|---------------|
| | 2003 | 2002 | 2001 ¹ | 2000 | 1999 |
| Results of Operations Data: | | | | | |
| Power generation revenues | \$ 53,365 | \$ 54,984 | \$ 53,518 | \$ 54,303 | \$ 48,268 |
| Costs and expenses: | | | | | |
| Operating expenses | 25,124 | 24,140 | 23,681 | 22,291 | 21,931 |
| Lease expenses | 22,382 | 25,291 | 24,706 | 26,416 | 23,111 |
| General and administrative expenses | 6,357 | 5,655 | 3,973 | 3,603 | 2,455 |
| Depreciation and amortization | 495 | 545 | 441 | 415 | 363 |
| | 54,358 | 55,631 | 52,801 | 52,725 | 47,860 |
| Operating (loss) income | (993) | (647) | 717 | 1,578 | 408 |
| Other income (expense): | | | | | |
| Other income | 2 | | 2,135 | | |
| Interest income | 31 | 48 | 78 | 737 | 111 |
| Interest expense | (352) | (142) | (185) | (320) | (375) |

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

| | | | | | |
|--|------------|-----------|-----------|-----------|-----------|
| Sale of NOx emission credits | | 2,428 | | 1,156 | 607 |
| Amortization of deferred gain | 308 | 308 | 308 | 308 | 308 |
| | (11) | 2,643 | 2,336 | 1,881 | 651 |
| (Loss) income before income taxes | (1,004) | 1,996 | 3,053 | 3,459 | 1,059 |
| Income tax benefit (expense) | 26 | (857) | (1,374) | (1,632) | (470) |
| (Loss) income before cumulative effect of a change in accounting principle | (978) | 1,138 | 1,679 | 1,827 | 589 |
| Cumulative effect of a change in accounting principle ² | | | | | 1,189 |
| Net (loss) income | \$ (978) | \$ 1,138 | \$ 1,679 | \$ 1,827 | \$ 1,778 |
| Basic earnings (loss) per common share | \$ (0.04) | \$ 0.05 | \$ 0.12 | \$ 0.16 | \$ 0.16 |
| Diluted earnings (loss) per common share | (0.04) | 0.05 | 0.11 | 0.16 | 0.16 |
| Weighted average number of common shares outstanding on a diluted basis | 23,632 | 20,811 | 14,746 | 11,409 | 11,407 |
| Balance Sheet Data: | | | | | |
| Total assets | \$ 103,154 | \$ 92,958 | \$ 85,566 | \$ 69,284 | \$ 58,782 |
| Working capital | 3,876 | (585) | (1,499) | (1,176) | (2,662) |
| Deferred gain ³ | 3,855 | 4,164 | 4,472 | 4,780 | 5,089 |
| Long-term obligations | 79,814 | 75,407 | 65,216 | 58,304 | 51,546 |
| Shareholders' equity (deficit) | 6,620 | 6,186 | 4,383 | (3,970) | (5,471) |

- (1) The Results of Operations Data for 2001 includes Microgy from July 23, 2001 to December 31, 2001.
- (2) Effective January 1, 1999, we changed the method of accounting for major equipment overhauls to adopt a more preferable method.
- (3) See Note B of the Consolidated Financial Statements.

Table of Contents

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Since our inception, we have developed and built power generation facilities that have used alternative fuels and environmental wastes as fuel sources. Our current business segments, Buzzard and Microgy, generate or are expected to generate power using processes that utilize two different environmental wastes: waste coal and animal wastes. Buzzard Power Corporation leases the Scrubgrass plant that uses waste coal generate approximately 83 MW of power while helping to reclaim land and reduce water pollution in western Pennsylvania. Microgy, acquired in 2001, has the exclusive rights to an advanced anaerobic digestion technology that will use animal wastes, specifically cow and hog wastes, to generate power while helping manage water pollution.

As of December 31, 2003 the Company had working capital of \$3,876,046, with current assets of \$16,741,832 exceeding current liabilities of \$12,865,786; its shareholder equity was \$6,619,534 as total assets of \$103,154,368 exceed total liabilities of \$96,534,834. During the year ended December 31, 2003, the Company incurred an operating loss of \$993,512 and a net loss of \$978,159.

This loss was mainly driven by the company's continued investment in the development of Microgy's business plan. The company's other business segment Buzzard had pre-tax income of \$1,854,433 and generated distributions of \$1,710,000.

In 2003, we secured a loan from ArcLight Capital to help fund the development of the Microgy business. All distributions from Buzzard are required to be used to repay this note. As an incentive fee for providing this note, we have also granted ArcLight a participation right in a portion of the distributions after the note has been repaid. ArcLight will receive half of the distributions after the note has been repaid in full and after EPC alone receives a total of \$1,400,000 of distributions. This participation right will end on December 31, 2012. We are required to make payments only when we receive distributions. Any unpaid interest by the 15th of any month will be accrued and rolled into the principal. Nevertheless, we are required to make at least one payment of any amount within a 24 month period. As of the date of this filing, we have satisfied this requirement for the next 22 months.

We met several internal milestones in pursuit of Microgy's business plan:

renegotiating the licensing agreement with DBT,

signing memorandum of understanding with Dairyland Power Cooperative,

signing an agreement for the construction and sale of our first plant based upon the Microgy technology.

subsequently, we have signed similar construction and sale agreements with four other farms, building a backlog of \$12 million.

Our plans are to continue to invest in the expansion of Microgy. On March 17, 2004 the company announced that it is conducting a private placement of up to \$5,040,000 of its equity securities, through its agent. The company raised additional capital in private placements of securities in both 2002 and 2003. As of this filing the Company's agent has begun to receive subscription agreements under its current private placement.

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

If we were unable to raise additional capital, we would need to curtail substantially all of the Microgy operations, and cut corporate overhead in order to meet our ongoing obligations and maintain our operations over the next 12 months.

The following Management's Discussion and Analysis of Financial Condition and Results of Operations compares our results of operations for the years ended December 31, 2003, 2002 and 2001 and should be read in conjunction with the consolidated financial statements and notes thereto, and the comparative summary of selected financial data appearing elsewhere in this report. Historical results and trends which might appear should not be taken as indicative of future operations.

Table of Contents**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. 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.

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. This was originally 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 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. Additional rents are not part of this straight-line basis and are recorded as incurred. Environmental Power, which 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.

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

As of December 31, 2003, 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:

| <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>Thereafter</u> | <u>Total</u> |
|--------------|-------------|-------------|-------------|-------------|-------------------|----------------|
| \$19,703,000 | 21,715,000 | 26,058,000 | 28,910,000 | 29,390,000 | 219,850,000 | \$ 345,626,000 |

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. Since 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 sales 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, since 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 which 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.

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

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

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

Table of Contents

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: 1) goodwill and indefinite-lived intangible assets will be tested for impairment at least annually; 2) goodwill and indefinite-lived intangible assets will no longer be amortized to income; and 3) 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. The Company assessed the implied fair value of the reporting unit by using a discounted cash flow analysis. Given consideration of these factors the Company 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

Year ended December 31, 2003 compared with the year ended December 31, 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 NOx emission 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 \$0.04 in 2003 compared to basic and diluted earnings per common share of \$0.05 in 2002. The weighted average common shares outstanding increased in 2003 due to the issuance of additional shares as stock compensation, totaling 808,456 shares, the exercise of 70,000 options and the issuance of 3,975,000 shares in our 2003 private placement.

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,

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

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.

Table of Contents

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 increased to \$6,357,195 for 2003 from \$5,655,207 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 emissions credits in 2002. Our NOx emission 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.

Year ended December 31, 2002 compared with the year ended December 31, 2001

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

Our net income decreased to \$1,138,383 for 2002 from \$1,679,331 in 2001. The decrease in net income was primarily due to increases in operating, lease, general administrative and depreciation and amortization expenses.

The effect of these changes was partially offset by an increase in power generation revenues, other income and a decrease in income tax expense.

Basic earnings per common share decreased to \$0.05 per common share in 2002 from \$0.12 per common share in 2001. The decrease was primarily due to a decrease in net income and an increase in the weighted average common shares outstanding. Diluted earnings per common share decreased to \$0.05 per common share in 2002 from \$0.11 per common share in 2001. The decrease was primarily due to a decrease in net income and an increase in the weighted average common shares outstanding. The weighted average common shares outstanding increased in 2002 due to the issuance of additional shares for the acquisition of Microgy during the second half of 2001 and the 2,080,000 shares, including 1,040,000 treasury shares, sold in our 2002 private placement.

Power generation revenues increased to \$54,983,934 for 2002 from \$53,518,000 in 2001 and all pertained to Scrubgrass. The increase in power generation revenues was primarily due to:

greater output from the Scrubgrass facility; and

a 5% increase in certain rates billed to Penelec under the terms of the power sales agreement.

Scrubgrass operated at 91.3% of its capacity in 2002 as compared to 91.2% for 2001. The improvement in the capacity rate occurred primarily because of fewer unplanned shutdowns to respond to equipment malfunctions and utility curtailments.

Table of Contents

This increase in overall power generation revenue was partially offset by a decrease in the component of power generation revenue recorded as a result of the straight-line accounting treatment of revenues under the power sales agreement which amounted to \$6,543,998 in 2002 and \$7,460,852 in 2001.

Operating expenses increased to \$24,139,819 for 2002 from \$23,681,081 in 2001 and all pertained to Scrubgrass. The increase in operating expenses was primarily due to:

higher fuel expense from cost escalations in certain fuel supply agreements, changes in fuel mix and the quality of fuel sources, and improvement in facility output totaling \$404,853; and

higher operator fees pursuant to the terms of the operations and maintenance agreement of \$74,527;

These increases were partially offset by a decrease in labor, and labor related costs.

Lease expenses increased to \$25,291,293 for 2002 from \$24,705,813 in 2001. The increase was primarily due to:

increases in scheduled base equity rents of \$ 1,655,657; and

a increase in additional rent of \$3,043,235 paid to the lessor, which amounts to 50 percent of the net available cash flows from Scrubgrass, as a result of increases in available cash flows from Scrubgrass.

These increases in lease expenses were partially offset by:

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 \$6,543,998 in 2002 and \$7,460,852 in 2001;

a decrease of \$334,012 in scheduled principal payments for the Scrubgrass debt which were billed to us under the terms of the lease; and

a decrease of \$2,801,566 in the lessor's loan costs, which are passed along to us as a lease expense, due to lower average interest rates on the tax exempt bonds and variable rate term loans and reduced outstanding balances on the Scrubgrass debt.

General and administrative expenses increased to \$5,655,207 for 2002 from \$3,973,025 in 2001. The increase was primarily due to an increase of \$1,990,204 for Microgy general expenses. In 2002, we recorded expenses for a full 12 months, whereas in 2001 such expenses were only included for 5 1/2 months following our acquisition of Microgy on July 23, 2001. These expenses were related to Microgy's business development and strategic planning and increases in our labor force for planned business expansion.

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

Interest income decreased to \$47,753 for 2002 from \$78,203 in 2001. The decrease was primarily due to lower average interest rates for investments.

Interest expense decreased to \$141,526 for 2002 from \$185,547 in 2001. The decrease was primarily due to lower variable interest rates.

Results for 2001 included \$2,135,048 from the settlement of the Sunnyside litigation. No such settlements were received in 2002.

We earned net proceeds of \$2,428,200 from the sale of NOx emissions credits in 2002. Our NOx emission credits are discussed further under Liquidity and Capital Resources. No such sales occurred in 2001.

Income tax expense decreased to \$857,274 for 2002 from \$1,373,454 in 2001. The decrease was primarily due to a decrease in income before taxes in 2002.

2004 Outlook

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

Power generation revenues are expected to increase in 2004 primarily due to a 5% increase in rates billed to Penelec under the Scrubgrass power sales agreement. This increase is expected to be partially offset by a decrease in revenue recorded as a result of the straight-line accounting treatment of revenue under the power sales agreement. We also expect to operate the facility at a capacity factor of 90% or greater. Due to the ArcLight

Table of Contents

loan, all distributions from Buzzard are required to repay the loan. Therefore, performance at Buzzard will not have an affect on our liquidity in 2004. See Cash Flow Outlook for more information.

We expect to generate revenues from our Microgy subsidiary in 2004. We have signed Digester Purchase and Management Agreements with 5 farms under the Dairyland agreement, described in Item 1. These deals represent backlog of approximately \$12 million. We expect to be able to record a portion of this backlog as revenue in 2004.

Operating expenses are expected to increase in 2004 primarily due to:

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

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

the addition of approximately \$8,195,000 of construction, engineering, and licensing costs associated with the Microgy facilities.

Lease expenses are expected to decrease by \$1,449,000 in 2004 primarily due to:

lower interest expense as we repay principal; and

lowered straight-line lease expenses recorded under FASB 13.

General and administrative expenses are expected to increase by \$1,807,000 during 2004 primarily because we plan to increase expenses to further implement Microgy's business plan. These expenses would include:

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

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

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

Interest expense is expected to increase in 2004 because we will pay interest on the ArcLight loan.

We expect our weighted average common shares outstanding to increase in 2004 as result of additional private placements and issuances of stock compensation and stock awards. In 2003, we issued 4,853,456 new shares and expect to issue as many shares or perhaps more in 2004.

Recently Issued Accounting Standards

There are several recently issued accounting standards which are required to be adopted in the future which are described in Note B to the Consolidated Financial Statements.

Liquidity and Capital Resources

Operating Activities

Our cash used in operating activities was \$4,001,701 in 2003 compared to cash provided by operating activities of \$328,088 in 2002 and \$2,687,504 in 2001. During these periods, our only sources of cash from operating activities were operating profits from Scrubgrass, proceeds from the settlement of the Sunnyside litigation, proceeds from sales of NOx emission credits and investment earnings. None of these sources are expected to provide cash in 2004.

We reported a net loss of \$978,159 during 2003 which contributed significantly to the cash used by operating activities. The following adjustments, which did not impact our cash flows, need to be considered in order to reconcile our net loss in 2003 to our net cash provided by operating activities:

Depreciation and amortization During 2003, we recognized depreciation and amortization for lease rights of \$149,004, licensed technology rights of \$185,881, deferred financing costs of \$36,110, and property plant and equipment of \$124,360.

Table of Contents

Deferred income taxes We had no deferred income tax liability as of December 31, 2003 and a net deferred income tax liability of \$78,071 as of December 31, 2002.

Deferred gain, net Our deferred gain, net, decreased to \$3,855,133 as of December 31, 2003 from \$4,163,544 as of December 31, 2002. The decrease is due to the amortization of the deferred gain related to Scrubgrass, which is being amortized on a straight-line basis over 22 years.

Interest expense, accrued and added to the balance of borrowing In 2003, we had \$216,160 of interest expense that was added to the outstanding principal balance. All of this interest is related to the ArcLight loan of \$3,700,000 secured in September 2003.

Stock-based compensation We issued stock and stock options with a fair market value of \$713,111 to consultants, directors, and employees for services performed for us in lieu of cash compensation.

We also offer the following information to discuss changes in operating assets and liabilities which most notably impacted our cash position during 2003:

Receivable from utility The increase in cash used for operations is primarily attributable to the increase in payment terms from Penelec. As part of our Power Purchase Agreement, the payment terms increased to 47 business days from 23 business days. This resulted in a \$5,089,806 increase in receivable from utility to \$13,063,529 on December 31, 2003 from \$7,973,723 on December 31, 2002.

Unrecognized prior pension service cost Our unrecognized prior pension service cost decreased to \$241,427 as of December 31, 2003 from \$641,885 as of December 31, 2002.

Other current assets Our other current assets decreased to \$679,125 as of December 31, 2003 from \$926,577 as of December 31, 2002. The increase was largely due to decreases in fuel inventories at Scrubgrass.

Accounts payable and accrued expenses Our accounts payable and accrued expenses increased to \$10,042,990 as of December 31, 2003 from \$9,650,092 as of December 31, 2002. The increase was primarily because we increased the additional rent accrual to \$3,118,000 in 2003 from \$1,045,000 in 2002.

Investing Activities

Our cash used for investing activities was \$417,346 in 2003 and \$180,654 in 2002. Our investing activities were concentrated primarily in the following areas:

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

Restricted cash We are contractually required to make scheduled deposits to a restricted maintenance fund for Scrubgrass to ensure that funds are available in the future for scheduled major equipment overhauls. We are allowed to use restricted cash for major equipment overhauls subject to certain restrictions. We made scheduled deposits to the restricted major maintenance fund of \$414,618 in 2003 and \$1,083,573 in 2002. Our payments for major equipment overhauls amounted to \$230,239 in 2003 and \$971,339 in 2002. The remaining changes to restricted cash primarily pertain to investment earnings on available cash balances. Major equipment overhauls are subject to certification by an independent engineer and are performed on a pre-established schedule which can differ widely from year to year. The selection of equipment for service and/or replacement each year depends on factors such as the condition of the equipment, expected wear and tear, and recommendations made by equipment manufacturers. Beginning in February 2002, we were required to make deposits to the restricted major maintenance fund of \$91,520 per month through April 2005. The required monthly payment is subject to possible recalculation after each annual maintenance outage to ensure that funds are sufficient to cover the long-term schedule of major equipment overhauls.

Property, plant and equipment Property, plant and equipment expenditures were \$7,739 in 2003 and \$50,533 in 2002. All capitalized expenditures during 2003 and 2002 were incurred by Microgy and Environmental Power Corporation. We do not have any commitments to purchase property, plant and equipment in 2004.

Table of Contents

Financing Activities

Our cash provided by financing activities was \$5,129,174 in 2003 and \$119,038 in 2002. We offer the following information concerning the financing activities for our business:

Dividend payments to preferred stock of subsidiary Buzzard paid dividends of \$5,000 to its preferred stockholder during 2003 and 2002.

Private Placement of Common Stock In August 2003, we completed a private placement of 3,975,000 shares of our common stock for aggregate gross proceeds of \$718,000. In 2002, we received \$1,039,999 in a private placement.

Net Borrowings Under Secured Promissory Note Payable In September 2003, we completed a transaction with Crystal Creek Coalpower Funding, LLC, an affiliate of ArcLight Energy Partners Fund I, L.P. or ArcLight, for the purpose of monetizing future cash flows from our Scrubgrass plant. As a result of this transaction, EPC Corporation obtained \$3,700,000 in borrowings with future distributions from Scrubgrass as collateral. The funds were used to repay the Alco loan described below and certain fees related to this transaction, as well as to fund the ongoing development of our Microgy subsidiary. See the Long Term Liabilities section below for more information on the loan.

Related Party Loan On September 14, 2001, we borrowed \$750,000 from Alco Financial Services LLC, or Alco, to fund certain expenses related to the acquisition of Microgy and provide additional working capital for our expansion efforts. Robert Weisberg, one of our directors, is the President, Director and a member of Alco. The loan has been repaid in its entirety with proceeds from the ArcLight loan described above.

Treasury Stock In 2003, we used \$21,273 to repurchase common stock. In 2002, we repurchased \$167,858 of common stock as part of a stock purchase agreement with Benjamin Brant (see Note O Related Party Transactions for more information) and sold \$260,000 of treasury shares as part of the 2002 private placement (see above).

Repayment of secured promissory note payable We made repayments of \$447,902 and \$148,310 in 2003 and 2002, respectively, related to a variable rate term loan at Buzzard.

Exercise of Stock Options We received \$19,200 of gross proceeds from the exercise of stock options in 2003. No stock options were exercised in 2002.

Working Capital Loan for Scrubgrass Buzzard may borrow up to \$4 million under a Lessee Working Capital Loan Agreement with the lessor of Scrubgrass for ongoing working capital requirements of this project. The outstanding borrowings under this loan were \$2,433,261 as of December 31, 2003 and \$517,112 as of December 31, 2002. Under the existing terms of this loan, we were required to pay the outstanding balance to zero for a minimum of twenty days during 2002 and 2003. We have met the pay down requirement for this loan for 2002 and 2003.

Long Term Liabilities

The following table shows all of our future contractual obligations:

| <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>Thereafter</u> | <u>Total</u> |
|---------------------------------|-------------|-------------|-------------|-------------|-------------------|----------------|
| Non-cancelable operating leases | | | | | | |
| \$110,518 | 97,671 | 93,716 | 13,411 | 0 | 0 | \$ 315,316 |
| ArcLight loan | | | | | | |
| \$1 | 1 | 1 | 1 | 1 | 3,699,995 | \$ 3,700,000 |
| Scrubgrass facility lease | | | | | | |
| \$19,703,000 | 21,715,000 | 26,058,000 | 28,910,000 | 29,390,000 | 219,850,000 | \$ 345,626,000 |
| Non-cancelable fuel agreements | | | | | | |
| \$2,433,000 | 2,513,000 | 2,599,000 | 2,687,000 | 2,385,000 | 8,687,000 | \$ 21,304,000 |
| TOTAL | | | | | | |
| \$ 22,246,519 | 24,325,672 | 28,750,717 | 31,610,412 | 31,775,001 | 232,236,995 | \$370,945,316 |

Table of Contents

EPC Corporation Debt Obligations In September 2003, EPC Corporation, our wholly-owned subsidiary, secured a \$3,700,000 loan from ArcLight described above. The principal note carries an interest rate of 20%. Any unpaid interest that has accrued on the 15th of each month shall be added to the balance of the note.

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

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

We also granted participation rights to share in 50% of the distributions from Buzzard after the \$3,700,000 loan is repaid and after we receive an additional \$1,400,000 in distributions. This right terminates on December 31, 2012.

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

| | <u>Balance at December 31, 2003</u> | <u>Balance at December 31, 2002</u> | <u>Interest Rate</u> |
|--|---|---|----------------------|
| ArcLight Note Payable | \$ 3,700,000 | | 20% |
| Accrued interest expense, added to principal balance | 216,160 | | 20% |
| TOTAL | \$ 3,916,160 | | |

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

| | <u>Balance at December 31, 2003</u> | <u>Balance at December 31, 2002</u> | <u>Interest Rate</u> |
|--|---|---|----------------------|
| 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 | 8,700,913 | 7.6725% |
| Variable rate term loan (2004) | 3,687,000 | 7,089,016 | LIBOR + 1.250% |
| Buzzard's debt obligations (maturity): | | | |
| Variable rate term loan (2004) | 389,535 | 837,437 | LIBOR + 1.250% |
| Working capital loan (2008) | 2,433,261 | 517,112 | LIBOR + 1.250% |

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

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

Notes Receivable from Officers We have outstanding notes receivable from officers and directors for shares purchased in connection with stock option plans which amounted to \$645,948 as of December 31, 2003 and 2002. These notes, secured by the underlying shares of stock, are payable upon demand and bear interest at a floating rate which is payable monthly. In accordance with company policy and applicable law, we no longer make loans to our officers or directors.

Sunnyside Contingent Obligations We had contingent obligations of \$1,218,078 on our consolidated balance sheet as of December 31, 2000. The contingent obligations were principally expenses for the sale of Sunnyside which were payable upon collection of certain obligations from the purchasers of Sunnyside. On April 10, 2001, we received aggregate proceeds of \$1,500,000 from the purchasers of Sunnyside and resolved litigation by executing a Binding Settlement Agreement. In this agreement, we were formally released from contingent obligations of \$177,962. We have also been released by the statute of limitations or the terms of the underlying agreements from

Table of Contents

additional contingent obligations of \$457,086. We reported the settlement proceeds of \$1,500,000 and the released liabilities of \$635,048 as other income in our consolidated financial statements for 2001.

