
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

- QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2015
- OR
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from _____ to _____

Commission File Number: 001-34112

Energy Recovery, Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation)

01-0616867
(IRS Employer Identification No.)

1717 Doolittle Drive, San Leandro, CA
(Address of Principal Executive Offices)

94577
(Zip Code)

(510) 483-7370
(Registrant's Telephone Number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

(Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2).

Yes No

As of November 2, 2015, there were 54,838,283 shares of the registrant's common stock outstanding.

ENERGY RECOVERY, INC.

QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED SEPTEMBER 30, 2015

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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited)

ENERGY RECOVERY, INC.
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (in thousands, except share data and par value)
 (unaudited)

| | September 30, 2015 | December 31, 2014 |
|---|-----------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 21,498 | \$ 15,501 |
| Restricted cash | 1,385 | 2,623 |
| Short-term investments | 1,344 | 13,072 |
| Accounts receivable, net of allowance for doubtful accounts of \$164 and \$155 at September 30, 2015 and December 31, 2014, respectively | 8,060 | 10,941 |
| Unbilled receivables, current | 828 | 1,343 |
| Inventories | 8,893 | 8,204 |
| Income taxes receivable | 5 | — |
| Deferred tax assets, net | 240 | 240 |
| Prepaid expenses and other current assets | 1,506 | 1,317 |
| Total current assets | 43,759 | 53,241 |
| Restricted cash, non-current | 2,232 | 2,850 |
| Unbilled receivables, non-current | 420 | 414 |
| Long-term investments | — | 267 |
| Property and equipment, net of accumulated depreciation of \$17,556 and \$15,143 at September 30, 2015 and December 31, 2014, respectively | 11,346 | 13,211 |
| Goodwill | 12,790 | 12,790 |
| Other intangible assets, net | 2,690 | 3,166 |
| Other assets, non-current | 2 | 2 |
| Total assets | <u>\$ 73,239</u> | <u>\$ 85,941</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,683 | \$ 1,817 |
| Accrued expenses and other current liabilities | 4,835 | 8,427 |
| Income taxes payable | — | 4 |
| Accrued warranty reserve | 600 | 755 |
| Deferred revenue | 948 | 519 |
| Current portion of long-term debt | 11 | — |
| Total current liabilities | 8,077 | 11,522 |
| Long-term debt, net of current portion | 39 | — |
| Deferred tax liabilities, non-current, net | 2,160 | 1,989 |
| Deferred revenue, non-current | 79 | 59 |
| Other non-current liabilities | 764 | 2,453 |
| Total liabilities | 11,119 | 16,023 |
| Commitments and Contingencies (Note 9) | | |
| Stockholders' equity: | | |
| Preferred stock, \$0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding | — | — |
| Common stock, \$0.001 par value; 200,000,000 shares authorized; 54,736,742 shares issued and 52,257,286 shares outstanding at September 30, 2015, and 54,398,421 shares issued and 51,918,965 shares outstanding at December 31, 2014 | 55 | 54 |
| Additional paid-in capital | 128,566 | 124,440 |
| Accumulated other comprehensive loss | (48) | (73) |
| Treasury stock, at cost 2,479,456 shares repurchased at both September 30, 2015 and December 31, 2014 | (6,835) | (6,835) |
| Accumulated deficit | (59,618) | (47,668) |
| Total stockholders' equity | 62,120 | 69,918 |
| Total liabilities and stockholders' equity | <u>\$ 73,239</u> | <u>\$ 85,941</u> |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

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

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|------------|-------------------|-------------|
| | September 30, | | September 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Net revenue | \$ 12,112 | \$ 5,342 | \$ 28,460 | \$ 15,646 |
| Cost of revenue | 4,948 | 3,007 | 12,315 | 7,991 |
| Gross profit | 7,164 | 2,335 | 16,145 | 7,655 |
| Operating expenses: | | | | |
| General and administrative | 3,590 | 3,078 | 15,230 | 8,112 |
| Sales and marketing | 2,195 | 2,351 | 6,622 | 7,548 |
| Research and development | 1,474 | 2,131 | 5,417 | 5,089 |
| Amortization of intangible assets | 159 | 216 | 476 | 646 |
| Total operating expenses | 7,418 | 7,776 | 27,745 | 21,395 |
| Loss from operations | (254) | (5,441) | (11,600) | (13,740) |
| Interest expense | — | — | (40) | — |
| Other non-operating (expense) income | (48) | (2) | (130) | 127 |
| Loss before income taxes | (302) | (5,443) | (11,770) | (13,613) |
| Provision for income taxes | 38 | 63 | 180 | 187 |
| Net loss | \$ (340) | \$ (5,506) | \$ (11,950) | \$ (13,800) |
| Basic and diluted net loss per share | \$ (0.01) | \$ (0.11) | \$ (0.23) | \$ (0.27) |
| Shares used in basic and diluted per share calculation | 52,237 | 51,861 | 52,071 | 51,626 |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
(in thousands)
(unaudited)