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

Cash Flow Outlook

During 2004, we expect to fund our business activities principally from available cash balances, investment earnings, raising additional debt at Microgy or equity funding, and the sale of the first products based upon Microgy's technology. As described in Item 1, we have a backlog of approximately \$12 million in sales that would be offset by expenses incurred for construction and development. We do not expect to receive cash from the operations of Buzzard (since these, if any, will be used to repay interest and principal on the ArcLight loan), nor proceeds from the sale of NOx emission credits, nor from any pending litigation, as we have in the past.

On December 31, 2003, our unrestricted cash balance was \$1,444,870 as compared to \$734,743 as of December 31, 2002. Our restricted cash balances were \$1,554,308 and \$1,144,701 at December 31, 2003 and 2002, respectively. As discussed further under investing activities, we are allowed to spend restricted cash to fund the cost of major equipment overhauls at Scrubgrass subject to certain restrictions.

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

Accordingly, in the event that the recorded Microgy backlog is delayed or not realized in 2004, our cash flow from operations for 2004 will not be sufficient to fund:

EPC's historic corporate overhead requirements;

current taxes due; and

continued implementation of Microgy's business plan.

Therefore, we are actively seeking additional debt or equity financing for our business in another private placement. On March 17, 2004 the Company announced that it is conducting a private placement of up to \$5,040,000 of its equity securities, through its agent. In the event that we are unsuccessful, we will need to curtail ongoing business development in Microgy and cut corporate overhead to sustain current operations and meet our obligations for the next 12 months.

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

During 2004, subject to the financing constraints described above, Microgy plans to commence the sale, development and construction of projects based upon the anaerobic digestion technology license. Our present business strategy generally anticipates the outright sale of facilities; however, in some circumstances, we expect that Microgy may own projects. We anticipate that, to the extent Microgy is the owner of projects, project financing may be obtained in the form of a credit facility with one or more lenders, the sale of tax exempt or taxable bonds to investors or equity or other financing. We cannot assure you that Microgy or any other prospective project owner will be able to secure project financing in the amount required to fulfill any development or construction requirements, that project financing will be obtained in time to meet such requirements, or that any such proposed project financing, if obtained, will be on terms acceptable to Microgy or any other prospective project owner. However, to the extent Microgy is the owner of projects, Microgy will need to obtain financing to allow it to develop and construct such projects.

Sale of NOx Credits Under applicable environmental laws and regulations, Scrubgrass needed to achieve certain seasonal nitrogen oxide emission levels beginning on May 1, 1999, and was also required to achieve reduced emission standards by May 2002. Due to the efficient design of the Scrubgrass facility, Scrubgrass met the 1999 requirements without any modifications to the facility. During 1999, we made capital improvements of \$811,568 to the Scrubgrass facility, which enabled Scrubgrass to meet the stricter standards in 2002. By making improvements to the facility before 2002, we anticipated that we would not require a portion of our future NOx Credits to maintain

Table of Contents

our compliance with the applicable regulations. Consequently, we sold our anticipated excess NOx Credits in recent years and used the proceeds to finance the capital improvements and generate additional cash flows for operations. We expect to comply with all material environmental regulations for the foreseeable future without any additional material modifications to the Scrubgrass facility. Recently, we received our next award of NOx Credits for the ozone seasons in 2002 through 2007. Similar to prior years, we expected that we may not require a portion of these future NOx Credits to maintain our compliance with the applicable regulations and sold the anticipated excess NOx Credits in 2002 for \$2,428,200. We did not have such sales in 2003 and do not anticipate the sale of NOx Credits in 2004.

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

Project development activities We expect to begin development and construction of facilities using Microgy's licensed technology during 2004. To the extent we are the owner of these facilities, we will require financing to complete the development and construction of the facilities which is discussed under financing activities. See 2004 Outlook for more information.

CERTAIN FACTORS THAT MAY AFFECT FUTURE RESULTS

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

Microgy, a company that we recently acquired, has very little operating history from which to evaluate its business and products.

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

Microgy has experienced losses to date and we anticipate it will continue to experience losses in the foreseeable future.

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

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

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

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

We are seeking and will require corporate, project or group financing to fund the cost of any development we may decide to pursue for our anaerobic digester projects. This financing may be difficult or impossible for us to obtain. If

Table of Contents

we are unable to obtain such financing, the value of our Microgy investment may be reduced significantly, and we may be required to substantially curtail our business or close any anaerobic digester projects. This financing will depend on prospective lenders or investors review of our financial capabilities as well as specific projects and other factors, including assessment of our ability to successfully construct and manage each project.

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

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

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

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

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

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

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

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

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

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

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

Our current Scrubgrass plant power generation revenue is earned under a long-term power purchase agreement for all output with one customer, Pennsylvania Electric Company, or Penelec, a subsidiary of FirstEnergy Corporation.

Table of Contents

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

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

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

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

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

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

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

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

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

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

We rely heavily on confidentiality agreements and licensing agreements to maintain the proprietary nature of our base of technologies relating to currently licensed technologies. To compete effectively, we may have to defend the

Table of Contents

rights to our intellectual property from time to time. Such defense costs may be significant. As a result, we may lack the financial resources to adequately defend our intellectual property.

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

Microgy licenses its anaerobic digester technology from Danish Biogas Technology, A.S., referred to as DBT, a Danish company. The license agreement grants to Microgy a perpetual, exclusive license to develop projects based on this technology in North America. Pursuant 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 this year, if it were unable to do so, its business would be materially adversely affected.

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

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

Site agreements;

Supply contracts;

Design/build or other construction related agreements;

Power sales contracts;

Various co-product sales agreements;

Waste disposal agreements;

Licenses;

Environmental and other permits;

Local government approvals; and

Financing commitments required for the successful completion of development projects.

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

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

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

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

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

Table of Contents

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

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

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

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

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

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

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

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

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

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

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

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

Table of Contents

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

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

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

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

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

As of December 31, 2003, the aggregate outstanding balance of our variable rate debt obligations was \$2,822,796 and the aggregate outstanding balance of the lessor's variable rate debt obligations, which are passed along to us as a lease expense, was \$145,555,163. Based on these balances, an immediate change of one percent for the variable interest rates would cause a change in interest expense of \$28,228 and lease expense of \$1,455,552. Our objective in maintaining these variable rate borrowings is to achieve a lower overall cost when compared to fixed-rate borrowings. We believe the lessor has the same objective for maintaining their variable rate borrowings.

Item 8. Financial Statements and Supplementary Data

The financial statements listed in the following Index to Financial Statements are filed as a part of this annual report under Item 14 Exhibits, Index to Financial Statements, and Reports on Form 8-K.

| | Page |
|--|--------|
| Index to Financial Statements | |
| <u>Independent Auditors' Report</u> | F-1 |
| <u>Consolidated Balance Sheets</u> | F-2 |
| <u>Consolidated Statements of Operations and Other Comprehensive (Loss) Income</u> | F-3 |
| <u>Consolidated Statements of Shareholders' Equity (Deficit)</u> | F-4 |
| <u>Consolidated Statements of Cash Flows</u> | F-5 |
| <u>Notes to Consolidated Financial Statements</u> | F-6 |
| Table of Contents | 63 |

Item 9. Disagreements on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Under the supervision and with the participation of the Environmental Power's management, including our chief executive officer and the principal accounting officer, we have evaluated the effectiveness of our disclosure controls and procedures as of a date within 90 days prior to the filing of this report. They have concluded that these disclosure controls were effective at December 31, 2003 and provide reasonable assurance that Environmental Power can collect, process and disclose, within the time periods specified in the Commission's rules and forms, the information required to be disclosed in its periodic Exchange Act reports. We also concluded that no changes in internal controls over financial reporting occurred during the quarter ended December 31, 2003 that has materially affected or is reasonably likely to materially affect such internal control over financial reporting.

Table of Contents**PART III****Item 10. Directors And Executive Officers****Directors**

The following table sets forth the age and principal occupation of each of our directors during the past five years. Except for Mr. Weisberg who is a trustee for Pacific Income Advisors, 1299 Ocean Avenue, Suite 210, Santa Monica, California 90401 and Chairman of Oceans Casino Cruises, Inc., 647 East Dania Beach Boulevard, Dania Beach, FL 33004; Mr. Cooper who is an advisory director of Republic Financial Corporation, 3300 S. Parker Road, Aurora, CO 80014; and Mr. Knight who is a director of Avista Corporation, PO Box 3727, Spokane, WA 99220, and Alaska Air Group, Seattle, Washington 98268-0947 none of the other directors holds any other directorships in any company subject to the reporting requirements of the Securities Exchange Act of 1934 or in any company registered as an investment company under the Investment Company Act of 1940.

| <u>Name</u> | <u>Age</u> | <u>Principal Occupation</u> |
|------------------------|------------|--|
| Joseph E. Cresci | 61 | Chairman and Director of Environmental Power Corporation (2003 present); Chairman and Chief Executive Officer of Environmental Power Corporation (1982 2003) |
| Kamlesh R. Tejwani | 43 | President and Chief Executive Officer (2003 present); President, Target Capital Corporation (1996 2003); Chairman and Chief Executive Officer, Air-Cure Technologies, Inc. (1990 1995) |
| Donald A. Livingston | 61 | Executive Vice President of Environmental Power Corporation (2003 present); President of Microgy (July 2001 present); President and Chief Operating Officer of Environmental Power Corporation (1991 2003); |
| John R. Cooper | 56 | President of Finance and Energy Advisory Services, LLC (2003 Present); Independent Director, Criimi Mae (2000 2003); Sr. Vice President, Treasurer and Principal Financial Officer, PG&E National Energy Group (1989 2003) |
| Robert I. Weisberg | 57 | Managing Partner, Alco Financial Services, LLC (1997 present); Chairman, President and CEO, Oceans Casino Cruises, Inc. (2004 present); Trustee, Pacific Income Advisors (1998 present); President and Chief Executive Officer, Pro-Care Financial Group, Inc. (1994 1997) |
| August Schumacher, Jr. | 64 | Managing Director, Washington D.C. Operations, SJH and Co., (2001 present); Consultant, W.K.K. Kellogg Foundation (2001 present); Under Secretary of Farm and Foreign Agricultural Service, U.S. Dept of Agriculture (1997 2001); Administrator, Foreign Agricultural Service, U.S. Dept. of Agriculture (1994 1997); Senior Agricultural Project Manager, World Bank (1990 1994); Commissioner of Food and Agriculture, Commonwealth of Massachusetts (1984 1990) |
| Jessie J. Knight, Jr. | 53 | President and Chief Executive Officer, San Diego Regional Chamber of Commerce (1998 Present); Director, Avista Corporation (1999 Present); Director Alaska Air Group (2002 Present); Commissioner, Electric, Gas and Telecommunications, California Public Utilities Commission (1993 1998) |

Executive Officers

Our executive officers, who are elected annually by the Board of Directors and serve at the discretion of the Board, are as follows:

| <u>Name</u> | <u>Age</u> | <u>Position</u> |
|-------------|------------|-----------------|
|-------------|------------|-----------------|

| | | |
|----------------------|----|---------------------------------------|
| Joseph E. Cresci | 61 | Chairman |
| Kamlesh R. Tejwani | 43 | President and Chief Executive Officer |
| Donald A. Livingston | 61 | Executive Vice President |
| R. Jeffrey Macartney | 49 | Chief Financial Officer and Treasurer |

Joseph E. Cresci, is a founder of EPC, and has served as Chairman since EPC's inception in 1982 and as Chief Executive Officer from 1982 to July 2003. From 1972 to 1982, Mr. Cresci held various executive positions as either President and or Chief Executive Officer at G.E. Stimpson Co., Inc., Ogden Recreation Inc. and Garden State Racing Association. From 1967 to 1969, he was an associate with the Philadelphia law firm of Townsend, Elliot and Munson. Mr. Cresci holds an A.B. degree from Princeton University and a law degree from Cornell Law School and was a member of the Pennsylvania and Massachusetts bars. Currently, Mr. Cresci is a member of the Boards of Directors of the Wang Center for the Performing Arts and the Commonwealth Shakespeare Company and is an overseer of the Boston Lyric Opera, all in Boston, Massachusetts.

Kamlesh Tejwani became President and Chief Executive Officer of EPC, effective July 3, 2003. Mr. Tejwani served as President of Target Capital Corporation, a private equity firm, from May 1996 to June 2003. His responsibilities included structuring and implementing investments for an offshore investment fund and assisting operating companies in operational and strategic planning. From April 1990 until December 1995, he served as the Chairman and Chief Executive Officer of Air-Cure Technologies, Inc., a manufacturer and marketer of air pollution control systems.

Donald A. (Andy) Livingston, a director and a founder of EPC, has served as Executive Vice President from EPC's inception and as President and Chief Operating Officer from September 1991 to July 2003. In addition, he serves as President and Chief Operating Officer of Microgy. Mr. Livingston was previously President and Chief Executive Officer of Green

Table of Contents

Mountain Outfitters, Inc., a manufacturer and distributor of industrial plastic parts. He has also been a partner in financial services firm, Capital Resources, Inc., where he was involved in obtaining debt and equity funds.

R. Jeffrey Macartney has been Chief Financial Officer of EPC since May 2002. Before joining Environmental Power, Mr. Macartney held a series of financial positions including Controller of Pitney Bowes Global Financial Services for four years from 1997 to 2001. Prior to Pitney Bowes, he worked as a business consultant from 1993 to 1997 and served as Senior Vice President of Finance and Administration for Bank Austria in San Francisco from 1989 to 1993.

Identification of Audit Committee and Audit Committee Financial Expert

EPC has a separately-designated standing Audit Committee of the board of directors, which provides the opportunity for direct contact between EPC's independent auditors and the board of directors. The Audit Committee is currently comprised of Messrs. Cooper, Weisberg and Knight, and was established in accordance with section 3(a)(58)(A) of the Exchange Act. The board of directors of EPC has designated Mr. Cooper as an audit committee financial expert under Item 401(h) of Regulation S-K. Mr. Cooper is independent as defined under applicable SEC rules as well as NASDAQ rules applicable to issuers listed on the NASDAQ Stock Market; although EPC is not so listed, EPC has chosen to follow the NASDAQ rules as closely as possible.

Code of Ethics

EPC has not adopted a formal code of ethics that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. EPC has not adopted such a formal code of ethics at this time due to the long-standing company policies already in place applicable to all employees, its emphasis on hiring persons of the highest integrity, and the close, collaborative manner in which the individuals fulfilling these functions work together. EPC will consider adopting such a code of ethics in the future as circumstances warrant.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires our Officers and Directors, and persons who own more than ten percent of a registered class of our equity securities, to file initial statements of beneficial ownership (Form 3), and statements of changes in beneficial ownership (Forms 4 or 5), of Common Stock and other equity securities of EPC with the Securities and Exchange Commission, or SEC. Officers, directors and greater than ten percent stockholders are required by SEC regulation to furnish us with copies of all such forms they file.

We believe, based solely on our review of the copies of forms we have received, or written representations from certain reporting persons, that no additional forms were required for those persons and that our officers, directors and greater than ten-percent beneficial owners complied with all filing requirements applicable to them for 2003, except for the following:

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

2003 Section 16a Compliance

| Individual | Form | Reason of Event Transaction Code | Number of Shares/ Options Granted | Granted Under | Date of Event | Reporting Time Allowance | Date Form Filed with SEC | Filing Late by |
|-----------------------|------|--|---|---------------------------------------|------------------|--------------------------------|--------------------------------------|-------------------|
| Cooper, John R. | 3 | New Director | | | 8/6/03 | 2 | 9/4/03 | 27 days |
| Cooper, John R. | 4 | A | 100,000 | Restated 2002 Director Option Plan | 8/6/03 | 10 | 9/4/03 | 19 days |
| Knight Jr., Jessie J. | 4 | A | 100,000 | Restated 2002 Director Option Plan | 10/27/03 | 2 | 10/30/03 | 1 day |
| Knight Jr., Jessie J. | 4 | J | 15,839 | 2001 Stock Incentive Plan | 8/8/03 | 2 | 9/16/03 | 37 days |
| Tejwani, Kamlesh | 3 | New Executive | | | 7/3/03 | 10 | 7/31/03 | 18 days |
| Tejwani, Kamlesh | 4 | A | 5,000,000 | Option Outside of Plan | 7/3/03 | 2 | 3/31/04 | 302 days* |
| Weisberg, Robert | 4 | P | 156,250 | Private Placement | 7/1/03 | 2 | Not filed** | |

* While the Company's board of directors approved this option grant on July 3, 2003, the agreement documenting this option was not finalized until September 2003. The option agreement was then subsequently amended in December 2003 and March 2004. The failure to file the applicable Form 4 was due in part to the continuing changes in the underlying option agreement.

** Please see footnote 4 to the table on page 14 setting forth the beneficial ownership of directors and officers. The Company is working with Mr. Weisberg to rectify the ownership records with respect to these shares and to file the required Form 4.

The Company has adopted procedures in order to assist its directors and officers in complying with their Section 16(a) reporting requirements in a more timely fashion.

Item 11. Executive Compensation

Compensation of Executive Officers

Summary Compensation Table: The following table sets forth certain information with respect to the annual and long-term compensation of our Chief Executive Officer, Chief Operating Officer and each other executive officer earning in excess of

Table of Contents

\$100,000 in salary and bonus in 2003 for the three fiscal years ended December 31, 2003. Such persons are referred to as the Named Executives.

| Name Principal Position | Year | Annual Compensation | | Long-Term Compensation | |
|---|------|---------------------|-------|------------------------|-----------|
| | | Salary | Bonus | Restricted Stock | Options |
| Joseph E. Cresci | 2003 | \$ 330,000 | | | |
| Chairman | 2002 | \$ 400,000 | | | |
| | 2001 | \$ 285,417 | | | |
| Kamlesh Tejwani | | | | | |
| President and Chief Executive Officer | 2003 | \$ 110,913 | | | 5,000,000 |
| <i>Mr. Tejwani joined EPC on July 3, 2003</i> | 2002 | | | | |
| | 2001 | | | | |
| Donald A. Livingston | 2003 | \$ 378,900 | | | |
| Executive Vice President | 2002 | \$ 400,000 | | | |
| | 2001 | \$ 285,417 | | | |
| R. Jeffrey Macartney | | | | | |
| Chief Financial Officer and Treasurer | 2003 | \$ 148,667 | | | 300,000 |
| <i>Mr. Macartney joined EPC on April 26, 2002</i> | 2002 | \$ 109,333 | | | 100,000 |
| | 2001 | | | | |

Stock Option Grants: The following table contains information concerning the grant of stock options made during 2003 to the Named Executives.

| 2003 Option Grants | Number of Securities Underlying Options Granted | % of Total Options Granted to Employees | Exercise Price (Avg.) | Expiration Date | Value of Options at Time of Issue |
|----------------------|---|--|--------------------------|--------------------|---|
| Joseph E. Cresci | | 0.00% | \$ | | \$ |
| Kamlesh Tejwani | 5,000,000(1) | 71.79% | \$ 0.71 | 1/3/2011 | \$ 772,645(2) |
| Donald A. Livingston | | 0.00% | \$ | | \$ |
| R. Jeffrey Macartney | 300,000(3) | 4.31% | \$ 0.88 | 12/16/2013 | \$ 256,051(4) |

(1) These options were issued outside of any compensation plan approved by security holders. On March 29, 2004, the Company and Mr. Tejwani entered into an amendment to the option agreement relating to these options pursuant to which 1,000,000 of these options were rescinded. The remaining options vest in two tranches of 2,500,000 options and 1,500,000 options upon the achievement of specific performance goals.

(2) Calculated using Black-Scholes Option Pricing Model with the following assumptions: stock price of \$0.20, annual volatility of 100.41%, no dividends, maturity of 8 years, and interest rate of 3.67%.

(3) Options issued under the Company's 2001 Stock Incentive Plan. Options vest as to 75,000 shares on each of the first four anniversaries of the October 29, 2003 grant date.

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

(4) Calculated using Black-Scholes Option Pricing Model with the following assumptions: stock price of \$0.88, annual volatility of 131.72%, no dividends, maturity of 10 years, and interest rate of 4.24%.

Option Exercises and Year-End Value Table: The following table sets forth information regarding the exercise of stock options during 2003 and the number and value of unexercised options held at December 31, 2003 by each Named Executive.

| 2003 Option Exercises & Year- End Option Values | Options Exercised | | Number of Securities Underlying Unexercised Options | | Value of Unexercised In-the-Money Options(1) | |
|---|--------------------|-------------------|--|---------------|---|---------------|
| | Shares Acquired | Value Realized | Exercisable | Unexercisable | Exercisable | Unexercisable |
| | Joseph E. Cresci | | \$ | | | \$ |
| Kamlesh Tejwani | | \$ | | 5,000,000 | \$ | \$ 1,625,000 |
| Donald A. Livingston | | \$ | | | \$ | \$ |
| R. Jeffrey Macartney | | \$ | 25,000 | 375,000 | \$ 8,000 | \$ 30,000 |

(1) Options are in-the-money if the fair market value of the underlying securities exceeds the exercise price of the options. The amounts set forth represent the difference between \$0.90 per share, the closing price per share on December 31, 2003, and the exercise price of the option, multiplied by the applicable number of options.

Defined Benefit Pension Plan

Effective January 1, 1998, we established a non-contributory defined benefit pension plan covering all of our employees who are at least 21 years of age and who have completed at least one year of service. Under the Plan, the benefits payable to each employee at the normal retirement age of 62 are based on years of service and compensation during the three consecutive years of the 10 years immediately preceding retirement which would yield the highest monthly benefit payment. Employees

Table of Contents

who have at least 20 years of service at the time of their retirement would receive the maximum retirement benefit. Our general funding policy is to contribute annually to the Plan the maximum amount that can be deducted for Federal income tax purposes.

Effective January 1, 2003, we amended the Plan to provide that benefits earned after 2002 will accrue at the rate of 1.5% of average compensation (with no cap on service) and will be payable at age 65 rather than age 62. Existing accrued benefits will remain intact. The amended Plan has a two-year waiting period before employees enter the Plan, rather than one year. Employees who join the Plan after two years will be fully vested at that time.

The following table shows the estimated annual pension benefits payable upon retirement to a participant of the Plan for various salary levels and years of service.

| Average Annual Compensation | Years of Service | | | |
|--------------------------------|------------------|--------|--------|--------|
| | 10 | 15 | 20 | 25 |
| 100,000 | 15,000 | 22,500 | 30,000 | 37,500 |
| 150,000 | 22,500 | 33,750 | 45,000 | 56,250 |
| 200,000 | 30,000 | 45,000 | 60,000 | 75,000 |
| 250,000 | 30,000 | 45,000 | 60,000 | 75,000 |

During fiscal year 2003, the maximum amount of annual compensation which may be included for Plan purposes was \$200,000. The figures shown above apply under the Plan as amended. The benefit amounts listed are not subject to any deduction for Social Security or other offset amounts. As a result of limitations imposed under the Federal income tax law, the maximum annual benefit payable under the Plan for the fiscal year ending December 31, 2003 is \$160,000, although the amount will be actuarially adjusted in accordance with Federal income tax regulations if payments commence prior to or following age 65. As of December 31, 2003, Messrs. Cresci and Livingston each had over twenty years of credited service under the Plan.

Employment, Termination and Change-in-Control Arrangements

On July 3, 2003, EPC and Mr. Tejwani executed an Employment Agreement and a related Non-Statutory Stock Option Agreement. These agreements were amended on March 29, 2004. Under the terms of the Employment Agreement, as amended, Mr. Tejwani is an at will employee until the Renewal Date, which is defined as the closing of the sale of equity securities of the Company or its subsidiary, Microgy Cogeneration Systems, Inc., referred to as Microgy, resulting in gross proceeds of at least \$3,500,000. Provided that the Renewal Date occurs and neither the Company nor Mr. Tejwani has terminated his employment, Mr. Tejwani would be employed under the terms of the Employment Agreement until July 3, 2006. In accordance with the terms of the Employment Agreement, Mr. Tejwani receives an annual base salary of \$225,000, subject to discretionary salary increases and annual discretionary bonuses determined by the Board of Directors. Other compensation and benefits include full health care coverage, paid vacation, the use of the company leased vehicle, and stock options under the terms of the Non-Statutory Stock Option Agreement. The original Non-Statutory Stock Option Agreement provided for options to acquire 5,000,000 shares of EPC's common stock that would vest at exercise prices of \$0.25, \$1.00, and \$1.50 over 3 different periods. The amended Non-Statutory Stock Option Agreement provides for options to acquire 4,000,000 shares of EPC's common stock that are exercisable in two tranches. The first tranche consists of 2,500,000 options exercisable at \$0.25. The second tranche consists of 1,500,000 options exercisable at \$1.00. These options will vest upon the successful completion of one or more Qualified Financings, defined as the sale of equity securities of the Company or Microgy on or before July 3, 2006, provided that the first such financing results in gross proceeds of at least \$3,500,000. The options will vest in the same

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

percentage as the percentage of \$8,000,000 which the gross proceeds in each Qualified Financing represents, with such percentage applied to the lower-priced options first. If Mr. Tejwani's employment is terminated after the Renewal Date but before the ending date of July 3, 2006, he would receive a maximum of 12 months of salary and benefits.

In April 2002, EPC and Mr. Macartney executed summary terms applicable to Mr. Macartney's employment as Chief Financial Officer of EPC. While not a formal employment agreement, such terms provide that Mr. Macartney receives a base salary of \$160,000 annually, subject to discretionary salary increases and annual discretionary bonuses determined by the Company's Chief Executive Officer. Mr. Macartney received a 100,000 share option grant in May 2002 upon election as CFO and is eligible for an annual discretionary option grant to be determined by the Chief Executive Officer. EPC provides a leased vehicle for Mr. Macartney's use at a cost of \$6,600 annually. Mr. Macartney is an at-will employee. However, in the event Mr. Macartney's employment is terminated by Mr. Tejwani as a result of Mr. Tejwani's desire to hire a new Chief Financial Officer or by a new Chief Executive Officer electing to hire a new Chief Financial Officer, Mr. Macartney will receive one year's severance and benefits, including health coverage and use of the company leased vehicle for one year. Mr. Macartney would then also be granted an additional 100,000 options to purchase common stock. All such options, together with any options previously granted, would become immediately vested and would remain exercisable based on the dates in the stock option agreements. In the event Mr. Macartney's employment is terminated for any other reason, he will receive six

Table of Contents

months severance and benefits, including but not limited to health coverage and use of the company leased vehicle for six months. The 100,000 options granted in May 2002 would become immediately vested and be exercisable based on the dates in the stock option agreement.

Compensation of Directors

Each director of EPC who is not an officer or employee of EPC receives \$2,000, plus expenses, for each scheduled meeting of the Board of Directors or non-coincident meeting of a board committee which he or she attends. In addition, the Chairman of the Audit Committee receives \$4,000 for each meeting of the Audit Committee attended. Furthermore, under our 2002 Director Option Plan, each non-employee director first elected on or after July 25, 2002, the date of our 2002 Annual Meeting, receives 50,000 options on the date of such first election or appointment. In addition, regardless of when first elected, each non-employee director will receive a grant of 50,000 options on each anniversary date of such director's election or appointment. The 2002 Director Option Plan was amended on July 25, 2003. As a result, each non-employee director receives 100,000 options on the date of the first board meeting following our annual meeting of stockholders.

The following table shows the number of options granted to each director under the Amended 2002 Director Option Plan or other plans approved by shareholders and the number of shares of stock granted in lieu of cash.

| Director | Options | Stock (1) |
|--------------------|------------|-----------|
| August Schumacher | 150,000(2) | 15,839 |
| Robert I. Weisberg | 100,000 | 15,839 |
| John Cooper | 100,000 | |
| Jessie Knight, Jr. | 100,000 | 15,839 |

(1) During 2003, certain directors received shares of stock in lieu of cash compensation for attending two scheduled meetings. The number of shares issued were based upon the closing price of the stock on the day of each of those meetings.

(2) Mr. Schumacher received 50,000 options that were granted under the 2001 Incentive Compensation Plan.

Compensation Committee Interlocks and Insider Participation

The Compensation Committee is comprised of Jessie Knight, Jr., August Schumacher, Jr., and Robert Weisberg. No member of the Compensation Committee is now an officer or an employee of EPC or any of its subsidiaries or has been at any time an officer or employee of EPC or any of its subsidiaries. Mr. Weisberg is a principal of Alco Financial Services, LLC, which was a lender to EPC. The loan transaction with Alco is described in Item 13 below.

Report of the Compensation Committee on Executive Compensation

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

The Compensation Committee of the Board of Directors determines the Company's executive compensation policy and sets compensation for the Chairman (the Chairman), the Chief Executive Officer (the CEO), and the President.

The Compensation Committee's policy is to offer the Chairman and the CEO competitive compensation packages that will permit the Company to attract and retain individuals with superior abilities and to motivate and reward such individuals on the basis of the Company's performance in an appropriate fashion in the long-term interests of the Company and its stockholders. Currently, executive compensation is comprised of salary and cash bonuses that may be awarded from time to time, as well as long-term incentive opportunities in the form of stock options as warranted.

The Compensation Committee takes into account various qualitative and quantitative indicators of corporate and individual performance in determining the level and composition of compensation for the Chairman and the CEO. While the Compensation Committee considers corporate performance measures such as net income, earnings per share, return on assets and return on equity, the Compensation Committee also appreciates the importance of achievements that may be difficult to quantify, and accordingly recognizes qualitative factors, such as successful supervision of major projects and demonstrated leadership ability. Base salaries for the Chairman and the CEO are established at levels considered appropriate in light of the duties and scope of responsibilities of each officer's position. Salaries are generally reviewed periodically and adjusted as warranted to reflect individual officer performance. The Compensation Committee focuses primarily on total annual compensation, including incentive awards and benefits derived from other fringe benefits such as the Pension Plan, rather than base salary alone, as the appropriate measure of executive officer performance and contribution. Compensation decisions regarding executive officers other than the Chairman and CEO are made by the Chairman and CEO, in consultation with the Compensation Committee and the Chief Financial Officer.

In 2003, Mr. Cresci, the Company's Chairman and Chief Executive Officer, agreed to reduce his base salary of \$400,000 by \$120,000, as a condition to his participation in the Company's newly adopted 2003 Incentive Compensation Plan. No bonuses were paid to Mr. Cresci in 2003. Furthermore, the Compensation Committee considered Mr. Cresci's substantial stock ownership and elected not to grant any options to him in 2003.

Table of Contents

In July 2003, Mr. Cresci elected to give up his position as Chief Executive Officer, and Mr. Tejwani was hired to fill that role. In connection with the hiring of Mr. Tejwani, the Compensation Committee determined to pay him a base salary of \$225,000, which the Compensation Committee believed to be commensurate with Mr. Tejwani's experience and the level of compensation accorded to chief executive officers of similarly-situated companies. In addition, as part of his employment package as CEO, the Company made an option grant to acquire 5,000,000 shares of common stock to Mr. Tejwani, which was subsequently reduced to 4,000,000 shares in March 2004. See "Employment, Termination and Change-in-Control Arrangements" above. The Compensation Committee believed that it was important to give Mr. Tejwani a strong equity-based incentive given his lack of ownership of the Company's stock, in order to more closely align his interests with those of the Company's stockholders. The March 2004 amendment to Mr. Tejwani's stock options was intended to tie the vesting of those options more closely with certain financing objectives important to the Company's future growth and for which Mr. Tejwani has principal responsibility. Given the Company's cash constraints, no bonus was paid to Mr. Tejwani for 2003.

In 1993, Congress enacted Section 162(m) of the Internal Revenue Code, which prevents publicly held corporations from deducting compensation in excess of \$1 million paid to CEO's and the four highest compensated officers unless the compensation is performance-based and certain other conditions are satisfied. The Compensation Committee takes the limitations of Section 162(m) into account in making its compensation decisions, but such limitations are not a determining factor. The Compensation Committee does not anticipate that the limitations of Section 162(m) would apply in any material respect to the Company's current compensation arrangements, if at all.

Respectfully submitted by the Compensation Committee,

Jessie J. Knight, Jr.

August Schumacher, Jr.

Robert I. Weisberg

STOCK PERFORMANCE GRAPH

The following graph compares the Company's cumulative stockholder return on its Common Stock with the return on the NASDAQ Market Index and with the SIC Code 4911 (Electric Services) Index for the five year period ended December 31, 2003.

Table of Contents**Item 12. Security Ownership Of Certain Beneficial Owners And Management****Equity Compensation Plan Information**

The following table sets forth the following information, as of December 31, 2003, with respect to compensation plans (including individual compensation arrangements) under which equity securities of EPC are authorized for issuance; the number of securities to be issued upon the exercise of outstanding options, warrants and rights; the weighted-average exercise price of such options, warrants and rights; and, other than the securities to be issued upon the exercise of such options, warrants and rights, the number of securities remaining available for future issuance under the plans.

| Plan Category | Shares Issued (a) | Exercise Price (b) | Shares Remaining (c) |
|--|----------------------|-----------------------|-------------------------|
| Equity compensation plans approved by security holders | 2,711,962 | 0.92 | 2,693,038 |
| Equity compensation plans not approved by security holders | 5,600,000 | 0.74 | |
| Total | 8,311,962 | 0.80 | 2,693,038 |

(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights

(b) Weighted average exercise price of outstanding options, warrants and rights

(c) Number of securities remaining available for future insurance under equity compensation plans

The options, warrants and rights to purchase 5,600,000 shares issued under compensation arrangements not approved by security holders consist of:

Options for 450,000 shares and warrants for 50,000 shares issued in 2001 and options for 100,000 shares issued in 2002 referred to in Note L and described in Note O to our Consolidated Financial Statements; and
5,000,000 options exercisable at an average price of \$0.75 per share issued to Kamlesh Tejwani on July 3, 2003 as part of his overall compensation package. This option was amended in March 2004 to reduce the number of shares issuable upon exercise thereof to 4,000,000.

Beneficial Ownership of Directors, Officers and 5% Stockholders**5% or Greater Stockholders**

The following table sets forth as of April 1, 2004 the name of each person who, to our knowledge, owned beneficially more than 5% of the shares of Common Stock of EPC outstanding at such date, the number of shares owned by each of such persons and the percentage of the class represented thereby.

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

| Name and Address of Beneficial Owner | Amount and Nature of Beneficial Ownership(1) | Percentage of Class |
|---|--|---------------------|
| Joseph E. Cresci c/o Environmental Power Corporation One Cate Street, 4 th Floor Portsmouth, NH 03801 | 5,500,011(2) | 20.6% |
| Donald A. Livingston c/o Environmental Power Corporation One Cate Street, 4 th Floor Portsmouth, NH 03801 | 2,850,505 | 10.7% |
| Lewis Warshauer c/o Red Bank Radiologists, P.A. 6 Riverview Plaza Red Bank, NJ 07701 | 2,000,000(3) | 7.5% |
| John O Shea c/o Westminster Securities Corporation 100 Wall Street, 7 th Floor New York, NY 10005 | 1,610,000 | 6.0% |

(1) Except as otherwise indicated, the named person has sole voting and investment power with respect to the shares. Except as indicated in the following notes all shares are held beneficially and of record. Shares of Common Stock subject to options or warrants currently exercisable or exercisable within 60 days of April 15, 2004 are deemed outstanding for computing the number and the percentage of outstanding shares beneficially owned by the person holding such options but are not deemed outstanding for computing the percentage beneficially owned by any person.

Table of Contents

- (2) Includes 3,643,618 shares held in a revocable trust for the benefit of members of Mr. Cresci's family, of which Mr. Cresci is the trustee, and 59,730 shares held in trust for the benefit of Mr. Cresci and his children, as to which Mr. Cresci has shared voting and investment power; but does not include 20,000 shares owned by Mr. Cresci's wife, as to which shares Mr. Cresci has neither voting nor investment power and as to which shares he disclaims beneficial ownership. Also includes 1,000,000 shares which Mr. Cresci deposited into a voting trust on November 20, 1996 and in which James F. Powers has beneficial ownership in his capacity as trustee with sole voting power. Mr. Cresci also has beneficial ownership in such shares which are evidenced by voting trust certificates held by The Cresci Family Limited Partnership of which Mr. Cresci is the sole general partner with sole dispositive power.
- (3) Includes 1,630,000 shares as to which Mr. Warshauer has sole voting and dispositive power, and 370,000 shares as to which he has shared voting and dispositive power, which are owned jointly with his wife.

Directors and Named Executive Officers

The following table sets forth as of April 1, 2004 the number and percentage of outstanding shares of Common Stock beneficially owned by our Named Executives, Directors, and Directors and Officers as a group.

| Name of Director/Officer & Date First Joined EPC (1) | Positions and Offices | Amount and Nature of Beneficial Ownership(2) | Percentage of Class |
|---|---------------------------------------|---|------------------------|
| Joseph E. Cresci 1982 | Chairman and Director | 5,500,011(3) | 20.6% |
| Kamlesh Tejwani 2003 | President and Chief Executive Officer | 0 | * |
| Donald A. Livingston 1982 | Executive Vice President | 2,850,505 | 10.7% |
| Robert I. Weisberg 1994 | Director | 786,250(4) | 2.9% |
| August Schumacher, Jr. 2002 | Director | 250,000(5) | * |
| Jessie Knight, Jr. 2002 | Director | 250,000(6) | * |
| John Cooper 2003 | Director | 100,000(7) | * |
| R. Jeffrey Macartney 2002 | Chief Financial Officer | 90,000(8) | * |
| All Directors and Officers as a Group | (8 Individuals) | 9,826,766(9) | 35.3% |

*Less than 1%

- (1) Each of the named individuals has an address c/o Environmental Power Corporation, One Cate Street, 4th Floor, Portsmouth, New Hampshire 03801.
- (2) Except as otherwise indicated, the named person has sole voting and investment power with respect to the shares. Except as indicated in the following notes all shares are held beneficially and of record by the named person.
- (3) Includes 3,643,618 shares held in a revocable trust for the benefit of members of Mr. Cresci's family, of which Mr. Cresci is the trustee, and 59,730 shares held in trust for the benefit of Mr. Cresci and his children, as to which Mr. Cresci has shared voting and investment power; but does not include 20,000 shares owned by Mr. Cresci's wife, as to which shares Mr. Cresci has neither voting nor investment power and as to which shares he disclaims beneficial ownership. Also includes 1,000,000 shares which Mr. Cresci deposited into a voting trust on November 20, 1996 and in which James F. Powers has beneficial ownership in his capacity as trustee with sole voting power. Mr. Cresci also has beneficial ownership in such shares which are evidenced by voting trust certificates held by The Cresci Family Limited Partnership of which Mr. Cresci is the sole general partner with sole dispositive power. Also includes 1,000,000 shares that Mr. Cresci has the right to acquire pursuant to stock options that are exercisable subsequent to specific performance achievements
- (4) Includes 500,000 shares that Mr. Weisberg has the right to acquire pursuant to stock options and 50,000 shares which Alco Financial Services, LLC has the right to acquire pursuant to warrants that are all currently exercisable. Also includes 156,250 shares which Mr. Weisberg may be deemed to own beneficially as a result of his agreement with Mr. Jack Rapp regarding Mr. Rapp's purchase of 312,500 shares in EPC's 2003 private placement, half of which shares were purchased for Mr. Weisberg's benefit but which were mistakenly registered in Mr. Rapp's name.

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

- (5) Includes 250,000 shares that Mr. Schumacher has the right to acquire pursuant to stock options that are all currently exercisable.
- (6) Includes 150,000 shares that Mr. Knight has the right to acquire pursuant to stock options that are all currently exercisable.
- (7) Includes 100,000 shares that Mr. Cooper has the right to acquire pursuant to stock options that are all currently exercisable.
- (8) Includes 25,000 shares Mr. Macartney has the right to acquire pursuant to stock options that are currently exercisable and 25,000 shares that Mr. Macartney has the right to acquire pursuant to stock options that are exercisable within 60 days of April 1, 2004.
- (9) Includes 1,100,000 shares that directors and officers have the right to acquire pursuant to various stock options or warrants that are currently exercisable or exercisable within 60 days of April 1, 2004.

Table of Contents

Item 13. Certain Relationships And Related Transactions

During 1993 and 1995, Messrs. Cresci and Livingston exercised options to purchase shares of the Company's Common Stock. As payment for the exercise price of these stock options, EPC accepted promissory notes payable upon our demand from Messrs. Cresci and Livingston aggregating \$332,875 and \$428,281, respectively. In 2000, EPC asked that a portion of these notes be repaid using the proceeds from bonuses due to concerns about ongoing cash requirements. In April 2001, the Company received \$1,500,000 pursuant to a settlement of the Sunnyside litigation and Messrs. Cresci and Livingston were allowed to each borrow \$100,000. As of December 31, 2003, Messrs. Cresci and Livingston had aggregate balances due to EPC of \$186,875 and \$410,498, respectively under these notes and loans. Interest on these notes and loans, which is payable monthly at the Applicable Federal Rate, amounted to \$9,055 in the aggregate during 2003 and has been fully collected from Messrs. Cresci and Livingston.

In September 1997, Mr. Weisberg exercised options to purchase 80,000 shares of the Company's Common Stock. As payment for the exercise price of these stock options, we accepted a promissory note which is payable upon our demand from Mr. Weisberg in the amount of \$48,575. Interest on this note, which is payable quarterly at the Applicable Federal Rate, amounted to \$736 in 2003 and has been fully collected from Mr. Weisberg.

In accordance with applicable federal law, the Company has adopted a policy of not making any new loans to its officers or directors.

On September 14, 2001, we borrowed \$750,000 from Alco Financial Services, LLC (Alco). Robert Weisberg, a Director of the Company, is the Managing Partner and a member of Alco. The loan was evidenced by a promissory note that bore interest at the prime rate plus 3.5%. We also paid an administrative fee of 0.6% per month and a commitment fee of \$7,500 to secure the loan. The loan was secured by all of our assets (other than the stock of our subsidiary, Buzzard Power Corporation). In connection with the loan, we granted Alco five year warrants to purchase 50,000 shares of common stock at \$0.60 per share. During 2003, we recognized interest expense and administrative fees of \$75,252 for this loan. The loan was fully repaid in September 2003.

On June 12, 2003 we granted August Schumacher, Jr. 50,000 options to purchase shares of common stock in lieu of cash compensation for services rendered as a Director of the Company. No compensation expense was recorded because the fair value of the options was equal to or below the exercise price.

On July 3, 2003, we entered into an Employment Agreement with Mr. Tejwani, and granted him an 5,000,000 option to purchase shares of common stock to Kamlesh Tejwani, President and Chief Executive Officer, as part of his compensation package. On March 29, 2004 this agreement was amended. See "Employment, Termination and Change-in-Control Arrangements" above for more information.

Item 14. Principal Accountant Fees And Services

Deloitte & Touche LLP served as the Company's independent auditors for the fiscal years ended December 31, 2002 and 2003, respectively. Deloitte & Touche LLP's fees billed for professional services rendered to the Company for the fiscal years ended December 31, 2002 and 2003 are described below.

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

Audit Fees. Deloitte & Touche LLP billed EPC an aggregate of \$141,800 and \$149,500 in the fiscal years ended December 31, 2002 and 2003, respectively, for professional services rendered in connection with the audit of EPC's financial statements and the reviews of financial statements included in each of EPC's Quarterly Reports on Form 10-Q for the years indicated.

Tax Fees. Deloitte & Touche LLP billed EPC an aggregate of \$3,750 and \$18,090 for the fiscal years ended December 31, 2002 and 2003, respectively, for tax compliance, tax planning and tax advisory services rendered to EPC and its affiliates.

All Other Fees. Deloitte & Touche LLP billed EPC an aggregate of \$0 and \$3,500 for the fiscal years ended December 31, 2002 and 2003, respectively, for other services rendered during such years.