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|-------------------|--------------------------|--------------------|
| | September 30, | | September 30, | |
| | 2015 | 2014 | 2015 | 2014 |
| Net loss | \$ (340) | \$ (5,506) | \$ (11,950) | \$ (13,800) |
| Other comprehensive (loss) income, net of tax: | | | | |
| Foreign currency translation adjustments | (4) | 22 | 21 | 68 |
| Unrealized gain (loss) on investments | 3 | (6) | 4 | 12 |
| Other comprehensive (loss) income | (1) | 16 | 25 | 80 |
| Comprehensive loss | <u>\$ (341)</u> | <u>\$ (5,490)</u> | <u>\$ (11,925)</u> | <u>\$ (13,720)</u> |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

| | Nine Months Ended September 30 | |
|---|-----------------------------------|------------------|
| | 2015 | 2014 |
| Cash Flows From Operating Activities | | |
| Net loss | \$ (11,950) | \$ (13,800) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Share-based compensation | 3,549 | 1,628 |
| Depreciation and amortization | 2,897 | 3,025 |
| Deferred income taxes | 172 | 169 |
| Amortization of premiums/discounts on investments | 154 | 348 |
| Provision for warranty claims | 91 | 87 |
| Provision for doubtful accounts | 88 | 293 |
| Loss on fair value remeasurement of put options | 55 | — |
| Loss on foreign currency transactions | 54 | (10) |
| Other non-cash adjustments | 11 | (179) |
| Valuation adjustments for excess or obsolete inventory | (126) | 212 |
| Reversal of accruals related to expired warranties | (213) | — |
| Gain on fair value remeasurement of contingent consideration | — | (149) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 2,810 | 10,935 |
| Unbilled receivables | 509 | 5,698 |
| Deferred revenue | 449 | 203 |
| Income taxes payable | (10) | (7) |
| Accounts payable | (134) | 64 |
| Prepaid and other assets | (242) | (1,045) |
| Inventories | (563) | (5,484) |
| Litigation settlement | (1,700) | — |
| Accrued expenses and other liabilities | (3,602) | (2,256) |
| Net cash used in operating activities | (7,701) | (268) |
| Cash Flows From Investing Activities | | |
| Maturities of marketable securities | 11,845 | 4,355 |
| Restricted cash | 1,856 | 3,338 |
| Purchase of marketable securities | — | (273) |
| Capital expenditures | (557) | (2,301) |
| Net cash provided by investing activities | 13,144 | 5,119 |
| Cash Flows From Financing Activities | | |
| Net proceeds from issuance of common stock | 558 | 1,165 |
| Proceeds from borrowings | 55 | — |
| Repayment of long-term debt | (5) | — |
| Payment of contingent consideration | — | (1,375) |
| Repurchase of common stock for treasury | — | (1,633) |
| Net cash provided by (used in) financing activities | 608 | (1,843) |
| Effect of exchange rate differences on cash and cash equivalents | (54) | 44 |
| Net change in cash and cash equivalents | 5,997 | 3,052 |
| Cash and cash equivalents, beginning of period | 15,501 | 14,371 |
| Cash and cash equivalents, end of period | \$ 21,498 | \$ 17,423 |

See Accompanying Notes to Unaudited Condensed Consolidated Financial Statements

ENERGY RECOVERY, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 1 — The Company and Summary of Significant Accounting Policies

The Company

Energy Recovery, Inc. (the “Company”, “Energy Recovery”, “we”, “our”, or “us”) is an energy solutions provider. We convert wasted pressure energy into a reusable asset and preserve or eliminate pumping technology in hostile processing environments. Our core competencies are fluid dynamics and advanced material science. Our products are marketed and sold in fluid flow markets, such as water and oil & gas, under the trademarks ERI[®], PX[®], Pressure Exchanger[®], PX Pressure Exchanger[®], IsoBoost[®], IsoGen[®], and VorTeq[™]. Our products are developed and manufactured in whole or in part, in the United States of America (“U.S.”) at our headquarters in San Leandro, California as well as other locations internationally. We have five wholly-owned subsidiaries: ERI Energy Recovery Holdings Ireland Limited, ERI Energy Recovery Ireland Ltd., Energy Recovery Iberia, S.L., Energy Recovery Canada Corp., and Energy Recovery (Cayman) Ltd. We also have sales offices in Dubai, United Arab Emirates and Shanghai, Peoples Republic of China.

Use of Estimates

The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles (“U.S. GAAP”) requires our management to make judgments, assumptions, and estimates that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Our more significant estimates and judgments that we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition; allowance for doubtful accounts; allowance for product warranty; valuation of stock options; valuation and impairment of goodwill, long-lived assets, and acquired intangible assets; useful lives for depreciation and amortization; valuation adjustments for excess and obsolete inventory; and deferred taxes and valuation allowances on deferred tax assets. Actual results could differ materially from those estimates.

Basis of Presentation

The condensed consolidated financial statements include the accounts of Energy Recovery, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

The accompanying condensed consolidated financial statements have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to such rules and regulations. The December 31, 2014 Condensed Consolidated Balance Sheet was derived from audited financial statements, and may not include all disclosures required by U.S. GAAP; however, we believe that the disclosures are adequate to make the information presented not misleading. These unaudited condensed consolidated financial statements should be read in conjunction with the audited Consolidated Financial Statements and the notes thereto for the fiscal year ended December 31, 2014 included in our Annual Report on Form 10-K filed with the SEC on March 6, 2015.

In the opinion of management, all adjustments, consisting of only normal recurring adjustments that are necessary to present fairly the financial position, results of operations, and cash flows for the interim periods, have been made. The results of operations for the interim periods are not necessarily indicative of the operating results for the full fiscal year or any future periods.

Reclassification

During the fourth quarter of 2014, we changed the classification of the payment of contingent consideration of \$1.4 million made during the third quarter of 2014 from operating to financing in the Consolidated Statements of Cash Flows at December 31, 2014. This change is reflected in the Condensed Consolidated Cash Flows in this filing on Form 10-Q for the nine months ended September 30, 2014. The \$1.4 million impact of the change was not considered material to the Condensed Consolidated Statement of Cash Flows for the nine months ended September 30, 2014.

Change in Accounting Principle for Goodwill Impairment Testing

Prior to July 1, 2015, we evaluated our goodwill for impairment at the reporting unit level annually during the fourth quarter or when indicators for potential impairment were present. At that time we operated under a single reporting unit.

Subsequent to July 1, 2015, we adopted a new organizational and reporting structure based on the operating segments, Water and Oil & Gas. We have reassessed our reporting units and the impairment analysis of goodwill and long-lived assets, and performed our analysis based on the new structure. During the third quarter of 2015, we changed the measurement date of our annual goodwill impairment test from the fourth quarter to July 1. This change was not material to our consolidated financial statements as it did not result in the delay, acceleration, or avoidance of an impairment charge. We believe this timing better aligns the goodwill impairment test with our strategic business planning process, which is a key component of the goodwill impairment test. We have completed the required annual testing of goodwill for impairment for all reporting units as of July 1, 2015 and have determined that goodwill is no impaired.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09, *Revenue from Contracts with Customers*. The amendment requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. ASU 2014-09 will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period.

On July 9, 2015, the FASB voted to approve a one-year deferral of the effective date of ASU 2014-09. Based on the FASB’s decision, ASU 2014-09 will apply to us for annual reporting periods beginning after December 15, 2017, including interim reporting periods within annual reporting periods beginning after December 15, 2017. Additionally, the FASB decided to permit early adoption, but not before the original effective date (that is, annual periods beginning after December 15, 2016). The FASB issued ASU 2015-14 in August 2015, formally deferring the effective date of ASU 2014-09 by one year. We expect to adopt this guidance as of January 1, 2018. ASU 2014-09 permits the use of either the retrospective or cumulative effect transition method. We are currently evaluating the effect that ASU 2014-09 will have on our financial statements and related disclosures. We have not yet selected a transition method nor have we determined the effect of the standard on our ongoing financial reporting.

In January 2015, the FASB issued ASU 2015-01, *Income Statement – Extraordinary and Unusual Items*. ASU 2015-01 eliminates from GAAP the concept of extraordinary items. As a result, an entity will no longer be required to separately present an extraordinary item on its statement of operations, net of tax, after income from continuing operations, or disclose income taxes and net income per share data applicable to an extraordinary item. However, ASU 2015-01 will still retain the presentation and disclosure guidance for items that are unusual in nature and occur infrequently. ASU 2015-01 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted provided the guidance is applied from the beginning of the fiscal year of adoption. We do not expect the adoption of this standard to have a material impact on our financial statements, absent any material transactions in future periods that would qualify for extraordinary item presentation under the prior guidance.