Table of Contents

PART IV

Item 15. Index to Financial Statements, Exhibits, and Reports on Form 8-K

The following documents are filed as part of this annual report:

(a) 1. Consolidated Financial Statements

| | Page |
|--|-------------|
| Index to Financial Statements | |
| <u>Independent Auditors Report</u> | F-1 |
| <u>Consolidated Balance Sheets</u> | F-2 |
| <u>Consolidated Statements of Operations and Other Comprehensive (Loss) Income</u> | F-3 |
| <u>Consolidated Statements of Shareholders Equity (Deficit)</u> | F-4 |
| <u>Consolidated Statements of Cash Flows</u> | F-5 |
| <u>Notes to Consolidated Financial Statements</u> | F-6 |

(a) 2. Financial Statement Schedules

The following consolidated financial statement schedule is required to be filed with this annual report:

Schedule II Valuation and Qualifying Accounts

| Column A | Column B | Column C | Column D | Column E |
|---|---------------------------------------|--|-------------------|---------------------------------|
| Description | Balance at beginning of period | Additions (charged to income tax expense) | Deductions | Balance at end of period |
| Year Ended December 31, 2003: | | | | |
| Valuation reserve for net operating loss carry forwards | \$ 227,123 | \$ 556,452 | \$ (137,735) | \$ 645,840 |
| Year Ended December 31, 2002: | | | | |
| Valuation reserve for net operating loss carry forwards | \$ 148,377 | \$ 78,746 | \$ | \$ 227,123 |

(a) 3. Exhibits

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

The following Exhibits are included in this report:

| <u>Exhibit No.</u> | <u>Description</u> | <u>Reference</u> |
|--------------------|---|------------------|
| 2.01 | Agreement and Plan of Merger dated as of June 2, 2003, among Environmental Power Corporation, EPC Holdings 1, Inc. and EPC Merger Sub, Inc. | A |
| 3.01 | Restated Certificate of Incorporation of the Registrant | A |
| 3.02 | Restated Bylaws of the Registrant | A |
| 4.01 | 2001 Stock Incentive Plan | B |
| 4.02 | Amended and Restated 2002 Director Stock Option Plan | C |
| 4.03 | 2003 Incentive Compensation Plan | C |
| 4.04 | 1993 Director Option Plan | W |

Table of Contents

| Exhibit No. | Description | Reference |
|--------------------|---|------------------|
| 4.05 | Option Agreement dated as of May 2, 2001 between the Company and Robert I. Weisberg | B |
| 4.06 | Option Agreement dated as of September 14, 2001 between the Company and Robert I. Weisberg | B |
| 4.07 | Warrant to purchase 50,000 shares of common stock issued to Alco Financial Services, LLC | K |
| 4.08 | Amended and Restated Non-Statutory Stock Option Agreement, dated as of March 29, 2003, between the Company and Kamlesh Tejwani | Y |
| 10.01 | Note Purchase Agreement, dated September 4, 2003, between EPC Corporation and Crystal Creek Coalpower Funding LLC | D |
| 10.02 | 20.0% Senior Secured Note due December 31, 2012 in the original principal amount of \$3.7 million, made by EPC Corporation in favor of Crystal Creek Coalpower Funding LLC | D |
| 10.03 | Form of 20.0% Senior Secured Note due December 31, 2012 in the original principal amount of \$1.7 million, to be made by EPC Corporation in favor of Crystal Creek Coalpower Funding LLC | D |
| 10.04 | Securities Deposit Agreement, dated September 4, 2003, among EPC Corporation, Crystal Creek Coalpower Funding LLC and the Security Deposit Agent and Securities Intermediary named therein. | D |
| 10.05 | Pledge Agreement, dated September 4, 2003, between the Company and Crystal Creek Coalpower Funding LLC | D |
| 10.06 | Management Agreement, dated September 4, 2003, between the Company and EPC Corporation | D |
| 10.07 | Tax Sharing Agreement, dated September 4, 2003, between the Company and EPC Corporation | D |
| 10.08 | Employment Agreement, dated as of July 3, 2003, between the Company and Kamlesh Tejwani | E |
| 10.09 | Letter Agreement, dated as of March 29, 2004, between the Company and Kamlesh Tejwani | Y |
| 10.10 | Services Agreement dated September 13, 2001 between the Company and PG&E Energy M Trading Power, L.P. pertaining to the sale and purchase of Nitrogen Oxide Ozone Transport Region (NOx) Budget Allowances completed in 2002. | Q |
| 10.11 | Purchase and Sale Agreements, dated as of December 16, 1998, January 4, 2000 and January 8, 2000, between PG&E Energy Trading Power, L.P. and Buzzard Power Corporation pertaining to Nitrogen Oxide Ozone Transport Region (NOx) Budget Allowances. | F |
| 10.12 | Agreement for the Sale of Electric Energy from the Scrubgrass Generating Plant by and between Pennsylvania Electric Company and Scrubgrass Power Corporation dated August 7, 1987 which was assigned by Scrubgrass Power Corporation to Scrubgrass Generating Company, L.P. on December 15, 1990 and assigned by Scrubgrass Generating Company, L.P. to Buzzard Power Corporation on June 17, 1994. | F |
| 10.13 | Supplemental Agreement for the Sale of Electric Energy from the Scrubgrass Generating Plant by and between Pennsylvania Electric Company and Scrubgrass Power Corporation dated February 22, 1989, as amended by letter agreement dated March 28, 1989, which was assigned by Scrubgrass Power Corporation to Scrubgrass Generating Company, L.P. on December 15, 1990 and assigned by Scrubgrass Generating Company, L.P. to Buzzard Power Corporation on June 17, 1994. | F |
| 10.14 | Second Supplemental Agreement for the Sale of Electric Energy from the Scrubgrass Generating Plant by and between Pennsylvania Electric Company and Scrubgrass Power Corporation dated September 27, 1989 which was assigned by Scrubgrass Power Corporation to Scrubgrass Generating Company, L.P. on December 15, 1990 and assigned by Scrubgrass Generating Company, L.P. to Buzzard Power Corporation on June 17, 1994. | F |
| 10.15 | Third Supplemental Agreement for the Sale of Electric Energy from the Scrubgrass Generating Plant by and between Pennsylvania Electric Company and Scrubgrass Power Corporation dated August 13, 1990 which was assigned by Scrubgrass Power Corporation to Scrubgrass Generating Company, L.P. on December 15, 1990 and assigned by Scrubgrass Generating Company, L.P. to Buzzard Power Corporation on June 17, 1994. | F |
| 10.16 | Amendment to the Third Supplemental Agreement for the Sale of Electric Energy from the Scrubgrass Generating Plant by and between Pennsylvania Electric Company and Scrubgrass Power Corporation dated November 27, 1990 which was assigned by Scrubgrass Power Corporation to Scrubgrass Generating Company, L.P. on December 15, 1990 and assigned by Scrubgrass Generating Company, | F |

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

L.P. to Buzzard Power Corporation on June 17, 1994.

10.17

Letter Agreement dated December 20, 1990 amending the Agreement for the Sale of Electric Energy from the Scrubgrass Generating Plant by and between Pennsylvania Electric Company and Scrubgrass Power Corporation dated August 7, 1987, as amended and supplemented from time to time through November 27, 1990, which was assigned by Scrubgrass Power Corporation to Scrubgrass Generating Company, L.P. on December 15, 1990 and assigned by Scrubgrass Generating Company, L.P. to Buzzard Power Corporation on June 17, 1994.

F

Table of Contents

| | | |
|--------|--|---|
| 10.18 | Management Services Agreement by and between Scrubgrass Generating Company, L.P. and PG&E-Bechtel Generating Company dated December 15, 1990 which was assigned by Scrubgrass Generating Company, L.P. to Buzzard Power Corporation on June 17, 1994. PG&E-Bechtel Generating Company has assigned its rights to this agreement ultimately to U.S. Gen. (now PG&E National Energy Group). | F |
| 10.19 | Agreement for Operation and Maintenance of the Scrubgrass Cogeneration Plant between Scrubgrass Generating Company, L.P. and Bechtel Power Corporation dated December 21, 1990 which was assigned by Scrubgrass Generating Company, L.P. to Buzzard Power Corporation on June 17, 1994. Bechtel Power Corporation has assigned its rights to this agreement ultimately to U.S. Operating Services Company (now PG&E Operating Services Company). | F |
| 10.20 | First Amendment to the Agreement for Operation and Maintenance of the Scrubgrass Cogeneration Plant between Buzzard Power Corporation and, ultimately, U.S. Operating Services Company (now PG&E Operating Services Company) dated December 22, 1995. | F |
| 10.21 | Stock Pledge Agreement, dated December 19, 1991, between Environmental Power Corporation and Scrubgrass Generating Company, L.P. | H |
| 10.22 | Amended and Restated Participation Agreement, dated as of December 22, 1995, among Buzzard Power Corporation, Scrubgrass Generating Company, L.P., Environmental Power Corporation, Bankers Trust Company and Credit Lyonnais. | K |
| 10.23 | Appendix I to the Amended and Restated Participation Agreement, dated as of December 22, 1995, among Buzzard Power Corporation, Scrubgrass Generating Company, L.P., Environmental Power Corporation, Bankers Trust Company and Credit Lyonnais, which Appendix defines terms used and not otherwise defined in other contracts. | K |
| 10.24 | Amendment No. 1, dated as of May 22, 1997, to the Amended and Restated Participation Agreement, dated as of December 22, 1995, among Buzzard Power Corporation, Scrubgrass Generating Company, L.P., Environmental Power Corporation, Bankers Trust Company and Credit Lyonnais. | G |
| 10.25 | Amendment No. 2, dated as of September 2, 1998, to the Amended and Restated Participation Agreement, dated as of December 22, 1995, among Buzzard Power Corporation, Scrubgrass Generating Company, L.P., Environmental Power Corporation, Bankers Trust Company and Credit Lyonnais. | I |
| 10.26 | Amended and Restated Lease Agreement between Scrubgrass Generating Company, L.P., a Delaware limited partnership, as Lessor, and Buzzard Power Corporation, a Delaware corporation, as Lessee, dated as of December 22, 1995. | F |
| 10.27 | Amendment No. 1, dated as of June 1, 1996, but not executed until July 24, 1998, to the Amended and Restated Lease Agreement between Scrubgrass Generating Company, L.P., a Delaware limited partnership, as Lessor, and Buzzard Power Corporation, a Delaware corporation, as Lessee, dated as of December 22, 1995. | I |
| 10.28 | Amended and Restated Disbursement and Security Agreement between Scrubgrass Generating Company, L.P., as Lessor, Buzzard Power Corporation, as Lessee, Bankers Trust Company as Disbursement Agent and Credit Lyonnais acting through its New York Branch as Agent, dated as of December 22, 1995. | F |
| 10.29 | Amendment No. 1, dated as of May 22, 1997, to the Amended and Restated Disbursement and Security Agreement between Scrubgrass Generating Company, L.P., as Lessor, Buzzard Power Corporation, as Lessee, Bankers Trust Company as Disbursement Agent and Credit Lyonnais acting through its New York Branch as Agent, dated as of December 22, 1995. | G |
| 10.30 | Amendment No. 1, updated as of October 9, 1998, to the Amended and Restated Disbursement and Security Agreement between Scrubgrass Generating Company, L.P., as Lessor, Buzzard Power Corporation, as Lessee, Bankers Trust Company as Disbursement Agent and Credit Lyonnais acting through its New York Branch as Agent, dated as of December 22, 1995. | I |
| 10.31 | Amended and Restated Lessee Working Capital Loan Agreement between Scrubgrass Generating Company, L.P., as Lender, and Buzzard Power Corporation, as Lessee, dated as of December 22, 1995. | F |
| 10.32 | Settlement Agreement, dated August 3, 2000 and effective February 27, 2001, among Buzzard Power Corporation, Scrubgrass Generating Company L.P. and Pennsylvania Electric Company. | J |
| 10.33 | Technology Licensing Agreement dated May 12, 2000 between Microgy and Danish Biogas Technology, A.S. (portions of this exhibit have been omitted and filed separately with the Securities and Exchange Commission pursuant to a request for confidential treatment). | O |
| 10.34* | Addendum, dated April 14, 2003, to Technology Licensing Agreement dated May 12, 2000, between Microgy and Danish Biogas Technology, A.S. | Y |
| 10.35 | Wisconsin Public Service Corporation Amended and Restated Agreement for Power Purchase with Microgy Cogeneration System, Inc., dated March 18, 2003. | X |

Table of Contents

| Exhibit No. | Description | Reference |
|-------------|--|-----------|
| 10.36 | Environmental Power Corporation Retirement Plan, as restated, effective as of January 1, 1998 and dated as of December 23, 1998. | Q |
| 10.37 | Trust Agreement for Environmental Power Corporation Retirement Plan, as amended and restated, effective as of January 1, 1998 and dated as of December 23, 1998. | Q |
| 10.38 | Indemnification Agreement dated February 12, 2002 between the Company and Joseph Cresci, Donald Livingston, William Linehan, and their successors. | Q |
| 10.39 | First Amendment, dated July 11, 2002, to the Environmental Power Corporation Retirement Plan (the Plan). | X |
| 10.40 | EGTRAA Amendment, dated December 19, 2002 and effective January 1, 2002, to the Environmental Power Corporation Retirement Plan (the Plan). | X |
| 10.41 | Environmental Power Corporation Medical Expense Reimbursement Plan effective as of September 1, 1998 and dated as of December 18, 1998. | I |
| 10.42 | Office Building Lease Agreement dated December 21, 2001 between the Company and Merkle, Soupcoff, & Fiorentino, Inc. | J |
| 10.43 | Promissory Note dated July 30, 1993 by Joseph E. Cresci in favor of Environmental Power Corporation in the original amount of \$161,000. | X |
| 10.44 | Promissory Note dated July 30, 1993 by Donald A. Livingston in favor of Environmental Power Corporation in the original amount of \$161,000 | X |
| 10.45 | Promissory Note dated December 15, 1995 by Donald A. Livingston in favor of Environmental Power Corporation in the original amount of \$267,280.50. | X |
| 10.46 | Promissory Note dated September 9, 1997 by Robert I. Weisberg in favor of Environmental Power Corporation in the original amount of \$48,575.00. | X |
| 10.47 | Promissory Note dated April 12, 2001 by Joseph E. Cresci in favor of Environmental Power Corporation in the original amount of \$100,000.00. | X |
| 10.48 | Promissory Note dated April 12, 2001 by Donald A. Livingston in favor of Environmental Power Corporation in the original amount of \$100,000.00. | X |
| 21.01 | Subsidiaries of the Registrant | Y |
| 23.01 | Consent of Deloitte & Touche LLP | Z |
| 23.02 | Updated Consent of Deloitte & Touche LLP | Z |
| 31.01 | Section 302 Certificate of Chief Executive Officer | Z |
| 31.02 | Section 302 Certificate of Chief Financial Officer | Z |
| 32.01 | Certificate of Chief Executive Officer pursuant to 18 U.S.C. § 1350 | Z |
| 32.02 | Certificate of Chief Financial Officer pursuant to 18 U.S.C. § 1350 | Z |

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

B Previously filed as an exhibit to our Registration Statement on Form S-8 filed August 22, 2002 (Commission File No.333-98559).

C Previously filed as an appendix to the definitive Schedule 14A relating to the Proxy Statement for our 2003 Annual Meeting of Stockholders (Commission File No. 0-15472).

D

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

Previously filed as an exhibit to our Current Report on Form 8-K dated September 4, 2003, as filed on September 10, 2003 (Commission File No. 0-15472).

- E Previously filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2003.
- F Previously filed as an exhibit to our Report on Form 10-K for the year ended December 31, 1996 (Commission File No. 0-15472).
- G Previously filed as an exhibit to our Report on Form 10-Q for the quarter ended June 30, 1997 (Commission File No. 0-15472).
- H Previously filed as an exhibit to our Report on Form 10-K for the year ended December 31, 1997 (Commission File No. 0-15472).
- I Previously filed as an exhibit to our Report on Form 10-K for the year ended December 31, 1998 (Commission File No. 0-15472).
- J Previously filed as an exhibit to our Report on Form 10-K for the year ended December 31, 1999 (Commission File No. 0-15472).
- K Previously filed as an exhibit to our Report on Form 10-K for the year ended December 31, 2000 (Commission File No. 0-15472).
- L Previously filed as an exhibit to Amendment No. 7 to Schedule 13D filed by Joseph E. Cresci on August 2, 2001
- M Previously filed as an exhibit to Schedule 13D filed by Daniel J. Eastman on August 2, 2001
- N Previously filed as an exhibit to our Report on Form 8-K dated as of August 7, 2001 (Commission File No. 0-15472).
- O Previously filed as an exhibit to our Report on Form 10-Q for the quarter ended September 30, 2001 (Commission File No. 0-15472).
- P Previously filed as an exhibit to our Registration Statement on Form S-8 filed August 22, 2002 (Commission File No. 33-98559).

Table of Contents

- Q Previously filed as an exhibit to our Report on Form 10-K for the year ended December 31, 2001 (commission File No. 0-15472).
- R Previously filed as an exhibit to our Current Report on Form 8-K/A dated June 2, 2003, as filed on June 10, 2003 (Commission File No. 0-15472).
- S Previously filed as an exhibit to our Registration Statement on Form S-8 filed August 22, 2002 (Commission File No.333-98559).
- T Previously filed as an appendix to the definitive Schedule 14A relating to the Proxy Statement for our 2003 Annual Meeting of Stockholders (Commission File No. 0-15472).
- U Previously filed as an appendix to the definitive Schedule 14A relating to the Proxy Statement for our 2003 Annual Meeting of Stockholders (Commission File No. 0-15472).
- V Previously filed as an exhibit to our Current Report on Form 8-K dated September 4, 2003, as filed on September 10, 2003 (Commission File No. 0-15472).
- W Previously filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 1993 (Commission File No. 0-15472)
- X Previously filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2002 (Commission File No. 0-15472)
- Y Previously filed with the Annual Report on Form 10-K to which this Amendment relates.
- Z Filed herewith.
- * Confidential treatment requested.

(b) Reports on Form 8-K

On December 22, 2003, the Registrant disclosed pursuant to Regulation FD a press release announcing that Environmental Power Corporation (POWR) had executed an agreement for construction and sale of the first digester project based upon Microgy technology.

Table of Contents

Signature Page

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: **ENVIRONMENTAL POWER CORPORATION**

November 15, 2004

By */s/* KAMLESH R. TEJWANI
Kamlesh R. Tejwani

President & Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act 1934, this report has been signed below by the following persons on behalf of registrant and in the capacities and on the dates indicated.

| <u>Signature</u> | <u>Title</u> | <u>Date</u> |
|---|---|-------------------|
| <i>/s/</i> Joseph E. Cresci Joseph E. Cresci | Chairman and Director | November 15, 2004 |
| <i>/s/</i> Kamlesh R. Tejwani Kamlesh R. Tejwani | President & Chief Executive Officer and Director | November 15, 2004 |
| <i>/s/</i> Donald A. Livingston Donald A. Livingston | Executive Vice President and Director | November 15, 2004 |
| <i>/s/</i> R. Jeffrey Macartney R. Jeffrey Macartney | Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer) | November 15, 2004 |
| John Cooper | Director | |
| <i>/s/</i> Jessie J. Knight, Jr. Jessie J. Knight, Jr. | Director | November 15, 2004 |
| <i>/s/</i> August Schumacher, Jr. August Schumacher, Jr. | Director | November 15, 2004 |
| <i>/s/</i> Robert I. Weisberg Robert I. Weisberg | Director | November 15, 2004 |

Table of Contents

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Shareholders of

Environmental Power Corporation:

We have audited the accompanying consolidated balance sheets of Environmental Power Corporation and subsidiaries (collectively, the Company) as of December 31, 2003 and 2002, and the related consolidated statements of operations and comprehensive (loss) income, shareholders' equity (deficit), and cash flows for each of the three years in the period ended December 31, 2003. Our audits also included the financial statement schedule listed in the Index at Item 15 (a) 2. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the consolidated financial statements and consolidated financial statement schedule based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Environmental Power Corporation and subsidiaries at December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly in all material respects the information set forth therein.

/s/ DELOITTE & TOUCHE LLP

Boston, Massachusetts

March 24, 2004

F-1

Table of Contents*Environmental Power Corporation and Subsidiaries***Consolidated Balance Sheets**

| | <u>December 31, 2003</u> | <u>December 31, 2002</u> |
|---|--------------------------|--------------------------|
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash and cash equivalents | \$ 1,444,870 | \$ 734,743 |
| Restricted cash | 1,554,308 | 1,144,701 |
| Receivable from utility | 13,063,529 | 7,973,723 |
| Other current assets | 679,125 | 926,577 |
| TOTAL CURRENT ASSETS | 16,741,832 | 10,779,744 |
| PROPERTY, PLANT AND EQUIPMENT, NET | 435,516 | 552,607 |
| LEASE RIGHTS, NET | 1,863,495 | 2,012,499 |
| ACCRUED POWER GENERATION REVENUES | 75,314,725 | 70,192,993 |
| GOODWILL | 4,912,866 | 4,912,866 |
| UNRECOGNIZED PRIOR PENSION SERVICE COST | 241,427 | 641,885 |
| LICENSED TECHNOLOGY RIGHTS, NET | 3,256,796 | 3,442,677 |
| OTHER ASSETS | 387,711 | 422,628 |
| TOTAL ASSETS | \$ 103,154,368 | \$ 92,957,899 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable and accrued expenses | \$ 10,042,990 | \$ 9,650,092 |
| Secured promissory note payable to related party | | 750,000 |
| Other current liabilities | 2,822,796 | 965,014 |
| TOTAL CURRENT LIABILITIES | 12,865,786 | 11,365,106 |
| DEFERRED GAIN, NET | 3,855,133 | 4,163,544 |
| SECURED PROMISSORY NOTES PAYABLE AND OTHER BORROWINGS | 4,499,190 | 972,565 |
| DEFERRED INCOME TAX LIABILITY | | 78,071 |
| ACCRUED LEASE EXPENSES | 75,314,725 | 70,192,993 |
| TOTAL LIABILITIES | 96,534,834 | 86,772,279 |
| SHAREHOLDERS' EQUITY: | | |
| Preferred Stock (\$.01 par value; 2,000,000 shares authorized, no shares issued) | | |
| Preferred Stock (no par value, 10 shares authorized; 10 shares issued as of December 31, 2003 and December 31, 2002, respectively) | 100 | 100 |
| Common Stock (\$.01 par value; 50,000,000 shares authorized; 27,263,749 issued and 26,644,735 outstanding as of December 31, 2003 and 22,410,293 issued and 21,852,059 outstanding as of December 31, 2002) | 272,638 | 224,103 |
| Additional paid-in capital | 9,071,127 | 7,669,351 |
| Accumulated deficit | (1,368,166) | (385,007) |
| Accumulated other comprehensive loss | (324,815) | (312,850) |

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

| | | |
|--|------------------------------|----------------------|
| | <u>7,650,884</u> | <u>7,195,697</u> |
| Treasury stock (619,014 and 558,234 common shares, at cost, as of December 31, 2003 and December 31, 2002, respectively) | (385,402) | (364,129) |
| Notes receivable from officers and board members | (645,948) | (645,948) |
| TOTAL SHAREHOLDERS EQUITY | <u>6,619,534</u> | <u>6,185,620</u> |
| TOTAL LIABILITIES AND SHAREHOLDERS EQUITY | <u>\$ 103,154,368</u> | <u>\$ 92,957,899</u> |

See Notes to Consolidated Financial Statements.