In April 2015, the FASB issued ASU 2015-03, *Interest – Imputation of Interest*. ASU 2015-03 require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this update. For public entities, ASU 2015-03 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. We do not expect the adoption of this standard to have a material impact on our financial statements.

Also in April 2015, the FASB issued ASU 2015-05, *Intangibles – Goodwill and Other- Internal-Use Software*. ASU 2015-05 provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. ASU 2015-05 does not change GAAP for customer’s accounting for service contracts. For public entities, ASU 2015-05 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. We do not expect the adoption of this standard to have a material impact on our financial statements.

In July 2015, the FASB issued ASU 2015-11, *Inventory – Simplifying the Measurement of Inventory*. ASU 2015-11 does not apply only to inventory that is measured using last-in, first-out (“LIFO”) or to the retail inventory method. ASU 2015-11 applies to all other inventory, which includes inventory that is measured using first-in, first-out (“FIFO”) or average cost. ASU 2015-11 provides that inventory be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. For public entities, ASU 2015-11 is effective for fiscal years beginning after December 15, 2016 and interim periods within those fiscal years. Early application is permitted as of the beginning of an interim or annual reporting period. We do not expect the adoption of this standard to have a material impact on our financial statements.

Note 2 — Goodwill and Other Intangible Assets

Goodwill as of September 30, 2015 and December 31, 2014 of \$12.8 million was the result of our acquisition of Pump Engineering, LLC in December 2009. During the three and nine months ended September 30, 2015, there were no changes in the recognized amount of goodwill, and there has been no impairment of goodwill to date.

The components of identifiable other intangible assets, all of which are finite-lived, as of the dates indicated were as follows (in thousands):

| | September 30, 2015 | | | |
|------------------------|--------------------------------------|-------------------------------------|--|------------------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Accumulated Impairment Losses | Net Carrying Amount |
| Developed technology | \$ 6,100 | \$ (3,558) | \$ — | \$ 2,542 |
| Non-compete agreements | 1,310 | (1,310) | — | — |
| Backlog | 1,300 | (1,300) | — | — |
| Trademarks | 1,200 | (180) | (1,020) | — |
| Customer relationships | 990 | (990) | — | — |
| Patents | 585 | (395) | (42) | 148 |
| Total | \$ 11,485 | \$ (7,733) | \$ (1,062) | \$ 2,690 |

| | December 31, 2014 | | | |
|------------------------|--------------------------------------|-------------------------------------|--|------------------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Accumulated Impairment Losses | Net Carrying Amount |
| Developed technology | \$ 6,100 | \$ (3,101) | \$ — | \$ 2,999 |
| Non-compete agreements | 1,310 | (1,310) | — | — |
| Backlog | 1,300 | (1,300) | — | — |
| Trademarks | 1,200 | (180) | (1,020) | — |
| Customer relationships | 990 | (990) | — | — |
| Patents | 585 | (376) | (42) | 167 |
| Total | \$ 11,485 | \$ (7,257) | \$ (1,062) | \$ 3,166 |

Accumulated impairment losses at September 30, 2015 and December 31, 2014, include a \$1.0 million impairment loss from 2012 for trademarks, a \$31,000 loss for patents from 2007, and an \$11,000 loss for patents from 2010. During the three and nine months ended September 30, 2015, there has been no impairment of our long-lived assets.

Note 3 — Loss per Share

Basic and diluted net loss per share is based on the weighted average number of common shares outstanding during the period. Potential dilutive securities are excluded from the calculation of loss per share, as their inclusion would be anti-dilutive.

The following table shows the computation of basic and diluted loss per share (in thousands, except per share data):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|-------------|--|-------------|
| | 2015 | 2014 | 2015 | 2014 |
| Numerator: | | | | |
| Net loss | \$ (340) | \$ (5,506) | \$ (11,950) | \$ (13,800) |
| Denominator: | | | | |
| Basic and diluted weighted average common shares outstanding | 52,237 | 51,861 | 52,071 | 51,626 |
| Basic and diluted net loss per share | \$ (0.01) | \$ (0.11) | \$ (0.23) | \$ (0.27) |