Table of Contents*Environmental Power Corporation and Subsidiaries***Statements of Operations and Comprehensive (Loss) Income**

| | Year Ended | | |
|--|----------------------|----------------------|----------------------|
| | December 31, 2003 | December 31, 2002 | December 31, 2001 |
| POWER GENERATION REVENUES | \$ 53,364,615 | \$ 54,983,934 | \$ 53,518,000 |
| COSTS AND EXPENSES: | | | |
| Operating expenses | 25,123,425 | 24,139,819 | 23,681,081 |
| Lease expenses | 22,382,152 | 25,291,293 | 24,705,813 |
| General and administrative | 6,357,195 | 5,655,207 | 3,973,025 |
| Depreciation and amortization | 495,355 | 544,796 | 441,410 |
| | 54,358,127 | 55,631,115 | 52,801,329 |
| OPERATING (LOSS) INCOME | (993,512) | (647,181) | 716,671 |
| OTHER INCOME (EXPENSE): | | | |
| Interest income | 31,152 | 47,753 | 78,203 |
| Interest expense | (351,755) | (141,526) | (185,547) |
| Amortization of deferred gain | 308,411 | 308,411 | 308,410 |
| Other income | 1,620 | | |
| Sales of NOx emission credits | | 2,428,200 | |
| Settlement of Sunnyside litigation | | | 2,135,048 |
| | (10,572) | 2,642,838 | 2,336,114 |
| (LOSS) INCOME BEFORE INCOME TAXES | (1,004,084) | 1,995,657 | 3,052,785 |
| INCOME TAX (BENEFIT) EXPENSE | (25,925) | 857,274 | 1,373,454 |
| NET (LOSS) INCOME | \$ (978,159) | \$ 1,138,383 | \$ 1,679,331 |
| PREFERRED SECURITIES DIVIDEND REQUIREMENTS OF SUBSIDIARY | (5,000) | (5,000) | (5,000) |
| NET (LOSS) INCOME AVAILABLE TO COMMON SHAREHOLDERS | \$ (983,159) | \$ 1,133,383 | \$ 1,674,331 |
| OTHER COMPREHENSIVE LOSS: | | | |
| Minimum pension liability adjustment, net of income tax benefit of \$7,849 in 2003, \$165,592 in 2002 and \$39,606 in 2001 | (11,965) | (252,465) | (60,385) |
| COMPREHENSIVE (LOSS) INCOME | \$ (990,124) | \$ 885,918 | \$ 1,618,946 |
| WEIGHTED AVERAGE COMMON SHARES OUTSTANDING: | | | |
| Basic | \$ 23,631,967 | 20,720,614 | 14,144,222 |
| Diluted | \$ 23,631,967 | 20,810,823 | 14,745,695 |

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

(LOSS) EARNINGS PER COMMON SHARE

| | | | | | | |
|---------|----|--------|----|------|----|------|
| Basic | \$ | (0.04) | \$ | 0.05 | \$ | 0.12 |
| Diluted | \$ | (0.04) | \$ | 0.05 | \$ | 0.11 |

See Notes to Consolidated Financial Statements.

F-3

Table of Contents

Environmental Power Corporation and Subsidiaries

Consolidated Statements of Shareholders Equity (Deficit)

| | Preferred Stock (\$01 par) | | Preferred Stock (no par) | | Common Stock (\$01 par value) | | Additional Paid-in Capital | Accum. Deficit | Accum. Other Comp. Loss | Treasury Stock | Receivable Officers & Directors | |
|---|-------------------------------|-------------|-----------------------------|--------|----------------------------------|-----------|----------------------------------|-------------------|----------------------------------|-------------------|------------------------------------|---------------|
| | Shares | Amount | Shares | Amount | Shares | Amount | | | | | | |
| STATE AT JANUARY 1, 2001 | | \$ | 10 | \$100 | 12,525,423 | \$125,254 | \$ | \$(3,192,721) | \$ | \$(456,271) | \$(445,948) | \$(3,192,721) |
| Change of stock options and warrants for services | | | | | | | 127,998 | | | | | |
| Change paid at subsidiary | | | | | | | | (5,000) | | | | |
| Change of convertible preferred stock (1) | 197,761 | 1,528,690 | | | 5,521,549 | 55,215 | 4,212,942 | | | | (200,000) | |
| Change of additional common stock (2) | | | | | 258,884 | 2,589 | 197,528 | | | | | |
| Change of preferred stock (3) | (197,761) | (1,528,690) | | | 1,977,607 | 19,776 | 1,508,914 | | | | | |
| Change of common stock (4) | | | | | 1,086,830 | 10,868 | 829,252 | | | | | |
| Change of options and warrants (5) | | | | | | | 55,697 | | | | | |
| Change of finance and registration costs | | | | | | | (82,285) | | | | | |
| Change of pension liability adjustment, net | | | | | | | | 1,679,331 | | | | |
| STATE AT DECEMBER 31, 2001 | | \$ | 10 | \$100 | 21,370,293 | \$213,702 | \$6,850,046 | \$(1,518,390) | \$(60,385) | \$(456,271) | \$(645,948) | \$(1,518,390) |
| Change of stock options for services | | | | | | | 49,707 | | | | | |
| Change paid at subsidiary | | | | | | | | (5,000) | | | | |
| Change of common stock | | | | | | | | | | (167,858) | | |
| Change of placement common stock | | | | | 1,040,000 | 10,401 | 769,598 | | | 260,000 | | |
| Change of pension liability adjustment, net | | | | | | | | 1,138,383 | | | | |
| STATE AT DECEMBER 31, 2002 | | \$ | 10 | \$100 | 22,410,293 | \$224,103 | \$7,669,351 | \$(385,007) | \$(312,850) | \$(364,129) | \$(645,948) | \$(385,007) |
| Change of stock grants and stock options for services | | | | | 808,456 | 8,085 | 705,026 | | | | | |
| Change paid at subsidiary | | | | | | | | (5,000) | | | | |
| Change of common stock | | | | | | | | | | (21,273) | | |
| Change of Stock Options | | | | | 70,000 | 700 | 18,500 | | | | | |
| Change of placement common stock | | | | | 3,975,000 | 39,750 | 678,250 | | | | | |
| Change of pension liability adjustment, net | | | | | | | | (978,159) | | | | |
| STATE AT DECEMBER 31, 2003 | | \$ | 10 | \$100 | 27,263,749 | \$272,638 | \$9,071,127 | \$(1,368,166) | \$(324,815) | \$(385,402) | \$(645,948) | \$(1,368,166) |
| Change of convertible preferred and common stock for 87.7% of outstanding equity of Microgy | | | | | | | | | | | | |
| Change of additional common stock to holders of 87.7% of outstanding equity in Microgy | | | | | | | | | | | | |
| Change of conversion of preferred stock to common stock | | | | | | | | | | | | |
| Change of common stock for 12.3% of outstanding equity of Microgy | | | | | | | | | | | | |
| Change of options and warrants for options and warrants of Microgy | | | | | | | | | | | | |
| Change to Consolidated Financial Statements. | | | | | | | | | | | | |

Table of Contents*Environmental Power Corporation and Subsidiaries***Consolidated Statements of Cash Flows**

| | December 31, 2003 | December 31, 2002 | December 31, 2001 |
|--|------------------------------|----------------------|----------------------|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net (loss) income | \$ (978,159) | \$ 1,138,383 | \$ 1,679,331 |
| <i>Adjustments to reconcile net (loss) income to net cash (used for) provided by operating activities:</i> | | | |
| Depreciation and amortization | 495,355 | 544,794 | 441,410 |
| Deferred income taxes | (78,071) | (68,325) | 104,425 |
| Amortization of deferred gain | (308,411) | (308,411) | (308,410) |
| Release of Sunnyside Project liabilities | | | (635,048) |
| Interest expense, accrued and added to balance of borrowing | 216,160 | | |
| Non-cash and stock based compensation expense | 713,111 | 49,707 | 113,600 |
| Accrued power generation revenues | (5,121,732) | (6,543,998) | (7,460,852) |
| Accrued lease expenses | 5,121,732 | 6,543,998 | 7,460,852 |
| <i>Changes in operating assets and liabilities:</i> | | | |
| Increase in receivable from utility | (5,089,806) | (67,859) | (569,456) |
| Decrease (increase) in unrecognized prior pension service cost | 400,458 | 45,849 | (106,637) |
| Decrease (increase) in other current assets | 247,452 | (318,987) | 164,510 |
| Decrease (increase) in other assets | (723) | 83,408 | (20,730) |
| Decrease (increase) in accounts payable and accrued expenses | 380,933 | (672,578) | 1,917,062 |
| Decrease in long-term debt to supplier | | (97,893) | (92,553) |
| Net cash (used for) provided by operating activities | (4,001,701) | 328,088 | 2,687,504 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Decrease in restricted cash | (409,607) | (130,121) | (427,104) |
| Cash paid for the acquisition of Microgy, net of cash acquired | | | (412,120) |
| Property, plant and equipment expenditures | (7,739) | (50,533) | (232,691) |
| Net cash used for investing activities | (417,346) | (180,654) | (1,071,915) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Dividend payments on preferred stock of subsidiary | (5,000) | (5,000) | (5,000) |
| Dividend payments | | | (171,102) |
| Private placement of common stock | 718,000 | 1,039,999 | |
| Borrowings under secured promissory note payable | 3,700,000 | | |
| (Repayments) borrowings under Secured promissory note payable to related party | (750,000) | | 750,000 |
| Repurchase of Treasury stock | (21,273) | (167,858) | |
| Borrowings under officer notes receivable | | | (200,000) |
| Repayment of secured promissory note payable | (447,902) | (148,310) | (202,826) |
| Exercise of stock options | 19,200 | | |
| Net borrowings under working capital loan | 1,916,149 | (599,793) | (1,626,056) |
| Net cash provided by (used for) financing activities | 5,129,174 | 119,038 | (1,454,984) |
| INCREASE IN CASH AND CASH EQUIVALENTS | 710,127 | 266,472 | 160,605 |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 734,743 | 468,271 | 307,666 |

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

| | | | |
|--|---------------------|-------------------|-------------------|
| CASH AND CASH EQUIVALENTS, END OF PERIOD | <u>\$ 1,444,870</u> | <u>\$ 734,743</u> | <u>\$ 468,271</u> |
|--|---------------------|-------------------|-------------------|

See Notes to Consolidated Financial Statements.

F-5

Table of Contents

ENVIRONMENTAL POWER CORPORATION AND SUBSIDIARIES

Notes To Consolidated Financial Statements

NOTE A BUSINESS AND ORGANIZATION

Environmental Power Corporation (individually EPC or consolidated We) is an independent developer and owner of generating facilities powered by non-commodity fuels and renewable energy sources. Our operations are discussed further in the following sections.

Buzzard Power Corporation

The Scrubgrass plant, located on a 600 acre site in Venango County, Pennsylvania, is an approximately 83 Megawatt waste coal-fired electric generating station (the Facility) which was constructed by Bechtel Power Corporation. On June 30, 1994, Buzzard Power Corporation (Buzzard), a subsidiary of EPC, entered into an agreement to lease the Facility from Scrubgrass Generating Company, L.P. (the Lessor), a joint venture of certain wholly owned indirect subsidiaries of PG&E Corporation and Bechtel Generating Company, Inc. On October 20, 1998, Bechtel Generating Company, Inc. transferred its interest in the Lessor to a wholly owned subsidiary of Cogentrix Energy, Inc. The lease provides for an initial term of 22 years with a renewal option for up to 3 years. Pursuant to the lease, the Lessor assigned to Buzzard all principal project agreements and its rights and obligations there under including, but not limited to, the power purchase agreement, management services agreement, operations and maintenance agreement, limestone supply agreements, ground lease agreements, fuel agreements and transportation and materials handling agreements. EPC has pledged Buzzard s common stock to the Lessor as security for Buzzard s performance of its obligations as lessee. Power Services Company (formerly PG&E National Energy Group Company) (the Manager), a wholly owned, indirect subsidiary of NEGТ, Inc., manages the business activities of the Facility pursuant to the management services agreement.

U.S. Operating Services Company (formerly PG&E Operating Services Company) (the Operator), a wholly owned, indirect subsidiary of NEGТ, Inc., operates the Facility pursuant to a 15-year Operating and Maintenance Agreement (the O&M). The Operator prepares a budget for all operating expenses, including a fixed management fee, and certain targeted output performance levels, which is approved annually. Under the terms of the O&M, the Operator can incur a liability not to exceed its management fee if the Operator does not achieve certain targeted output performance levels.

Buzzard maintains a long-term supply agreement with Quality Aggregates, Inc. to supply the Scrubgrass plant with limestone which, in September 2000, was extended through the year 2008 and which may be extended up to 10 additional years. Buzzard also maintains a 15-year agreement with Savage Industries, Inc. for the transportation of fuel, ash and limestone which expires in 2005. The costs established under these agreements will escalate at partially fixed and partially indexed rates.

Buzzard sells electric output to Pennsylvania Electric Company, known as Penelec, a subsidiary of FirstEnergy Group, pursuant to a twenty-five year Power Sales Agreement (PSA) which commenced in June 1993, at fixed rates initially averaging 4.68 cents per kWh and which escalated at 5% per year through calendar year 2000. For the years 2001 through 2012, the PSA provides for a rate equal to the greater of an inflation adjusted rate or a rate based on the PJM Billing Rate (the monthly average of the hourly rates for purchases by FirstEnergy Group from, or sale by FirstEnergy Group to, the Pennsylvania-New Jersey-Maryland Interconnection). For years 2005 through 2012, we estimate that the prevailing rate will be lower than the 5% increase which is currently assumed. This will result in a decrease in average bill rate between 2004 and 2005. For

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

the years 2013 through 2015 and 2016 through 2018, if the renewal term option is exercised, the PSA provides for a rate equal to the lower of the average monthly PJM Billing Rate or the rate paid for the calendar year 2012 adjusted annually by the percentage change in the Gross National Product Deflator less one percent. The Facility achieved commercial operation on June 8, 1993.

Buzzard deposits all revenues earned under the PSA into an account administered by a disbursement agent. Before Buzzard can receive cash generated by the Scrubgrass plant, all operating expenses, base lease payments (which are described below), restricted cash deposits and other subordinated payments must be satisfied. Buzzard, as lessee, is required to pay the Lessor, in addition to a specified base rent, which consists of all of the Lessor's debt service, equity repayment, base return on equity and related expenses, and an additional rent of 50 percent of the net cash flows Buzzard receives from the Scrubgrass plant's operations. Buzzard is not required to fund operating losses, or otherwise invest further, from sources outside of the Scrubgrass plant.

Buzzard and the Lessor have various debt obligations related to Scrubgrass. As discussed above, Buzzard is required to pay the principal, interest and fees for the Lessor's debt obligations as a base lease payment. As such, Buzzard is committed to pay all of the Scrubgrass debt obligations as either a debt or lease obligation. The Scrubgrass plant had the following debt obligations as of December 31, 2003 and 2002:

F-6

Table of Contents

| | Balance at December 31, 2003 | Balance at December 31, 2002 | |
|--|---|---|-------------------|
| 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 | 8,700,913 | 7.6725% |
| Variable rate term loan (2004) | 3,687,000 | 7,089,016 | LIBOR + 1.250% |
| Buzzard's debt obligations (maturity): | | | |
| Variable rate term loan (2004) | 389,535 | 837,437 | LIBOR + 1.250% |
| Working capital loan (2008) | 2,433,261 | 517,112 | LIBOR + 1.250% |

The Lessor's debt obligations and Buzzard's debt obligation incur interest at either quoted rates, rates fixed by swap agreements, or variable rates which are based on the London Interbank Offering Rate (LIBOR). On December 22, 1995, the Lessor entered into an interest rate swap arrangement which fixed the LIBOR component for the life of its swap rate term loan at 6.4225%. As a result, the interest rate for the swap-rate term loan was fixed at 7.5475% (LIBOR + 1.125%) through December 31, 2000 and 7.6725% (LIBOR + 1.25%) for the remaining term of the obligation. The Lessor's tax-exempt bonds incurred interest at floating rates ranging from 0.80% to 1.35% and 1.10% to 1.85% during 2003 and 2002, respectively. Under the terms of the Lessor's loan agreements, we are subject to various customary financial and operating covenants. As of December 31, 2003 and 2002, we were in compliance with these covenants.

The Environmental Protection Agency and the Pennsylvania Department of Environmental Protection (the Regional Authorities) granted Nitrogen Oxide Ozone Transport Region Budget Allowances (NOx Credits) to Environmental Power Corp. based on numerous factors that primarily pertain to the design and operation of the Facility. We are required annually to maintain sufficient NOx Credits which equal or exceed the quantity of its nitrogen oxide emissions during a specified seasonal period (the ozone season). If our nitrogen oxide emissions exceed its available NOx Credits, we would be subject to fines by the Regional Authorities. During 2000, we installed machinery, costing \$811,568, which has significantly reduced our nitrogen oxide emissions. Accordingly, we anticipate that it may not require a portion of its future NOx Credits to maintain its compliance with the applicable regulations. Because NOx Credits are transferable and marketable, we have sold for delivery through 2007 and may sell, from time to time, our available NOx Credits or purchase additional NOx credits that are necessary to meet the applicable regulations. We received net proceeds from NOx Credit transactions of \$2,428,200 in 2002, which has been reported as other income in the accompanying consolidated statements of operations.

In June 2003, we created a wholly owned subsidiary, EPC Corporation, which holds our investment in Buzzard Power. In September 2003, EPC Corporation obtained a \$3,700,000 loan from ArcLight Capital Partners. This debt is secured by the stock of EPC Corporation. This loan incurs a 20% interest rate. All distributions from Buzzard will be used to repay this note. As an incentive fee for providing this note, we have also granted ArcLight a participation right in a portion of the distributions after the note has been repaid. They will receive half of the distributions after the note has been repaid in full and after EPC alone receives a total of \$1,400,000 of distributions. This participation right will end on December 31, 2012. We are required to make payments only when receive distributions. Any unpaid interest by the 15th of any month will be accrued and rolled into the principal. Nevertheless, we are required to make at least one payment of any amount within a 24 month period. As of the date of this filing, we have satisfied this requirement for the next 22 months.

Microgy Cogeneration Systems

In the second half of 2001, we acquired Microgy Cogeneration Systems, Inc., a development-stage company based in Golden, Colorado. The acquisition is described in Note C to our consolidated financial statements. Microgy intends to market and operate in the renewable energy and distributed generation sectors of the electric energy industry and the pollution mitigation area of the agricultural industry. Microgy has an exclusive license to an anaerobic digestion technology that is designed to provide efficient conversion of certain agricultural wastes into combustible biogas and an environmentally improved waste effluent. Microgy also has a license for a micro-turbine technology which it is currently evaluating.

The licensor of the anaerobic digester technology is Danish Biogas Technology A/S (DBT). DBT is 50% owned by Schouw & Co., a Danish public company and 50% by DDH Contractors A/S, a Danish engineering firm. On May 12, 2000, Microgy entered into a revised licensing agreement with DBT which granted Microgy a perpetual and exclusive license in certain territories, specifically North America, for use of certain proprietary technologies in its cogeneration facilities, including the anaerobic digestion technology. This agreement superseded previous license agreements. As part of the agreement renegotiated in 2003, DBT will receive fixed payments for engineering work and construction drawings and a licensing fee that is based on a percentage of the total cost for each project facility where the licensed technology is installed and operating.

F-7

Table of Contents

Microgy plans to develop projects based upon the anaerobic digestion technology license and may hold various interests in these facilities. Microgy's present business strategy anticipates the outright sale of facilities, however, in some instances, Microgy may own some or a portion of the projects. In addition, Microgy may or may not operate and/or manage the facilities. These facilities are expected to deliver renewable energy for supply to the utility grid and provide pollution control benefits to the agricultural markets.

Sunnyside Project

The Sunnyside Project is an approximately 51 Megawatt (net) waste coal-fired facility located at a site adjacent to the Sunnyside Coal Mine in Carbon County, Utah. We sold its remaining interest in the Sunnyside Project on December 31, 1994 to B&W Sunnyside, L.P. and NRG Sunnyside, Inc. (the Purchasers). From May 1996 to April 2001, we had been involved in a legal proceeding to collect the Purchasers' remaining obligations from the sale.

On April 10, 2001, we received aggregate proceeds of \$1,500,000 from the Purchasers and resolved the litigation by executing a Binding Settlement Agreement dated April 9, 2001 (the Settlement). At the time of making the Settlement, we had contingent obligations of \$1,218,078 recorded on our consolidated balance sheet. The contingent obligations were principally expenses for the sale of the Sunnyside Project which were payable upon collection of the Purchasers' obligations. In the Settlement, we were formally released from contingent obligations of \$177,962. We have also been released as a result of the statute of limitations or by the terms of the underlying agreements from additional contingent obligations of \$457,086. We reported the settlement proceeds of \$1,500,000 and the released liabilities of \$635,048 as other income in our consolidated statement of operations for 2001.

Because of the terms of the Settlement, which terms represented a substantial compromise of our previous claims against the Purchasers; we are presently considering its rights and obligations with respect to the remaining contingent obligations. Until we resolve these remaining issues, the unsettled contingent obligations will remain recorded on our consolidated balance sheet.

Management's Plans

Our plans are to continue to invest in the expansion of Microgy. On March 17, 2004, the Company announced that it is conducting a private placement of up to \$5,040,000 of its equity securities, through its agent. The Company raised additional capital in private placements of securities in both 2002 and 2003. If we were unable to raise additional capital, we would need to curtail substantially all of the Microgy operations and cut corporate overhead, in order to meet our ongoing obligations and maintain our operations over the next 12 months.

NOTE B SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation: The consolidated financial statements include the accounts of Environmental Power Corporation and its wholly owned subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation. The consolidated financial statements include the accounts of Microgy from the date of acquisition (July 23, 2001) (See Note C).

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

Use of Estimates: 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.

Cash Equivalents: We consider all highly liquid investments with maturities of three months or less when purchased to be cash equivalents.

Concentrations of Credit Risk: Our financial instruments that are exposed to concentrations of credit risk consist primarily of cash equivalents and receivable from utility. Our cash equivalents represent short-term financial instruments which are issued from reputable financial institutions. Receivable from utility represents amounts due from our sole customer Penelec, a subsidiary of FirstEnergy Group, a public utility with a credit rating of BBB- by Standard & Poors, pursuant to the terms of the 25 year power sales agreement.

Restricted Cash: Restricted cash includes all cash held by the disbursement agent for the Scrubgrass plant pursuant to project agreements which require requisition and/or certification by the Lessor or bank to withdraw (See Note A). We make scheduled deposits to restricted cash accounts which are restricted primarily for scheduled maintenance procedures.

Non-Cash Activities: We had the following non-cash investing and financing activities during 2003:

| <u>Description</u> | <u>Value</u> |
|---|--------------|
| Fair value of 808,456 shares and 950,000 options issued for consulting services and salaries: | \$ 713,111 |

Fuel Inventory: Fuel inventory for the Scrubgrass plant consists primarily of handling and hauling costs and is recorded on a lower of cost or market basis with cost determined on a monthly weighted average basis.

Table of Contents

Property, Plant and Equipment: Property, plant and equipment are stated at cost less accumulated depreciation. We capitalize significant renewals and betterments that increase the useful lives of assets while repairs and maintenance charges are expensed when incurred. The cost and accumulated depreciation for property, plant and equipment disposals are removed from the balance sheet and any resulting gains or losses are reported in the statement of operations at the time of the asset disposition. We depreciate property plant and equipment using straight-line and accelerated methods over the estimated useful lives of the assets. We record depreciation for office equipment and furniture using the straight-line method over periods ranging from three to five years, for machinery and equipment modifications using the double declining balance method over seven years, and for leasehold improvements using the straight-line method over the life of the lease. We evaluate the impairment of long-lived assets based on the projection of undiscounted cash flows whenever events or changes in circumstances indicated that the carrying amounts of such assets may not be recoverable. In the event such cash flows are not expected to be sufficient to recover the recorded value of the assets, the assets are written down to their estimated fair values.