The following potential common shares were not considered in the computation of diluted loss per share because their effect would have been anti-dilutive (in thousands):

| | Three and Nine Months Ended | |
|---------------|------------------------------------|-------------|
| | September 30, | |
| | 2015 | 2014 |
| Stock options | 7,550 | 6,481 |
| Warrants | — | 200 |

Note 4 — Other Financial Information

Restricted Cash

We have pledged cash in connection with stand-by letters of credit. We have deposited a corresponding amount into a non-interest bearing account at one financial institution for these items as follows (in thousands):

| | September 30, | December 31, |
|---|----------------------|---------------------|
| | 2015 | 2014 |
| Collateral for stand-by letters of credit | \$ 1,385 | \$ 2,623 |
| Current restricted cash | \$ 1,385 | \$ 2,623 |
| Collateral for stand-by letters of credit | \$ 2,232 | \$ 2,850 |
| Non-current restricted cash | \$ 2,232 | \$ 2,850 |
| Total restricted cash | <u>\$ 3,617</u> | <u>\$ 5,473</u> |

Inventories

Our inventories are stated at the lower of cost (using the first-in, first out “FIFO” method) or market and consisted of the following (in thousands):

| | September 30, | December 31, |
|-----------------|----------------------|---------------------|
| | 2015 | 2014 |
| Raw materials | \$ 2,423 | \$ 2,903 |
| Work in process | 2,051 | 1,915 |
| Finished goods | 4,419 | 3,386 |
| Inventories | <u>\$ 8,893</u> | <u>\$ 8,204</u> |

Prepaid and Other Current Assets

Prepaid expenses and other current assets consisted of the following (in thousands):

| | September 30, | December 31, |
|---|----------------------|---------------------|
| | 2015 | 2014 |
| Interest receivable | \$ 12 | \$ 112 |
| Foreign currency put options | 36 | — |
| Property taxes | 156 | 58 |
| Supplier advances | 213 | 107 |
| Insurance | 384 | 154 |
| Other prepaid expenses and current assets | 705 | 886 |
| Total prepaid and other current assets | <u>\$ 1,506</u> | <u>\$ 1,317</u> |

Accrued Expenses and Other Current Liabilities

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

| | September 30, 2015 | December 31, 2014 |
|--|-----------------------|----------------------|
| Accrued legal expenses | \$ 160 | \$ 1,734 |
| Payroll and commissions payable | 3,037 | 3,116 |
| Other accrued expenses and current liabilities | 1,638 | 3,577 |
| Accrued expenses and other current liabilities | <u>\$ 4,835</u> | <u>\$ 8,427</u> |

Other Non-Current Liabilities

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

| | September 30, 2015 | December 31, 2014 |
|-------------------------------------|-----------------------|----------------------|
| Deferred rent expense, non-current | \$ 760 | \$ 866 |
| Accrued legal expenses, non-current | — | 1,587 |
| Other non-current liabilities | 4 | — |
| Other non-current liabilities | <u>\$ 764</u> | <u>\$ 2,453</u> |

Accumulated Other Comprehensive Loss

Changes in accumulated other comprehensive loss by component for the nine months ended September 30, 2015 were as follows (in thousands):

| | Foreign Currency Translation Adjustments Net of Tax Benefit | Unrealized Gains (Losses) on Investments | Total Accumulated Other Comprehensive Loss |
|--------------------------------|---|---|---|
| Balance, December 31, 2014 | \$ (67) | \$ (6) | \$ (73) |
| Net other comprehensive income | 21 | 4 | 25 |
| Balance, September 30, 2015 | <u>\$ (46)</u> | <u>\$ (2)</u> | <u>\$ (48)</u> |

There were no reclassifications of amounts out of accumulated other comprehensive loss during the quarter. The tax impact of the changes in accumulated other comprehensive loss were not material.

Note 5 — Investments

Our short-term and long-term investments are all classified as available-for-sale. There were no sales of available-for-sale securities during the three and nine months ended September 30, 2015.

Available-for-sale securities as of the dates indicated consisted of the following (in thousands):

| | September 30, 2015 | | | |
|------------------------------|--------------------|-----------------------------------|------------------------------------|-----------------|
| | Amortized Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Fair Value |
| Short-term investments: | | | | |
| Corporate notes and bonds | \$ 1,346 | \$ — | \$ (2) | \$ 1,344 |
| Total short-term investments | <u>\$ 1,346</u> | <u>\$ —</u> | <u>\$ (2)</u> | <u>\$ 1,344</u> |
| Total investments | <u>\$ 1,346</u> | <u>\$ —</u> | <u>\$ (2)</u> | <u>\$ 1,344</u> |