Goodwill and Intangible Assets: Intangible assets are recorded at cost and consist of licensed technology rights and goodwill. Licensed technology rights are being amortized using the straight-line method over a useful life of 20 years. Goodwill represents the excess of cost over the fair value of tangible and identifiable intangible assets and is not being amortized pursuant to Statement of Financial Accounting Standards (SFAS) No. 142 Goodwill and Other Intangible Assets . We periodically review the carrying value of other intangible assets against the operating performance and future undiscounted net cash flows of the related businesses and recognizes impairment losses whenever circumstances indicate that the carrying values may not be recoverable. Goodwill is reviewed for impairment on an annual basis in accordance with SFAS No. 142. We did not have acquired goodwill or intangible assets recorded on our balance sheet prior to the Microgy acquisition. Accumulated amortization of licensed technology rights was \$453,204 and \$267,323 at December 31, 2003 and 2002, respectively. 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 December 31, 2003. We assessed the implied fair value of the reporting unit by using a discounted cash flow analysis. Given consideration of these factors, we concluded that the fair value of the reporting unit exceeded the carrying amount of our net assets and, thus, goodwill was not impaired as of December 31, 2002 and December 31, 2003. The future estimated amortization expense for licensed technology rights is as follows:

| 2004 | 2005 | 2006 | 2007 | 2008 | Thereafter | Total |
|-----------|---------|---------|---------|---------|------------|--------------|
| \$185,500 | 185,500 | 185,500 | 185,500 | 185,500 | 2,329,296 | \$ 3,256,796 |

Deferred Financing Costs: In 1997 and 1995, we incurred deferred financing costs of \$139,925 and \$300,000, respectively, in connection with restructuring debt related to the Scrubgrass plant. Deferred financing costs are being amortized over the lives of the related debt which range from three to nine years. Accumulated amortization of deferred financing costs was \$425,075 and \$389,435 at December 31, 2003 and 2002, respectively.

Lease Rights: Lease rights are recorded at cost and are being amortized over the 22-year lease term for the Scrubgrass plant. Accumulated amortization of lease rights was \$1,415,565 and \$1,266,561 at December 31, 2003 and 2002, respectively.

Accrued Power Generation Revenue and Accrued Lease Expense: As discussed in Note A, we have entered into a long-term agreement, to provide electricity to Penelec, which provides for scheduled rate increases. In accordance with accounting principles generally accepted in the United States of America, revenue has been recorded on the straight-line basis over the 22-year lease term. The accrual for power generation revenue is limited to the amount of accrued lease expense, as described below. Therefore, no amount for the straight lining of future revenues, which would result in profits, has been provided for in the consolidated financial statements. Accrued power generation revenue was \$75,314,725 and \$70,192,993 at December 31, 2003 and 2002, respectively, and represents the portion of revenue earned that has not yet been received.

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

As discussed in Note A, we have entered into a long-term lease agreement for the Scrubgrass plant which provides for scheduled lease expense increases. In accordance with accounting principles generally accepted in the United States of America, the scheduled lease expense has been recorded on the straight-line basis over the 22-year lease term. Accrued lease expense was \$75,314,725 and \$70,192,993 at December 31, 2003 and 2002, respectively, and represents the portion of lease expense that has not yet been paid.

Deferred Gain: Our sale of the Scrubgrass plant on December 28, 1990 was not treated as a sale for financial accounting purposes. Accordingly, we removed from the Consolidated Balance Sheet the gross assets and liabilities of the Scrubgrass plant and recorded a deferred gain of \$6,785,035 arising from the original sale of the Scrubgrass plant in 1990. The deferred gain is being amortized over the 22-year minimum lease term given that we have continuing involvement, which commenced on June 30, 1994. Accumulated amortization of the deferred gain was \$2,929,902 and \$2,621,491 at December 31, 2003 and 2002, respectively.

Table of Contents

Major Maintenance: We record the expense of major equipment overhauls as incurred.

Interest Payments: We classify interest payments according to the nature of our contractual obligations. Our base lease payments for interest on the Lessor's debt obligations are reported as lease expense. Our interest payments on our own debt obligations are reported as interest expense. We paid interest on our debt obligations of \$100,785, \$141,526, and \$196,811 during the years ended December 31, 2003, 2002 and 2001, respectively. In 2003, we accrued interest of \$216,160 on the ArcLight loan .

Income Taxes: We account for income taxes in accordance SFAS No. 109, Accounting for Income Taxes . Under SFAS No. 109, deferred tax assets and liabilities are determined based on differences between the financial reporting and tax reporting bases of assets and liabilities and are measured by applying the enacted tax rates and laws to taxable years in which the differences are expected to reverse. We recognize a deferred tax asset for the tax benefit of net operating loss carry forwards when it is more likely than not that the tax benefits will be realized and reduce the deferred tax asset with a valuation reserve when it is more likely than not that some portion of the tax benefits will not be realized.

Earnings Per Common Share: We compute earnings per common share using the treasury stock method in accordance with SFAS No. 128, Earnings per Share . We compute basic earnings per share by dividing net income for the period, less Buzzard's preferred stock dividends, by the weighted average number of shares of common stock outstanding during the period. For purposes of calculating diluted earnings per share, we consider shares issuable in connection with stock options to be dilutive common stock equivalents when the exercise price is less than the average market price of our common stock for the period. We exclude anti-dilutive common stock equivalents from the calculation of diluted earnings per share. The following table outlines the calculation of basic earnings per share and diluted earnings per share for the years ended December 31, 2003, 2002 and 2001.

| | Income | Shares | Per Share |
|---|--------------|---------------|-----------|
| | (Numerator) | (Denominator) | Amounts |
| <u>Year Ended December 31, 2003</u> | | | |
| Loss available to shareholders | \$ (978,159) | 23,631,967 | \$ (0.04) |
| Effect of dividends to preferred stockholders | (5,000) | | |
| Basic EPS | \$ (983,159) | 23,631,967 | \$ (0.04) |
| Assumed exercise of dilutive stock options | | | |
| Diluted EPS | \$ (983,159) | 23,631,967 | \$ (0.04) |
| <u>Year Ended December 31, 2002</u> | | | |
| Income available to shareholders | \$ 1,138,383 | 20,720,614 | \$ 0.05 |
| Effect of dividends to preferred stockholders | (5,000) | | |
| Basic EPS | \$ 1,133,383 | 20,720,614 | \$ 0.05 |
| Assumed exercise of dilutive stock options | | 90,209 | |
| Diluted EPS | \$ 1,133,383 | 20,810,823 | \$ 0.05 |
| <u>Year Ended December 31, 2001</u> | | | |
| Income available to shareholders | \$ 1,679,331 | 14,144,222 | \$ 0.12 |
| Effect of dividends to preferred stockholders | (5,000) | | |
| Basic EPS | \$ 1,674,331 | 14,144,222 | \$ 0.12 |

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

| | | | |
|--|----------------------------------|--------------|--------------------|
| Assumed conversion of preferred stock | | 585,155 | |
| Assumed exercise of dilutive stock options | | 16,318 | |
| | | | |
| Diluted EPS | Income available to shareholders | \$ 1,674,331 | 14,745,695 \$ 0.11 |
| | | | |

As of December 31, 2003 and 2002 respectively, there were outstanding options and warrants to purchase 4,672,962 and 1,116,962 shares of our common stock which were anti-dilutive and not included in the computation of diluted EPS. The options and warrants expire at various dates through 2013.

Stock Options: As permitted by SFAS 123, Accounting for Stock-Based Compensation, we account for employee and director stock compensation plans under Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees. Generally, compensation expense has not been recorded as our options have been issued at an option price equal to the quoted market price on the date of the grant. Compensation expense is recorded for those options issued outside of option plans. During 2003 and 2002, respectively, we recognized \$713,111 and \$49,707 in stock-based compensation expense for stock and options issued outside of its option plans for employees and directors.

Table of Contents

Under the provisions of Accounting Principles Board Opinion (APB) No. 25, we do not recognize compensation expense for stock option awards under the 2001 Plan, 1993 Director Plan and 2002 Director Option Plan since the underlying options have exercise prices equal to 100 percent of the fair market value of the common stock on the date of grant (110 percent of the fair market value in the case officers or other employees holding 10% or more of our common stock for the 2001 Plan). However, pursuant to the provisions of SFAS No. 123, we are required to calculate the fair market value of its stock options using different criteria from the provisions of APB No. 25. Using the fair market value criteria required by SFAS No. 123 to calculate compensation expense, pro forma net income and earnings per share would be as follows:

| | Year Ended | | |
|---|-------------------------|----------------------|----------------------|
| | December 31, 2003 | December 31, 2002 | December 31, 2001 |
| Fair Market Per Share | \$ 0.25 | \$ 0.38 | \$ 0.28 |
| <i>Assumptions</i> | | | |
| Risk-free rate of return | 3.33% | 3.82% | 3.73% |
| Volatility | 113.20% | 74.31% | 88.04% |
| Expected Annual Dividend Yield | 0% | 0% | 0% |
| Option Life (years) | 7 | 10 | 2 |
| Compensation expense under the intrinsic value method | \$ 713,111 | \$ 49,707 | \$ 113,600 |
| Net (Loss) Income available to common shareholders | (983,159) | 1,133,383 | 1,674,331 |
| Additional Compensation Expense under SFAS 123, net of taxes | (60,570) | 51,896 | 3,118 |
| Net Income (Loss) available to common shareholders under SFAS 123 | \$ (1,043,729) | \$ 1,081,487 | \$ 1,671,213 |
| Basic EPS, as reported | \$ (0.04) | \$ 0.05 | \$ 0.12 |
| Basic EPS, under SFAS 123 | \$ (0.04) | \$ 0.05 | \$ 0.12 |
| Diluted EPS, as reported | \$ (0.04) | \$ 0.05 | \$ 0.11 |
| Diluted EPS, under SFAS 123 | \$ (0.04) | \$ 0.05 | \$ 0.11 |

Derivative Instruments and Hedging Activities: On January 1, 2001, we adopted SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, which established accounting and reporting standards for derivative instruments, derivative instruments embedded in other contracts, and hedging activities. SFAS No. 133 requires that entities recognize all derivative instruments as either assets or liabilities in the statement of financial position and measure those instruments at fair value. We do not have any derivative instruments which should be recognized in our financial statements. However, the Lessor has certain interest rate swap arrangements with financial institutions that meet the definition of derivative instruments under SFAS No. 133. Since Buzzard funds the Lessor's debt obligations as a base lease payment, we have disclosed in Note M certain information about the Lessor's derivative instruments.

Recent Accounting Pronouncements:

In June 2001, the FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations, which was effective January 1, 2003. SFAS 143 addresses the financial accounting and reporting for obligations and retirement costs related to the retirement of tangible long-lived assets. The adoption of SFAS 143 did not have a significant impact on our consolidated financial statements.

In June 2002, the Financial Accounting Standards Board issued SFAS No 146 Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 addresses financial accounting and reporting for costs associated with or disposal activities and replaces Emerging Issues Task Force (EITF) Issue No. 94-3. Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

Certain Costs Incurred in a Restructuring). It requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred, rather than at the date of a commitment to an exit or disposal plan. The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002. No exit or disposal activities occurred in 2003.

In December 2002, the FASB issued SFAS No. 148, *Accounting for Stock-Based Compensation, Transition and Disclosure*. SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also requires that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently in a tabular format. Additionally, SFAS No. 148 requires disclosure of the pro forma effect in interim financial statements. The transition and annual disclosure requirements of SFAS No. 148 were effective for the fiscal year ended December 31, 2002. The disclosure provisions of SFAS No. 148 were adopted in 2002.

In November 2002, the FASB issued FASB Interpretation No. 45, *Guarantors' Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45), which requires that, for guarantees within the scope of FIN 45 issued or amended after December 31, 2002, a liability for the fair value of the obligation undertaken in

Table of Contents

issuing the guarantee be recognized. FIN 45 also requires additional disclosures in financial statements for periods ending after December 15, 2002. The recognition and measurement provisions of FIN 45 did not have a material effect on our financial position or operating results.

In January and December 2003, the FASB issued FASB Interpretation No. 46 (FIN 46) and No. 46, revised (FIN 46R), Consolidation of Variable Interest Entities. These statements, which address perceived weaknesses in accounting for entities commonly known as special-purpose or off-balance-sheet, require consolidation of certain interests or arrangements by virtue of holding a controlling financial interest in such entities. Certain provisions of FIN 46R related to interests in special purpose entities were applicable for the period ended December 31, 2003. We must apply FIN 46R to our interests in all entities subject to the interpretation as of the first interim or annual period ending after March 15, 2004. Adoption of this new method of accounting for variable interest entities did not and is not expected to have a material impact on our consolidated results of operations and financial position.

NOTE C ACQUISITION

During 2001, we acquired 100% of the common stock of Microgy in two related transactions. On July 23, 2001, we exchanged our securities for approximately 87.7% of the outstanding common stock of Microgy under a June 20, 2001 agreement with Microgy and certain principal Microgy shareholders. Under the agreement, we agreed to offer the remaining Microgy shareholders the opportunity to exchange their Microgy securities for our securities. On December 28, 2001, we completed the exchange of our securities for the remaining outstanding securities of Microgy. The details of the two exchange transactions are discussed in the following section.

Transaction Details

On July 23, 2001, we issued an aggregate of 5,521,549 shares of common stock and 197,760.7 shares of newly designated Series B Convertible Preferred Stock to certain principal stockholders of Microgy in exchange for 15,919,147 shares of Microgy common stock. Each share of preferred stock, which voted with the common stock on an as-converted basis, was automatically converted into ten shares of common stock as of November 9, 2001 upon an increase in the authorized common stock to an amount sufficient to allow conversion of the preferred stock. The exchange ratio of 0.4711 shares of our common stock for each share of Microgy common stock was determined by negotiations among EPC, Microgy and the primary principal Microgy shareholders. The exchange ratio is based on all of the fully diluted equity of Microgy being exchanged for 45% of fully diluted equity and assumes exercise or conversion of all derivative securities. The exchange ratio may be increased to reflect certain issuances of equity by us to generate funds to be available for financing Microgy. However, holders of approximately 94% of the Microgy common stock agreed to waive their right to adjustments in the exchange ratio, other than any adjustment resulting from 400,000 options and warrants issued in September 2001. One of the principal Microgy shareholders exchanged a warrant to purchase 800,000 shares of Microgy common stock for a warrant to purchase our securities based on the exchange ratio such warrant expired unexercised on September 30, 2002. In connection with our issuance of 400,000 options and warrants in September 2001, we adjusted the exchange ratio to 0.4873 shares of our common stock for each share of Microgy common stock. We then issued 258,884 additional shares of common stock to the principal Microgy shareholders on December 28, 2001 and amended the warrant issued to the principal Microgy shareholder to reflect the adjusted exchange ratio.

On October 17, 2001, we offered the remaining security holders of Microgy, who owned an aggregate of 2,230,126 shares of Microgy common stock, warrants to purchase 885,000 shares of Microgy common stock and options to purchase 290,000 shares of Microgy common stock, an opportunity to exchange their securities of Microgy for our securities based on the adjusted exchange ratio. On December 28, 2001, we issued 1,086,830 shares of our common stock and exchanged warrants to purchase 821,170 shares of our common stock and options to purchase 141,329 shares of our common stock for the remaining Microgy securities. Such warrants expired unexercised on September 30, 2002.

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

Under the terms of a Registration Rights Agreement dated July 23, 2001, we were required to file a resale registration statement for the former Microgy security holders by November 30, 2001. In November 2001, the deadline for filing the registration statement was extended to March 31, 2002. The registration statement was filed on April 4, 2002. It did not go effective.

Purchase Accounting and Valuation

We acquired Microgy to pursue a prospective growth opportunity in the area of environmentally sound power generation. We paid \$7,343,528 for Microgy and accounted for the transaction using the purchase method of accounting as required by SFAS No. 141. The purchase price represents the fair value of the securities issued and the direct costs of the acquisition. The fair value of the common stock was determined using available market information and appropriate valuation methodologies. The fair value of the common stock options and warrants were determined using an option pricing model (See Note L). The following table outlines the components of the purchase price:

F-12

Table of Contents

| Components of Purchase Price | Number Of Units | Fair Value |
|------------------------------|-----------------|--------------|
| Common stock | 8,844,870 | \$ 6,837,084 |
| Common stock options | 141,329 | 11,967 |
| Common stock warrants | 821,170 | 43,730 |
| Acquisition costs | | 450,747 |
| Total purchase price | 9,807,369 | \$ 7,343,528 |

The purchase price was allocated to the assets acquired and liabilities assumed based on their fair values as of July 23, 2001. The fair values of the assets acquired and liabilities assumed are summarized as follows:

| Assets Acquired and Liabilities Assumed | Fair Value |
|---|--------------|
| Cash | \$ 18,306 |
| Other current assets | 4,662 |
| Property plant, and equipment | 29,127 |
| Investment in projects | 100,694 |
| Licensed technology rights | 3,710,000 |
| Goodwill | 4,912,866 |
| Less: Liabilities assumed | (1,432,127) |
| Total Purchase Price | \$ 7,343,528 |

At the time of the acquisition, we believed that Microgy held numerous elements of value which could not be separated from the value of the overall business. These elements of value were assigned to goodwill and included: 1) technology rights for products and processes which currently do not have a commercial application; 2) preliminary business relationships; 3) an established workforce; 4) a proprietary market analysis; and 5) strategic business plans to capitalize on future market opportunities.

On July 23, 2001, we commenced accounting for 100% of Microgy's operations since the minority interest shareholders were no longer at risk for Microgy's losses.

Pro Forma Information

The following summarized unaudited pro forma information assumes the acquisition of Microgy occurred on January 1, 2001. The unaudited pro forma results are not necessarily indicative of the results which might have been obtained had the acquisition occurred as of January 1, 2001, nor are they intended to be indicative of future results of operations. The amounts below do not include any amortization of goodwill or indefinite-lived intangible assets.

| | Year Ended |
|-----------|-------------------|
| Pro Forma | December 31, 2001 |

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

| | | |
|-----------------------------------|----|------------|
| Power generation revenues | \$ | 54,303,222 |
| Net income | | 1,038,323 |
| Basic earnings per common share | \$ | 0.05 |
| Diluted earnings per common share | \$ | 0.05 |

NOTE D OTHER CURRENT ASSETS

Other current assets consist of the following as of December 31, 2003 and 2002:

| <u>Other Current Assets</u> | <u>2003</u> | <u>2002</u> |
|-----------------------------------|-------------------|-------------------|
| Fuel inventory | \$ 485,021 | \$ 776,187 |
| Prepaid expenses | 178,332 | 149,487 |
| Deposits and other current assets | 15,772 | 903 |
| | <u>\$ 679,125</u> | <u>\$ 926,577</u> |

NOTE E PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment is recorded at cost less accumulated depreciation and consists of the following as of December 31, 2003 and 2002:

| <u>Property, Plant and Equipment</u> | <u>2003</u> | <u>2002</u> |
|--------------------------------------|-------------|-------------|
| Power generating facilities: | | |

Table of Contents

| | | |
|--|-------------------|-------------------|
| Machinery and equipment modifications Scrubgrass | \$ 1,163,863 | \$ 1,163,863 |
| Less: Accumulated depreciation | (782,407) | (683,184) |
| Sub-Total | 381,456 | 480,679 |
| Office: | | |
| Equipment and furniture | 125,726 | 117,987 |
| Less: Accumulated depreciation | (71,666) | (46,059) |
| Sub-Total | \$ 54,060 | \$ 71,928 |
| | \$ 435,516 | \$ 552,607 |

During 2003 we had no retirements of property, plant and equipment. In 2002, we retired from service and removed from its balance sheet fully depreciated property, plant and equipment with an original cost of \$15,832. Depreciation expense for the years ended 2003, 2002 and 2001 was \$124,830, \$150,756, and \$167,003, respectively.

NOTE F OTHER ASSETS

Other assets consist of the following as of December 31, 2003 and 2002:

| | 2003 | 2002 |
|---------------------------------------|-------------------|-------------------|
| Other Assets | | |
| Scrubgrass plant deposits | \$ 324,746 | \$ 361,098 |
| Deferred financing costs (See Note B) | 14,850 | 50,490 |
| Security deposits | \$ 48,115 | \$ 11,040 |
| | \$ 387,711 | \$ 422,628 |

Scrubgrass plant deposits represent performance bonds required by state and local governing authorities for excess highway maintenance and reclamation of fuel sites.

NOTE G ACCOUNTS PAYABLE AND ACCRUED EXPENSES

Accounts payable and accrued expenses consist of the following as of December 31, 2003 and 2002:

| | 2003 | 2002 |
|--|--------------|--------------|
| Accounts Payable and Accrued Expenses | | |
| Accounts payable | \$ 6,333,158 | \$ 4,547,993 |
| Accrued expenses | 2,720,236 | 3,113,548 |
| Corporate taxes payable | 389,111 | 887,947 |

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

| | | |
|---------------------------|----------------------|---------------------|
| Accrued benefit liability | 600,485 | 1,100,604 |
| | <u>600,485</u> | <u>1,100,604</u> |
| | \$ 10,042,990 | \$ 9,650,092 |

NOTE H RETIREMENT PLAN

Effective January 1, 1998 we established a non-contributory defined benefit pension plan (the Plan) covering all of its employees who are at least 21 years of age and who have completed at least one year of service. Under the Plan, the benefits payable to each employee at normal retirement age 62 are based on years of service and compensation during the three consecutive years of the latest 10 years immediately preceding retirement which would yield the highest monthly benefit payment. Employees who have at least 20 years of service at the time of their retirement would receive the maximum retirement benefit. Our general funding policy is to contribute annually to the Plan the maximum amount that can be deducted for Federal income tax purposes.

As of January 1, 1998, the commencement date for the Plan, we had a projected benefit obligation of \$871,130. The projected benefit obligation as of January 1, 1998 is being amortized as a prior service cost over 18 years which represents the average future years of service for the participants in the Plan at that date.

As of January 1, 2003 we amended the Plan. Certain employees after 2002 will have an accrued benefit plus the benefit earned under the new formula applied to years of credited service earned after 2002. The normal retirement age is now age 65. The amended plan has a two year waiting period before employees enter the plan, it was previously one year. Employees who join the plan after two years will be fully vested at that time. The benefit is now accrued at 1.5% of the average monthly compensation for each year of credited service, without a cap. This amendment resulted in a gain of \$384,359.

Table of Contents

The following table sets forth the changes during 2003 and 2002 in the projected benefit obligation for the Plan:

| Projected Benefit Obligation | 2003 | 2002 |
|---|--------------|--------------|
| Projected benefit obligation, beginning of the year | \$ 2,083,278 | \$ 1,694,111 |
| Service cost | 153,181 | 220,785 |
| Interest cost | 127,080 | 114,352 |
| Gain due to plan amendment | (384,359) | |
| Actuarial loss | 87,980 | 54,030 |
| | | |
| Projected benefit obligation, end of the year | \$ 2,067,160 | \$ 2,083,278 |

The following table sets forth a reconciliation of the funded status of the Plan to the amounts recognized in the consolidated balance sheets as of December 31, 2003 and 2002:

| Accrued Pension Costs | 2003 | 2002 |
|---------------------------------------|--------------|--------------|
| Projected benefit obligation | \$ 2,067,160 | \$ 2,083,278 |
| Accumulated benefit obligation | 1,987,084 | 1,951,650 |
| Fair market value of Plan assets | (1,386,598) | (851,046) |
| Unfunded projected benefit obligation | 680,562 | 1,232,232 |

The amounts recognized in the consolidated balance sheets as of December 31, 2003 and 2002 consist of:

| Balance Sheet Pension Items | 2003 | 2002 |
|--|--------------|--------------|
| Accrued benefit liability | \$ 600,485 | \$ 1,100,604 |
| Intangible asset unrecognized prior service cost | (241,427) | (641,885) |
| Accumulated other comprehensive income | (537,862) | (507,037) |
| | | |
| Net amount recognized | \$ (178,804) | \$ (48,318) |

The accrued benefit liability and intangible asset are reported in accounts payable and accrued expenses and unrecognized prior pension service cost, respectively on the consolidated balance sheets. Accumulated other comprehensive income is reported, net of tax of \$213,046 and \$194,187, at December 31, 2003 and 2002, respectively, in stockholders' equity on the consolidated balance sheet.