| | December 31, 2014 | | | |
|--|-------------------|--------------------------------|---------------------------------|------------|
| | Amortized Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Fair Value |
| Short-term investments | | | | |
| State and local government obligations | \$ 225 | \$ — | \$ — | \$ 225 |
| Corporate notes and bonds | 12,851 | 4 | (8) | 12,847 |
| Total short-term investments | \$ 13,076 | \$ 4 | \$ (8) | \$ 13,072 |
| Long-term investments | | | | |
| Corporate notes and bonds | 268 | — | (1) | 267 |
| Total long-term investments | \$ 268 | \$ — | \$ (1) | \$ 267 |
| Total investments | \$ 13,344 | \$ 4 | \$ (9) | \$ 13,339 |

Gross unrealized losses and fair values of our investments in an unrealized loss position as of the dates indicated, aggregated by investment category and length of time that the security has been in a continuous loss position, were as follows (in thousands):

| | September 30, 2015 | | | | | |
|---------------------------|---------------------|-------------------------|----------------------|-------------------------|------------|-------------------------|
| | Less than 12 months | | 12 months or greater | | Total | |
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Corporate notes and bonds | \$ 583 | \$ (1) | \$ 761 | \$ (1) | \$ 1,344 | \$ (2) |
| Total | \$ 583 | \$ (1) | \$ 761 | \$ (1) | \$ 1,344 | \$ (2) |

| | December 31, 2014 | | | | | |
|---------------------------|---------------------|-------------------------|----------------------|-------------------------|------------|-------------------------|
| | Less than 12 months | | 12 months or greater | | Total | |
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Corporate notes and bonds | \$ 5,085 | \$ (6) | \$ 1,205 | \$ (3) | \$ 6,290 | \$ (9) |
| Total | \$ 5,085 | \$ (6) | \$ 1,205 | \$ (3) | \$ 6,290 | \$ (9) |

Expected maturities can differ from contractual maturities because borrowers may have the right to prepay obligations without prepayment penalties. The amortized cost and fair value of available-for-sale securities that had stated maturities as of September 30, 2015 are shown below by contractual maturity (in thousands):

| | September 30, 2015 | |
|--|--------------------|------------|
| | Amortized Cost | Fair Value |
| Due after one year through three years | \$ 1,346 | \$ 1,344 |
| Total available-for-sale securities | \$ 1,346 | \$ 1,344 |

Note 6 — Long-Term Debt and Lines of Credit

Debt

In March 2015, we entered into a loan agreement with a financial institution for a \$55,000 fixed-rate installment loan with an annual interest rate of 6.35%. The loan is payable in equal monthly installments and matures on April 2, 2020. The note is secured by the asset purchased.

Long-term debt consisted of the following (in thousands)

| | September 30, 2015 | December 31, 2014 |
|-----------------------|--------------------|-------------------|
| Loan payable | \$ 50 | \$ — |
| Less: current portion | (11) | — |
| Total long-term debt | \$ 39 | \$ — |

Future minimum principal payments due under long-term debt arrangements consist of the following (in thousands):

| | September 30, 2015 |
|-------------------------------|-------------------------------|
| 2015 (remaining three months) | \$ 2 |
| 2016 | 11 |
| 2017 | 11 |
| 2018 | 11 |
| 2019 | 11 |
| Thereafter | 4 |
| Total debt | \$ 50 |

Lines of Credit

In June 2012, we entered into a loan agreement (the “2012 Agreement”) with a financial institution. The 2012 Agreement matured in June 2015 and was amended in June 2015. The 2012 Agreement, as amended, provides for a total available credit line of \$16.0 million. Under the 2012 Agreement, we are allowed to draw advances not to exceed, at any time, \$10.0 million as revolving loans. The total stand-by letters of credit issued under the 2012 Agreement may not exceed the lesser of the \$16.0 million credit line or the credit line minus all outstanding revolving loans. At no time may the aggregate of the revolving loans and stand-by letters of credit exceed the total available credit line of \$16.0 million. Revolving loans may be in the form of a base rate loan that bears interest equal to the prime rate plus 0% or a Eurodollar loan that bears interest equal to the adjusted LIBOR rate plus 1.25%. Stand-by letters of credit are subject to customary fees and expenses for issuance or renewal. The unused portion of the credit facility is subject to a facility fee in an amount equal to 0.25% per annum of the average unused portion of the revolving line. The 2012 Agreement, as amended, also requires us to maintain a cash collateral balance equal to 101% of all outstanding advances and all outstanding stand-by letters of credit collateralized by the line of credit. The 2012 Agreement, as amended, matures in June 2018 and is collateralized by substantially all of our assets. As of September 30, 2015 and December 31, 2014, there were no advances drawn under the 2012 Agreement, as amended. Remaining stand-by letters of credit collateralized under the 2012 Agreement, as amended, totaled \$3.6 million and \$3.1 million as of September 30, 2015 and December 31, 2014, respectively. Total cash restricted related to these stand-by letters of credit totaled \$3.6 million and \$3.1 million as of September 30, 2015 and December 31, 2014, respectively.

We are subject to certain financial and administrative covenants under the 2012 Agreement, as amended. As of September 30, 2015, we were in compliance with these covenants.

In 2009, we entered into a loan and security agreement (the “2009 Agreement”) with another financial institution. The 2009 Agreement, as amended, provided a total available credit line of \$16.0 million. Under the 2009 Agreement, we were allowed to draw advances of up to \$10.0 million on a revolving line of credit or utilize up to \$15.9 million as collateral for stand-by letters of credit, provided that the aggregate of the outstanding advances and collateral did not exceed the total available credit line of \$16.0 million. Advances under the revolving line of credit incurred interest based on a prime rate index or LIBOR plus 1.375%. The 2009 Agreement, as amended, also required us to maintain cash collateral balances equal to at least 101% of the face amount of all outstanding stand-by letters of credit collateralized by the line of credit and 100% of the amount of all outstanding advances. The amended 2009 Agreement expired in May 2012, at which time we became required to maintain a cash collateral balance equal to at least 105% of the face amount of all outstanding stand-by letters of credit collateralized by the line of credit. There were no advances drawn under the 2009 Agreement’s credit line at the time it expired. Remaining stand-by letters of credit issued under the 2009 Agreement totaled zero and \$2.3 million as of September 30, 2015 and December 31, 2014, respectively. Total cash restricted related to these stand-by letters of credit totaled zero and \$2.4 million as of September 30, 2015 and December 31, 2014, respectively.

Note 7 — Equity

Share-Based Compensation Expense

For the three and nine months ended September 30, 2015 and 2014, we recognized share-based compensation expense related to employees and consultants as follows (in thousands):

| | Three Months Ended September 30, | | Nine months Ended September 30, | |
|--|-------------------------------------|---------------|------------------------------------|-----------------|
| | 2015 | 2014 | 2015 | 2014 |
| Cost of revenue | \$ 32 | \$ 27 | \$ 104 | \$ 75 |
| General and administrative | 280 | 222 | 2,856 | 916 |
| Sales and marketing | 114 | 80 | 321 | 388 |
| Research and development | 70 | 84 | 268 | 249 |
| Total share-based compensation expense | <u>\$ 496</u> | <u>\$ 413</u> | <u>\$ 3,549</u> | <u>\$ 1,628</u> |

As of September 30, 2015, total unrecognized compensation cost related to non-vested share-based awards, net of estimated forfeitures, was \$3.3 million, which is expected to be recognized as expense over a weighted average period of approximately 2.65 years.

In February 2015, we granted 344,090 stock options to our non-employee directors. The vesting start date for options granted to incumbent non-employee directors was June 20, 2014, the date of the previous annual meeting. The vesting start date for options granted to newly appointed non-employee directors was the date of grant. The options became fully vested on June 19, 2015, the date of our annual meeting; had an exercise price of \$3.53 per share, as determined on the date of grant; and will expire 10 years from the grant date. The total compensation cost associated with these option grants was recognized over the period from the grant date in February 2015 (which was determined to be the service inception date) to the vesting end date in June 2015. Accordingly, the nine months ended September 30, 2015 includes compensation expense from the service inception date through the vesting end date of June 19, 2015.

In March 2015, we granted 1,415,739 stock options to certain officers and other employees. The options vest over a four-year period, have an exercise price of \$2.75 per share, and will expire 10 years from the grant date.

In connection with the resignation of Mr. Thomas S. Rooney, Jr. as President and Chief Executive Officer, additional stock based compensation of approximately \$170,000 was recorded in the first quarter of 2015 related to the accelerated vesting of options previously granted to Mr. Rooney.

In June 2015, we entered into a consulting agreement with Mr. Rooney, under which his unvested options outstanding on the first day of consultancy continue to vest for the period of consultancy and all vested options continue to be exercisable through the 90 day period following the last day of the consultancy. In connection with this modification, we recorded additional stock based compensation of approximately \$1.1 million related to the additional vesting and extended exercise period in the three months ended June 30, 2015.