The following table sets forth the changes during 2003 and 2002 in the fair market value of Plan assets:

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

| <u>Plan Asset Changes</u> | <u>2003</u> | <u>2002</u> |
|---|---------------------|-------------------|
| Fair market value of Plan assets, beginning of the period | \$ 851,046 | \$ 599,577 |
| Contributions by us to the Plan | 373,134 | 382,890 |
| Benefits paid | (43,403) | |
| Return on Plan assets, net of expenses | 205,821 | (131,421) |
| | <u> </u> | <u> </u> |
| Fair market value of Plan assets, end of the period | <u>\$ 1,386,598</u> | <u>\$ 851,046</u> |

Our net periodic pension cost for 2003 and 2002 are comprised of the following components:

| <u>Net Periodic Pension Cost</u> | <u>2003</u> | <u>2002</u> |
|------------------------------------|-------------------|-------------------|
| Service cost | \$ 153,181 | \$ 220,785 |
| Interest cost | 127,080 | 114,352 |
| Expected return on assets | (74,203) | (47,966) |
| Amortization of actuarial loss | 16,099 | 19,653 |
| Amortization of prior service cost | 20,492 | 45,849 |
| | <u> </u> | <u> </u> |
| Net periodic pension cost | <u>\$ 242,649</u> | <u>\$ 352,673</u> |

The actuarial assumptions used in 2003 and 2002 to determine the pension benefits for the Plan were:

| <u>Actuarial Assumptions</u> | <u>2003</u> | <u>2002</u> |
|--|-------------|-------------|
| Weighted average discount rate | 5.75% | 6.10% |
| Expected long-term return on Plan assets | 8.00% | 8.00% |
| Weighted average rate of increase in compensation levels | 5.00% | 5.00% |

The expected long-term return on plan assets is based upon the long run performance of the S&P 500, which serves as the benchmark for the asset allocation style.

Table of Contents

Our pension plan weighted average asset allocations at December 31, 2003 and 2002, by asset category, are as follows:

| Asset Allocation | 2003 | 2002 |
|-------------------------|------|------|
| Equity securities | 64% | 95% |
| Fixed Income securities | 27% | 0% |
| Cash | 9% | 5% |
| Total | 100% | 100% |

Our investment strategy has been to emphasize growth over time but also provide current income. Our investments are allocated to Large-Cap Growth stocks, Large-Cap Value stocks, Mid-Cap Value stocks, International stocks, and Fixed Income and cash. The long run asset allocation target is benchmarked to a Style Index, represented by 100% S&P 500 with Dividends.

We expect to contribute \$403,651 to the plan in 2004.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid:

| 2004 | 2005 | 2006 | 2007 | 2008 | Thereafter |
|------|---------|---------|---------|---------|------------|
| \$ | 220,000 | 218,073 | 215,890 | 213,455 | 3,657,701 |

NOTE I OTHER CURRENT LIABILITIES

Other current liabilities consist of the following as of December 31, 2003 and 2002:

| Other Current Liabilities | 2003 | 2002 |
|--|---------------------|-------------------|
| Scrubgrass plant working capital loan | \$ 2,433,261 | \$ 517,112 |
| Scrubgrass plant note payable-current portion (See Note J) | 389,535 | 447,902 |
| TOTAL | \$ 2,822,796 | \$ 965,014 |

The Scrubgrass plant working capital loan represents outstanding borrowings due to the Lessor under a Lessee Working Capital Loan Agreement. Under the terms of this agreement, which expires in December 2008, Buzzard may borrow up to \$4 million for the ongoing working capital requirements of the Scrubgrass plant. Buzzard paid interest on the outstanding borrowings under this agreement at LIBOR plus 1.25% during 2003 and 2002 (2.41% as of December 31, 2003 and ranged from 2.35% to 2.69% during 2003 and 2.63% to 3.12% during 2002).

NOTE J SECURED PROMISSORY NOTES PAYABLE AND OTHER BORROWINGS

Secured promissory notes payable and other borrowings as of December 31, 2003 and 2002 consist of:

| Secured Promissory Notes Payable and Other Borrowings | 2003 | 2002 |
|--|---------------------|-------------------|
| Scrubgrass plant note payable (See Note I) | \$ | \$ 389,535 |
| Sunnyside plant obligations (See Note A) | 583,030 | 583,030 |
| ArcLight Note Payable, net of debt discount and accrued interest | 3,700,000 | |
| Accrued interest expense, added to principal balance | 216,160 | |
| TOTAL | \$ 4,499,190 | \$ 972,565 |

The Scrubgrass plant note payable represents an installment obligation that was incurred as part of the Lessor's debt restructuring in December 1995, when Buzzard extended the term of certain current liabilities through 2004. Buzzard paid interest on the outstanding borrowings under the Scrubgrass plant note payable at LIBOR plus 1.25% (2.42% as of December 31, 2003 and ranging from 2.17% to 2.98% during 2003 and 2.63% to 3.12% during 2002). The scheduled aggregate annual repayment for the Scrubgrass plant note payable is \$389,535 in 2004.

The ArcLight Loan In September 2003, we secured a \$3,700,000 loan from ArcLight. The principal note carries an interest rate of 20%. Any unpaid interest that has accrued on the 15th of each month shall be capitalized and added to the balance of the note.

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

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

Table of Contents

In relation to the ArcLight loan, we granted participation rights to share in 50% of the distributions from Buzzard after the \$3,700,000 loan and any accrued interest is repaid and after we receive an additional \$1,400,000 in distributions. This right terminates on December 31, 2012.

We are required to use all of the distributions from Buzzard to repay this loan and are only required to make payments when we receive distributions. However, we are required to make at least one payment in a 24 month period. We are also required to provide ArcLight with financial statements. We are prohibited from incurring additional debt at EPC Corporation, our wholly-owned subsidiary. We are in full compliance with our covenants.

NOTE K INCOME TAXES

Income tax expense consists of the following for the years ended December 31, 2003, 2002 and 2001:

| ANALYSIS INCOME TAX (BENEFIT) EXPENSE | 2003 | 2002 | 2001 |
|--|---------------------|-------------------|---------------------|
| Current | | | |
| Federal | \$ (320,211) | \$ 511,380 | \$ 788,843 |
| State | 187,905 | 248,627 | 480,186 |
| Total current tax (benefit) expense | \$ (132,306) | \$ 760,007 | \$ 1,269,029 |
| Deferred | | | |
| Federal | \$ 127,553 | \$ 135,910 | \$ 90,530 |
| State | (21,172) | (38,642) | 13,895 |
| Total deferred tax expense | 106,381 | 97,268 | 104,425 |
| TOTAL INCOME TAX (BENEFIT) EXPENSE | \$ (25,925) | \$ 857,274 | \$ 1,373,454 |

Income taxes paid during the years ended December 31, 2003, 2002 and 2001 amounted to \$656,930, \$1,172,127, and \$855,363, respectively.

The reconciliation between the actual income tax expense and the income tax expense computed by applying the statutory federal income tax rate to the income before income taxes for the years ended December 31, 2003, 2002 and 2001 is as follows:

| RECONCILIATION OF TAX (BENEFIT) EXPENSE | 2003 | 2002 | 2001 |
|---|--------------|-------------|--------------|
| Federal tax (benefit) expense at 34% | \$ (384,368) | \$ 678,523 | \$ 1,037,947 |
| State tax expense, net of federal tax benefit | 110,044 | 89,364 | 320,249 |
| State tax valuation allowance, net of federal tax benefit | | 85,827 | 8,856 |
| Federal valuation allowance | 236,241 | | |
| Permanent differences | 12,158 | 3,560 | 5,141 |
| Other | | | 1,261 |

| | | | |
|---|--------------------|-------------------|---------------------|
| TOTAL INCOME TAX (BENEFIT) EXPENSE | \$ (25,925) | \$ 857,274 | \$ 1,373,454 |
|---|--------------------|-------------------|---------------------|

The components of the net deferred income tax (asset) liability as of December 31, 2003 and 2002 are as follows:

| ANALYSIS OF DEFERRED TAX (ASSET) LIABILITY | 2003 | 2002 |
|--|----------------------|----------------------|
| Deferred tax assets | | |
| Accrued lease expense | \$ 30,572,808 | \$ 28,493,722 |
| Deferred tax effect of the sale of the Scrubgrass plant for which the net gain was deferred for financial reporting purposes | 770,562 | 832,238 |
| Capital loss carry forwards | | 99,025 |
| Stocks and warrants | 156,577 | 75,838 |
| Other comprehensive income | 213,047 | 205,199 |
| Pre-acquisition net operating loss carry forward of Microgy | 497,285 | 497,285 |
| Federal NOL & AMT Credits | 429,205 | |
| State net operating loss carry forwards | 20,570 | 94,681 |
| Total deferred tax assets | \$ 32,660,054 | \$ 30,297,990 |
| Deferred tax liabilities | | |
| Accrued power generation revenue | \$ 30,572,808 | \$ 28,493,722 |
| Defined benefit pension plan contribution | 234,574 | 175,163 |
| Licensed technology rights | 1,206,832 | 1,275,712 |
| Other | | 204,339 |
| Total deferred tax liabilities | \$ 32,014,214 | \$ 30,148,936 |
| Less: valuation allowances | (645,840) | (227,123) |
| DEFERRED INCOME TAX LIABILITY, net | \$ 0 | \$ 78,071 |

Table of Contents

As of December 31, 2003, we have Federal and state net operating loss carry forwards of \$2,276,342 and \$1,666,094, respectively, which are available to reduce future taxable income. These net operating loss carry forwards relate to the acquisition of Microgy and expire at various dates through 2020 as well as the Federal net operating loss generated in the current year. Due to the change of ownership provisions in Section 382 of the Internal Revenue Code, our utilization of Microgy's pre-acquisition net operating loss carry forwards is limited to \$367,911 per year.

As of December 31, 2003, we had a \$645,840 valuation reserve for the tax benefit of net operating loss carry forwards which may not be realized in the future. We expect that future taxable income would be sufficient to realize the tax benefits of the remaining net operating loss carry forwards.

NOTE L SHAREHOLDERS' EQUITY

Stock Options

In November 2001, our Board of Directors and stockholders approved the 2001 Stock Incentive Plan (the 2001 Plan), which provides for the award of up to 3,000,000 shares of common stock to eligible employees, consultants and directors of EPC. Our awards under the 2001 Plan may consist of incentive stock options, nonqualified stock options, restricted stock, stock appreciation rights and other stock awards. The 2001 Plan provides that stock options and similar awards may be issued with exercise periods of up to 10 years and minimum option prices equal to 100 percent of the fair market value of the common stock on the date of grant (110 percent of the fair market value in the case of individuals holding 10% or more of our common stock). During 2003, we granted options for 1,515,000 shares under the 2001 Plan. As of December 31, 2003, there were 888,038 shares available for grant under the 2001 Plan.

We have reserved 405,000 shares of common stock for issuance upon exercise of stock options which are outstanding or may be granted under our 1993 Director Plan. The options granted under the 1993 Director Plan were principally intended to constitute non-qualified options with an option price of 100 percent of the fair market value of the common stock on the date of the grant. The options vest at the date of grant and expire 10 years from the date of grant. We granted 155,000 shares in 2002 and 20,000 shares in 2001. As of December 31, 2002, the 1993 Director Plan has been terminated and replaced by the 2002 Director Plan.

In July 2002, our Board of Directors and stockholders approved the 2002 Director Option Plan (the 2002 Plan), which provides for the award of up to 2,000,000 shares of common stock to eligible directors of the company. The options granted under the 2002 Plan were principally intended to constitute non-qualified options with an option price of 100 percent of the fair market value of the common stock on the date of the grant. The options vest at the date of grant and expire 10 years from the date of grant. We granted options for 450,000 shares under the 2002 Director Plan during 2003. As of December 31, 2003, there were 1,450,000 shares available for grant under the 2002 Director Plan.

During 2003, we granted options for 5,000,000 shares of common stock to related parties outside of stock plans. During 2002, we granted options for 120,000 shares of common stock to related parties outside of stock plans. These stock options and warrants are discussed in Note O.

Stock option transactions during 2003, 2002 and 2001 are summarized as follows:

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

| <u>Description</u> | <u>Shares</u> | <u>Exercise Price Range</u> | |
|-------------------------------------|------------------|-----------------------------|-------------|
| Balance at January 1, 2001 | 60,000 | 0.50 | 1.69 |
| Options Granted | 1,456,866 | 0.43 | 3.08 |
| <u>Options Expired or Exercised</u> | (845,537) | | |
| Balance at December 31, 2001 | 671,329 | 0.43 | 3.08 |
| Options Granted | 1,090,633 | 0.20 | 0.65 |
| <u>Options Expired or Exercised</u> | | | |
| Balance at December 31, 2002 | 1,761,962 | 0.20 | 3.08 |
| Options Granted | 6,965,000 | 0.17 | 1.75 |
| <u>Options Expired or Exercised</u> | (415,000) | | |
| Balance at December 31, 2003 | 8,311,962 | 0.17 | 3.08 |

F-18

Table of Contents

The following table summarizes information about our options outstanding as of December 31, 2003:

| SUMMARY OF OPTIONS | | Outstanding | | | Exercisable | |
|--------------------|--------|------------------|----------------|-------------|------------------|-------------|
| | | Shares | Remaining Life | Price | Shares | Price |
| \$ 0 | \$0.42 | 2,830,000 | 7.23 | 0.26 | 307,500 | 0.33 |
| \$0.43 | \$0.63 | 1,069,000 | 6.71 | 0.49 | 744,000 | 0.47 |
| \$0.64 | \$0.83 | 563,000 | 3.89 | 0.71 | 563,000 | 0.71 |
| \$0.83 | \$3.08 | 3,849,962 | 6.29 | 1.29 | 917,962 | 1.39 |
| TOTAL | | 8,311,962 | 6.50 | 0.80 | 2,532,462 | 0.84 |

Dividends

Since December 2000, our Board of Directors has not declared dividends on its common stock. Due to the acquisition of Microgy and anticipated expansion of its business, our Board of Directors has concluded that available cash flows should be redirected to operating and investing activities for the foreseeable future.

Buzzard paid dividends of \$5,000 per year to a preferred stockholder during 2003, 2002 and 2001. The preferred stockholder is entitled to cumulative dividends of \$5,000 per year and has a liquidation preference to receive \$500 per share, plus any cumulative unpaid dividends, prior to the distribution of any remaining assets to common shareholders. There were no dividends in arrears to the preferred stockholder as of December 31, 2003.

Other Equity Transactions

We have outstanding notes receivable from officers and directors for shares purchased in connection with the 1990 Stock Plan and 1993 Director Plan which amounted to \$645,948 as of December 31, 2003 and 2002. The notes, which are classified as a reduction of shareholders' equity, are payable upon demand and bear interest at a floating rate which is payable monthly. The notes are also secured by the shares purchased by the officers and directors.

NOTE M COMMITMENTS**Corporate**

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

We are obligated under various non-cancelable operating leases for office space and automotive vehicles. As of December 31, 2003, the future minimum payments due under these leases are as follows:

| <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>Thereafter</u> | <u>Total</u> |
|-------------|-------------|-------------|-------------|-------------|-------------------|--------------|
| \$110,518 | 97,671 | 93,716 | 13,411 | 0 | 0 | \$315,316 |

Rent expense for these operating leases was \$107,180, \$94,758 and \$46,800 in 2003, 2002 and 2001, respectively.

We are obligated to make at least one payment in any 24-month period to satisfy the terms of the ArcLight loan, described above. All distributions from Buzzard will be used to repay these obligations. The future minimum principal repayments are:

| <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>Thereafter</u> | <u>Total</u> |
|-------------|-------------|-------------|-------------|-------------|-------------------|--------------|
| \$1 | 1 | 1 | 1 | 1 | 3,699,995 | \$3,700,000 |

Scrubgrass Plant

We are obligated under a facility lease related to the Scrubgrass plant. As of December 31, 2003, the estimated minimum lease payments over the remaining 14.5 year base term of the Scrubgrass lease are as follows:

| <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>Thereafter</u> | <u>Total</u> |
|--------------|-------------|-------------|-------------|-------------|-------------------|----------------|
| \$19,703,000 | 21,715,000 | 26,058,000 | 28,910,000 | 31,762,000 | 249,240,000 | \$ 345,626,000 |

Our Scrubgrass plant lease expense was \$22,382,152, \$25,291,293, and \$24,705,813 in 2003, 2002 and 2001, respectively. As discussed in Note A, in addition to scheduled base rent and additional rent payments, the Scrubgrass plant lease expense includes principal, interest and related fees on the Lessor's debt obligations. Since a portion of the Lessor's debt obligations have variable interest rates, we have estimated its future minimum lease payments using average interest rates of 3.12% for the tax-exempt bonds and 7.795% for the variable rate term loan.

As discussed in Notes A and B, the Lessor has an interest rate swap arrangement for one of its term debt obligations which is considered a derivative instrument.

Table of Contents

We have also been assigned various long-term non-cancelable obligations under contractual agreements for fuel handling and excavation, limestone supply, and waste disposal. The contractual terms are generally for 5 to 15 years and provide for renewal options. The estimated future minimum payments due under these non-cancelable obligations at December 31, 2003 are as follows (See Note A):

| <u>2004</u> | <u>2005</u> | <u>2006</u> | <u>2007</u> | <u>2008</u> | <u>Thereafter</u> | <u>Total</u> |
|-------------|-------------|-------------|-------------|-------------|-------------------|---------------|
| \$2,433,000 | 2,513,000 | 2,599,000 | 2,687,000 | 2,385,000 | 8,687,000 | \$ 21,304,000 |

NOTE N DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

Our financial instruments primarily consist of cash and cash equivalents, restricted cash, receivable from utility, accounts payable, Lessee working capital loan, short-term debt obligations and long-term debt obligations. As of December 31, 2003 and 2002, the carrying amounts for cash and cash equivalents, restricted cash, receivable from utility, accounts payable, Lessee working capital loan and short-term debt obligations approximate fair value because of the short maturity of these instruments. As of December 31, 2003 and 2002, the carrying amounts for the long-term debt obligations also approximate fair value because 93% of such obligations or \$139,287,000 incur interest at variable rates or quoted bond rates. The remainder of our long-term debt obligations of \$6,268,163 and \$3,700,000 mature in 2005 and 2012, respectively, and bear interest rates of 7.6725% and 20%, respectively.

NOTE O RELATED PARTY TRANSACTIONS

In September 2001, we paid \$150,000 to George Kast, previously a Principal Microgy Shareholder, a principal shareholder of EPC and Director, in full satisfaction of a pre-acquisition Microgy obligation.

On September 14, 2001, we borrowed \$750,000 from Alco Financial Services, LLC (Alco). Robert Weisberg, a Director of Environmental Power, Corp. is the President, Director and a member of Alco. The loan was evidenced by a one-year promissory note that bears interest at the prime rate plus 3.5%. We also pay an administrative fee of 0.6% per month and paid a commitment fee of \$7,500 to secure the loan. In connection with the loan, we granted Alco five year warrants to purchase 50,000 shares of common stock at \$0.60 per share. During 2003, we recognized interest expense and administrative fees of \$75,252 for this loan. The loan was fully discharged in September 2003 using proceeds from the ArcLight loan.

In May 2001, we granted Mr. Weisberg five-year options to purchase 100,000 shares of common stock at \$0.43 per share. In September 2001, we granted Mr. Weisberg five-year options to purchase 350,000 shares of common stock at \$0.72 per share. The options were issued in exchange for Mr. Weisberg's services performed for EPC. We reported the fair value of the securities granted to Mr. Weisberg as stock-based compensation in our general and administrative expenses for 2001. The fair value of the securities granted to Alco, along with the commitment fee and related legal expenses were reported as deferred financing costs and were amortized over the initial term of the loan.

On May 2, 2002, Benjamin Brant, a former director of EPC and a former officer of our Microgy subsidiary, granted to EPC a transferable one-year option to purchase 1,802,486 shares of his Common Stock at \$0.35 per share. EPC is required to exercise the option to purchase at least 342,857 of such shares by specified times. To the extent any portion of the option expires unexercised, Mr. Brant would grant EPC a transferable right of first refusal for the underlying shares for a 12 month period beginning upon expiration of the option. Mr. Brant also agreed to deliver an

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

additional 197,514 shares of his Common Stock to EPC in satisfaction of an obligation in the amount of \$69,129 to Microgy by a company of which Mr. Brant is a principal. Mr. Brant had previously guaranteed this obligation to Microgy under a June 2001 agreement. Mr. Brant also agreed to a 24 month standstill whereby an additional 753,066 shares of his Common Stock would not be sold into the public markets.

On May 3, 2002, EPC exercised the option to purchase 120,000 shares of Mr. Brant's Common Stock by a cash payment of \$42,000. On May 3, 2002, Mr. Brant also delivered 197,514 shares of his Common Stock to EPC in full satisfaction of the obligation to Microgy described in the previous paragraph. On May 17, 2002, EPC exercised the option to purchase 20,260 shares of Mr. Brant's Common Stock by a cash payment of \$7,091. As of March 5, 2003 EPC had exercised the option to purchase 100% of the required 342,857 shares. The shares acquired by the Company from Mr. Brant are being held as treasury shares, reducing the outstanding Common Stock.

On May 22, 2002, EPC granted Madison Power a ten-year option to purchase 100,000 shares of common stock at \$.58 per share. Edward Chapman, a Senior Vice President of EPC, is an owner of Madison Power. The options were issued in exchange for Mr. Chapman's services prior to joining EPC as an employee. We recorded a \$49,707 expense related to these options.

Table of Contents

On June 12, 2003 we granted August Schumacher 50,000 options to purchase shares of common stock in lieu of cash compensation for services rendered as a Director of the company. No compensation expense was recorded since the fair value of the options was below the exercise price.

On June 23, 2003, we granted 100,000 shares of stock to Jeffrey Dasovich, an employee of the company, in lieu of cash compensation for services rendered between June 23, 2003 and September 1, 2003. We recorded a compensation expense of based on the closing share price of \$0.29 on that day or a total of \$29,000 for these options.

On July 3, 2003, we granted 5,000,000 options to purchase shares of common stock to Kamlesh Tejwani, President and Chief Executive Officer, as part of his compensation package. 2,500,000 vest on April 3, 2004 at an exercise price of \$0.25 per option. 1,250,000 vest on January 3, 2005 at an exercise price of \$1.00 per option. The remaining options vest on January 3, 2006 at an exercise price of \$1.50 per option. No compensation expense was recorded since the fair value of the options was below the exercise price.

On July 29, 2003, we granted 625,000 shares of stock (over a five-month period) and 900,000 options to purchase shares of common stock to Steven Wildstein for consulting services rendered. The options vest over a six-month period at exercise prices ranging from \$0.50 to \$1.50 per option. These shares and options resulted in 2003 compensation expense of \$559,073. Additional compensation expense will be recorded in 2004.

On July 29, 2003 and September 9, 2003, we granted Richard Steubi, 50,000 and 40,000 shares of stock, respectively, for services rendered. Mr. Steubi is President of Next Wave Energy, a consulting firm focused on renewable and alternative energy. These options were recorded as a \$66,200 expense.

On August 8, 2003 we issued 15,839 shares of stock each to August Schumacher, Robert Weisberg, Jessie Knight Jr., and Peter Blampied, respectively. These shares were issued in lieu of cash compensation for services rendered as Directors of the company. The aggregate compensation expense recorded was \$27,243 based upon the closing share price of \$0.43 on the day of issue.

On October 29, 2003 we issued 30,100 shares of stock to various employees of the company as part of their incentive compensation. We recorded a \$31,595 compensation expense for these shares of stock.

NOTE P SEGMENT INFORMATION

We manage and evaluate its operations in two reportable business segments: Scrubgrass plant and Microgy. These segments have been classified separately by the chief operating decision maker because of the different technologies used in the generation of energy and the future growth prospects of those technologies. Our reportable business segments, which are described in Note A, follow the same significant accounting policies discussed in Note B. Financial data for reportable business segments is as follows:

| SEGMENT INFORMATION (UNAUDITED) | Scrubgrass Plant | Microgy | All Other Segments | Consolidated |
|---------------------------------|---------------------|---------|-----------------------|--------------|
|---------------------------------|---------------------|---------|-----------------------|--------------|

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

| Year Ended December 31, 2003 | | | | |
|-------------------------------------|------------|-------------|-------------|-------------|
| Power generation revenues | 53,364,615 | | | 53,364,615 |
| Pre-tax income (loss) | 1,854,433 | (1,718,108) | (1,140,409) | (1,004,084) |
| Identifiable Assets | 93,205,799 | 8,634,334 | 1,314,235 | 103,154,368 |
| Year Ended December 31, 2002 | | | | |
| Power generation revenues | 54,983,934 | | | 54,983,934 |
| Pre-tax income (loss) | 2,046,172 | (2,586,146) | 2,535,631 | 1,995,657 |
| Identifiable Assets | 83,106,156 | 8,415,600 | 1,436,143 | 92,957,899 |
| Year Ended December 31, 2001 | | | | |
| Power generation revenues | 53,518,000 | | | 53,518,000 |
| Pre-tax income (loss) | 3,027,625 | (492,008) | 517,168 | 3,052,785 |
| Identifiable Assets | 76,358,553 | 8,668,675 | 539,018 | 85,566,246 |

There were no transactions between reportable business segments. Excluding reportable business segments, we had income from the settlement of the Sunnyside Project litigation, general corporate assets and operating activities for its corporate office. General corporate assets primarily consist of cash and equivalents, office equipment, prepaid expenses and a deferred income tax asset. Since the Sunnyside Project is no longer an operating business, this income was not included in a reportable business segment and therefore is included in Other in the table above.

Table of Contents**NOTE Q SELECTED UNAUDITED QUARTERLY FINANCIAL RESULTS**

The following tables set forth certain unaudited quarterly data of the Company for each of the quarters since January 2002. This information has been prepared on the same basis as the annual financial statements and all necessary adjustments, consisting only of normal recurring adjustments, have been included in the amounts stated below to present fairly the selected quarterly information when read in conjunction with the annual financial statements and the notes thereto included elsewhere in this document. The quarterly operating results are not necessarily indicative of future results of operations. See Factors That May Affect Future Results and Financial Condition Historical Net Losses; Variability of Quarterly Results.

| | Quarters Ended | | | |
|----------------------------------|----------------|----------------|--------------------|-------------------|
| | March 31, 2003 | June 30, 2003 | September 30, 2003 | December 31, 2003 |
| POWER GENERATION REVENUES | \$ 14,535,334 | \$ 12,553,759 | \$ 11,923,173 | \$ 14,352,349 |
| OPERATING (LOSS) INCOME | \$ 2,336,502 | \$ (1,559,834) | \$ (1,197,130) | \$ (573,050) |
| NET (LOSS) INCOME | \$ 1,149,468 | \$ (801,958) | \$ (748,392) | \$ (577,277) |
| EARNINGS (LOSS) PER COMMON SHARE | | | | |
| Basic | \$ 0.05 | \$ (0.04) | \$ (0.03) | \$ (0.02) |
| Diluted | \$ 0.05 | \$ (0.04) | \$ (0.03) | \$ (0.02) |

| | Quarters Ended | | | |
|-----------------------------------|-------------------|----------------|-----------------------|----------------------|
| | March 31, 2002 | June 30, 2002 | September 30, 2002 | December 31, 2002 |
| POWER GENERATION REVENUES | \$ 14,113,256 | \$ 11,977,205 | \$ 14,683,232 | \$ 14,210,241 |
| OPERATING INCOME (LOSS) | \$ 691,293 | \$ (2,897,634) | \$ 1,875,891 | \$ (316,731) |
| NET INCOME (LOSS) | \$ 1,766,650 | \$ (1,742,507) | \$ 875,839 | \$ 238,401 |
| EARNINGS (LOSS) PER COMMON SHARE: | | | | |
| Basic | \$ 0.09 | \$ (0.09) | \$ 0.04 | \$ 0.01 |
| Diluted | \$ 0.09 | \$ (0.09) | \$ 0.04 | \$ 0.01 |

Table of Contents**Exhibit Index**

| <u>Exhibit No.</u> | <u>Description</u> | <u>Reference</u> |
|---------------------------|---|-------------------------|
| 2.01 | Agreement and Plan of Merger dated as of June 2, 2003, among Environmental Power Corporation, EPC Holdings 1, Inc. and EPC Merger Sub, Inc. | A |
| 3.01 | Restated Certificate of Incorporation of the Registrant | A |
| 3.02 | Restated Bylaws of the Registrant | A |
| 4.01 | 2001 Stock Incentive Plan | B |
| 4.02 | Amended and Restated 2002 Director Stock Option Plan | C |
| 4.03 | 2003 Incentive Compensation Plan | C |
| 4.04 | 1993 Director Option Plan | W |
| 4.05 | Option Agreement dated as of May 2, 2001 between the Company and Robert I. Weisberg | B |
| 4.06 | Option Agreement dated as of September 14, 2001 between the Company and Robert I. Weisberg | B |
| 4.07 | Warrant to purchase 50,000 shares of common stock issued to Alco Financial Services, LLC | K |
| 4.08 | Amended and Restated Non-Statutory Stock Option Agreement, dated as of March 29, 2003, between the Company and Kamlesh Tejwani | Y |
| 10.01 | Note Purchase Agreement, dated September 4, 2003, between EPC Corporation and Crystal Creek Coalpower Funding LLC | D |
| 10.02 | 20.0% Senior Secured Note due December 31, 2012 in the original principal amount of \$3.7 million, made by EPC Corporation in favor of Crystal Creek Coalpower Funding LLC | D |
| 10.03 | Form of 20.0% Senior Secured Note due December 31, 2012 in the original principal amount of \$1.7 million, to be made by EPC Corporation in favor of Crystal Creek Coalpower Funding LLC | D |
| 10.04 | Securities Deposit Agreement, dated September 4, 2003, among EPC Corporation, Crystal Creek Coalpower Funding LLC and the Security Deposit Agent and Securities Intermediary named therein. | D |
| 10.05 | Pledge Agreement, dated September 4, 2003, between the Company and Crystal Creek Coalpower Funding LLC | D |
| 10.06 | Management Agreement, dated September 4, 2003, between the Company and EPC Corporation | D |
| 10.07 | Tax Sharing Agreement, dated September 4, 2003, between the Company and EPC Corporation | D |
| 10.08 | Employment Agreement, dated as of July 3, 2003, between the Company and Kamlesh Tejwani | E |
| 10.09 | Letter Agreement, dated as of March 29, 2004, between the Company and Kamlesh Tejwani | Y |

Table of Contents

| Exhibit No. | Description | Reference |
|--------------------|---|------------------|
| 10.10 | Services Agreement dated September 13, 2001 between the Company and PG&E Energy M Trading Power, L.P. pertaining to the sale and purchase of Nitrogen Oxide Ozone Transport Region (NOx) Budget Allowances completed in 2002. | Q |
| 10.11 | Purchase and Sale Agreements, dated as of December 16, 1998, January 4, 2000 and January 8, 2000, between PG&E Energy Trading Power, L.P. and Buzzard Power Corporation pertaining to Nitrogen Oxide Ozone Transport Region (NOx) Budget Allowances. | F |
| 10.12 | Agreement for the Sale of Electric Energy from the Scrubgrass Generating Plant by and between Pennsylvania Electric Company and Scrubgrass Power Corporation dated August 7, 1987 which was assigned by Scrubgrass Power Corporation to Scrubgrass Generating Company, L.P. on December 15, 1990 and assigned by Scrubgrass Generating Company, L.P. to Buzzard Power Corporation on June 17, 1994. | F |
| 10.13 | Supplemental Agreement for the Sale of Electric Energy from the Scrubgrass Generating Plant by and between Pennsylvania Electric Company and Scrubgrass Power Corporation dated February 22, 1989, as amended by letter agreement dated March 28, 1989, which was assigned by Scrubgrass Power Corporation to Scrubgrass Generating Company, L.P. on December 15, 1990 and assigned by Scrubgrass Generating Company, L.P. to Buzzard Power Corporation on June 17, 1994. | F |
| 10.14 | Second Supplemental Agreement for the Sale of Electric Energy from the Scrubgrass Generating Plant by and between Pennsylvania Electric Company and Scrubgrass Power Corporation dated September 27, 1989 which was assigned by Scrubgrass Power Corporation to Scrubgrass Generating Company, L.P. on December 15, 1990 and assigned by Scrubgrass Generating Company, L.P. to Buzzard Power Corporation on June 17, 1994. | F |
| 10.15 | Third Supplemental Agreement for the Sale of Electric Energy from the Scrubgrass Generating Plant by and between Pennsylvania Electric Company and Scrubgrass Power Corporation dated August 13, 1990 which was assigned by Scrubgrass Power Corporation to Scrubgrass Generating Company, L.P. on December 15, 1990 and assigned by Scrubgrass Generating Company, L.P. to Buzzard Power Corporation on June 17, 1994. | F |
| 10.16 | Amendment to the Third Supplemental Agreement for the Sale of Electric Energy from the Scrubgrass Generating Plant by and between Pennsylvania Electric Company and Scrubgrass Power Corporation dated November 27, 1990 which was assigned by Scrubgrass Power Corporation to Scrubgrass Generating Company, L.P. on December 15, 1990 and assigned by Scrubgrass Generating Company, L.P. to Buzzard Power Corporation on June 17, 1994. | F |
| 10.17 | Letter Agreement dated December 20, 1990 amending the Agreement for the Sale of Electric Energy from the Scrubgrass Generating Plant by and between Pennsylvania Electric Company and Scrubgrass Power Corporation dated August 7, 1987, as amended and supplemented from time to time through November 27, 1990, which was assigned by Scrubgrass Power Corporation to Scrubgrass Generating Company, L.P. on December 15, 1990 and assigned by Scrubgrass Generating Company, L.P. to Buzzard Power Corporation on June 17, 1994. | F |

Table of Contents

| Exhibit No. | Description | Reference |
|--------------------|--|------------------|
| 10.18 | Management Services Agreement by and between Scrubgrass Generating Company, L.P. and PG&E-Bechtel Generating Company dated December 15, 1990 which was assigned by Scrubgrass Generating Company, L.P. to Buzzard Power Corporation on June 17, 1994. PG&E-Bechtel Generating Company has assigned its rights to this agreement ultimately to U.S. Gen. (now PG&E National Energy Group). | F |
| 10.19 | Agreement for Operation and Maintenance of the Scrubgrass Cogeneration Plant between Scrubgrass Generating Company, L.P. and Bechtel Power Corporation dated December 21, 1990 which was assigned by Scrubgrass Generating Company, L.P. to Buzzard Power Corporation on June 17, 1994. Bechtel Power Corporation has assigned its rights to this agreement ultimately to U.S. Operating Services Company (now PG&E Operating Services Company). | F |
| 10.20 | First Amendment to the Agreement for Operation and Maintenance of the Scrubgrass Cogeneration Plant between Buzzard Power Corporation and, ultimately, U.S. Operating Services Company (now PG&E Operating Services Company) dated December 22, 1995. | F |
| 10.21 | Stock Pledge Agreement, dated December 19, 1991, between Environmental Power Corporation and Scrubgrass Generating Company, L.P. | H |
| 10.22 | Amended and Restated Participation Agreement, dated as of December 22, 1995, among Buzzard Power Corporation, Scrubgrass Generating Company, L.P., Environmental Power Corporation, Bankers Trust Company and Credit Lyonnais. | K |
| 10.23 | Appendix I to the Amended and Restated Participation Agreement, dated as of December 22, 1995, among Buzzard Power Corporation, Scrubgrass Generating Company, L.P., Environmental Power Corporation, Bankers Trust Company and Credit Lyonnais, which Appendix defines terms used and not otherwise defined in other contracts. | K |
| 10.24 | Amendment No. 1, dated as of May 22, 1997, to the Amended and Restated Participation Agreement, dated as of December 22, 1995, among Buzzard Power Corporation, Scrubgrass Generating Company, L.P., Environmental Power Corporation, Bankers Trust Company and Credit Lyonnais. | G |
| 10.25 | Amendment No. 2, dated as of September 2, 1998, to the Amended and Restated Participation Agreement, dated as of December 22, 1995, among Buzzard Power Corporation, Scrubgrass Generating Company, L.P., Environmental Power Corporation, Bankers Trust Company and Credit Lyonnais. | I |
| 10.26 | Amended and Restated Lease Agreement between Scrubgrass Generating Company, L.P., a Delaware limited partnership, as Lessor, and Buzzard Power Corporation, a Delaware corporation, as Lessee, dated as of December 22, 1995. | F |
| 10.27 | Amendment No. 1, dated as of June 1, 1996, but not executed until July 24, 1998, to the Amended and Restated Lease Agreement between Scrubgrass Generating Company, L.P., a Delaware limited partnership, as Lessor, and Buzzard Power Corporation, a Delaware corporation, as Lessee, dated as of December 22, 1995. | I |

Table of Contents

| <u>Exhibit No.</u> | <u>Description</u> | <u>Reference</u> |
|--------------------|---|------------------|
| 10.28 | Amended and Restated Disbursement and Security Agreement between Scrubgrass Generating Company, L.P., as Lessor, Buzzard Power Corporation, as Lessee, Bankers Trust Company as Disbursement Agent and Credit Lyonnais acting through its New York Branch as Agent, dated as of December 22, 1995. | F |
| 10.29 | Amendment No. 1, dated as of May 22, 1997, to the Amended and Restated Disbursement and Security Agreement between Scrubgrass Generating Company, L.P., as Lessor, Buzzard Power Corporation, as Lessee, Bankers Trust Company as Disbursement Agent and Credit Lyonnais acting through its New York Branch as Agent, dated as of December 22, 1995. | G |
| 10.30 | Amendment No. 1, updated as of October 9, 1998, to the Amended and Restated Disbursement and Security Agreement between Scrubgrass Generating Company, L.P., as Lessor, Buzzard Power Corporation, as Lessee, Bankers Trust Company as Disbursement Agent and Credit Lyonnais acting through its New York Branch as Agent, dated as of December 22, 1995. | I |
| 10.31 | Amended and Restated Lessee Working Capital Loan Agreement between Scrubgrass Generating Company, L.P., as Lender, and Buzzard Power Corporation, as Lessee, dated as of December 22, 1995. | F |
| 10.32 | Settlement Agreement, dated August 3, 2000 and effective February 27, 2001, among Buzzard Power Corporation, Scrubgrass Generating Company L.P. and Pennsylvania Electric Company. | J |
| 10.33 | Technology Licensing Agreement dated May 12, 2000 between Microgy and Danish Biogas Technology, A.S. (portions of this exhibit have been omitted and filed separately with the Securities and Exchange Commission pursuant to a request for confidential treatment). | O |
| 10.34* | Addendum, dated April 14, 2003, to Technology Licensing Agreement dated May 12, 2000, between Microgy and Danish Biogas Technology, A.S. | Y |
| 10.35 | Wisconsin Public Service Corporation Amended and Restated Agreement for Power Purchase with Microgy Cogeneration System, Inc., dated March 18, 2003. | X |
| 10.36 | Environmental Power Corporation Retirement Plan, as restated, effective as of January 1, 1998 and dated as of December 23, 1998. | Q |
| 10.37 | Trust Agreement for Environmental Power Corporation Retirement Plan, as amended and restated, effective as of January 1, 1998 and dated as of December 23, 1998. | Q |
| 10.38 | Indemnification Agreement dated February 12, 2002 between the Company and Joseph Cresci, Donald Livingston, William Linehan, and their successors. | Q |
| 10.39 | First Amendment, dated July 11, 2002, to the Environmental Power Corporation Retirement Plan (the Plan). | X |
| 10.40 | EGTRAA Amendment, dated December 19, 2002 and effective January 1, 2002, to the Environmental Power Corporation Retirement Plan (the Plan). | X |
| 10.41 | Environmental Power Corporation Medical Expense Reimbursement Plan effective as of September 1, 1998 and dated as of December 18, 1998. | I |
| 10.42 | Office Building Lease Agreement dated December 21, 2001 between the Company and Merkle, Soupcoff, & Fiorentino, Inc. | J |

Table of Contents

| Exhibit No. | Description | Reference |
|--------------------|---|------------------|
| 10.43 | Promissory Note dated July 30, 1993 by Joseph E. Cresci in favor of Environmental Power Corporation in the original amount of \$161,000. | X |
| 10.44 | Promissory Note dated July 30, 1993 by Donald A. Livingston in favor of Environmental Power Corporation in the original amount of \$161,000 | X |
| 10.45 | Promissory Note dated December 15, 1995 by Donald A. Livingston in favor of Environmental Power Corporation in the original amount of \$267,280.50. | X |
| 10.46 | Promissory Note dated September 9, 1997 by Robert I. Weisberg in favor of Environmental Power Corporation in the original amount of \$48,575.00. | X |
| 10.47 | Promissory Note dated April 12, 2001 by Joseph E. Cresci in favor of Environmental Power Corporation in the original amount of \$100,000.00. | X |
| 10.48 | Promissory Note dated April 12, 2001 by Donald A. Livingston in favor of Environmental Power Corporation in the original amount of \$100,000.00. | X |
| 21.01 | Subsidiaries of the Registrant | Y |
| 23.01 | Consent of Deloitte & Touche LLP | Z |
| 23.02 | Updated Consent of Deloitte & Touche LLP | Z |
| 31.01 | Section 302 Certificate of Chief Executive Officer | Z |
| 31.02 | Section 302 Certificate of Chief Financial Officer | Z |
| 32.01 | Certificate of Chief Executive Officer pursuant to 18 U.S.C. § 1350 | Z |
| 32.02 | Certificate of Chief Financial Officer pursuant to 18 U.S.C. § 1350 | Z |

- A Previously filed as an exhibit to our Current Report on Form 8-K/A dated June 2, 2003, as filed on June 10, 2003 (Commission File No. 0-15472).
- B Previously filed as an exhibit to our Registration Statement on Form S-8 filed August 22, 2002 (Commission File No.333-98559).
- C Previously filed as an appendix to the definitive Schedule 14A relating to the Proxy Statement for our 2003 Annual Meeting of Stockholders (Commission File No. 0-15472).
- D Previously filed as an exhibit to our Current Report on Form 8-K dated September 4, 2003, as filed on September 10, 2003 (Commission File No. 0-15472).
- E Previously filed as an exhibit to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2003.
- F Previously filed as an exhibit to our Report on Form 10-K for the year ended December 31, 1996 (Commission File No. 0-15472).
- G Previously filed as an exhibit to our Report on Form 10-Q for the quarter ended June 30, 1997 (Commission File No. 0-15472).
- H Previously filed as an exhibit to our Report on Form 10-K for the year ended December 31, 1997 (Commission File No. 0-15472).
- I Previously filed as an exhibit to our Report on Form 10-K for the year ended December 31, 1998 (Commission File No. 0-15472).

Edgar Filing: ENVIRONMENTAL POWER CORP - Form 10-K/A

- J Previously filed as an exhibit to our Report on Form 10-K for the year ended December 31, 1999 (Commission File No. 0-15472).
- K Previously filed as an exhibit to our Report on Form 10-K for the year ended December 31, 2000 (Commission File No. 0-15472).
- L Previously filed as an exhibit to Amendment No. 7 to Schedule 13D filed by Joseph E. Cresci on August 2, 2001

Table of Contents

- M Previously filed as an exhibit to Schedule 13D filed by Daniel J. Eastman on August 2, 2001
- N Previously filed as an exhibit to our Report on Form 8-K dated as of August 7, 2001 (Commission File No. 0-15472).
- O Previously filed as an exhibit to our Report on Form 10-Q for the quarter ended September 30, 2001 (Commission File No. 0-15472).
- P Previously filed as an exhibit to our Registration Statement on Form S-8 filed August 22, 2002 (Commission File No. 33-98559).
- Q Previously filed as an exhibit to our Report on Form 10-K for the year ended December 31, 2001 (commission File No. 0-15472).
- R Previously filed as an exhibit to our Current Report on Form 8-K/A dated June 2, 2003, as filed on June 10, 2003 (Commission File No. 0-15472).
- S Previously filed as an exhibit to our Registration Statement on Form S-8 filed August 22, 2002 (Commission File No.333-98559).
- T Previously filed as an appendix to the definitive Schedule 14A relating to the Proxy Statement for our 2003 Annual Meeting of Stockholders (Commission File No. 0-15472).
- U Previously filed as an appendix to the definitive Schedule 14A relating to the Proxy Statement for our 2003 Annual Meeting of Stockholders (Commission File No. 0-15472).
- V Previously filed as an exhibit to our Current Report on Form 8-K dated September 4, 2003, as filed on September 10, 2003 (Commission File No. 0-15472).
- W Previously filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 1993 (Commission File No. 0-15472)
- X Previously filed as an exhibit to our Annual Report on Form 10-K for the year ended December 31, 2002 (Commission File No. 0-15472)
- Y Previously filed as an exhibit to the Annual Report on Form 10-K to which this Amendment relates.
- Z Filed herewith
- * Confidential treatment requested.

(b) Reports on Form 8-K

On December 22, 2003, the Registrant disclosed pursuant to Regulation FD a press release announcing that Environmental Power Corporation (POWR) had executed an agreement for construction and sale of the first digester project based upon Microgy technology.