In April 2015, Ms. Audrey Bold resigned as our Chief Marketing Officer. In connection with her resignation and the providing of a general release, the Company agreed to provide her with continued vesting of granted options during the six month period following her termination and the ability to exercise the vested options through the 90 days following this six month period. In connection with this modification, we recorded additional stock based compensation of approximately \$43,000 related to the additional vesting and extended exercise period in the three months ended June 30, 2015.

In June 2015, we granted 300,000 stock options to our new Chief Financial Officer and Vice President of Strategy. These options vest over a four-year period, have an exercise price of \$2.61 per share, and will expire 10 years from the grant date.

In June 2015, we granted 16,000 stock options to an employee. The options vest over a four-year period, have an exercise price of \$2.60 per share, and will expire 10 years from the grant date.

In June 2015, we granted 373,744 stock options to our non-employee directors. The vesting start date was June 23, 2015, the date of grant. The options will become fully vested on June 17, 2016, the anticipated date of our next annual meeting. The options have an exercise price of \$2.92 per share, as determined on the date of grant, and will expire 10 years from the grant date.

In August 2015, we granted 7,337 stock options to an employee. The options vest over a four-year period, have an exercise price of \$2.84 per share, and will expire 10 years from the grant date.

Also in August 2015, we granted 5,000 stock options to a new employee. The options vest over a four-year period, have an exercise price of \$2.67 per share, and will expire 10 years from the grant date.

In September 2015, Dr. Prem Krish resigned as our Chief Technical Consultant. In connection with his resignation and the providing of a general release, the Company agreed to provide him with continued vesting of granted options during a 14-week period following his termination and the ability to exercise the vested options through the 90 days following the 14-week period. In connection with this modification, we recorded additional stock based compensation of approximately \$17,000 related to the additional vesting and extended exercise period in the three months ended September 30, 2015.

In September 2015, we granted 50,000 stock options to a new employee. The options vest over a four-year period, have an exercise price of \$2.14 per share, and will expire 10 years from the grant date.

Warrants

On July 1, 2015, warrants to purchase 200,000 shares of our common stock were exercised for cash at a price of \$1.00 per share. The proceeds from this exercise totaled \$200,000. This exercise represents the last outstanding warrant issued in 2005.

Note 8 — Income Taxes

The effective tax rate for the nine months ended September 30, 2015 and 2014 was (1.53%) and (1.4%), respectively. As of December 31, 2014, a full valuation allowance of approximately \$20.4 million had been established to reduce our deferred income tax assets to the amount expected to be realized. As such, no tax benefit related to our pre-tax loss was recognized for the nine months ended September 30, 2015, as there was no change in our assessment of the amount of deferred income tax assets expected to be realized.

Note 9 — Commitments and Contingencies

Operating Lease Obligations

We lease facilities under fixed non-cancellable operating leases that expire on various dates through November 2019. Future minimum lease payments consist of the following (in thousands):

| | September 30, 2015 |
|-------------------------------------|-------------------------------|
| 2015 (remaining three months) | \$ 439 |
| 2016 | 1,581 |
| 2017 | 1,567 |
| 2018 | 1,591 |
| 2019 | 1,398 |
| Total future minimum lease payments | <u>\$ 6,576</u> |

Product Warranty

The following table summarizes the activity related to the product warranty liability during the three and nine months ended September 30, 2015 and 2014 (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|---------------|--|---------------|
| | 2015 | 2014 | 2015 | 2014 |
| Balance, beginning of period | \$ 747 | \$ 705 | \$ 755 | \$ 709 |
| Warranty costs charged to cost of revenue | 76 | 34 | 91 | 87 |
| Release of accrual related to expired warranty | (213) | — | (213) | — |
| Utilization of warranty | (10) | (50) | (33) | (107) |
| Balance, end of period | <u>\$ 600</u> | <u>\$ 689</u> | <u>\$ 600</u> | <u>\$ 689</u> |

Purchase Obligations

We enter into purchase order arrangements with our vendors. As of September 30, 2015, there were open purchase orders for which we had not yet received the related goods or services. These arrangements are subject to change based on our sales demand forecasts, and we have the right to cancel the arrangements prior to the date of delivery. As of September 30, 2015, we had approximately \$2.4 million of cancellable open purchase order arrangements related primarily to materials and parts.

Guarantees

We enter into indemnification provisions under our agreements with other companies in the ordinary course of business, typically with customers. Under these provisions, we generally indemnify and hold harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of our activities, generally limited to personal injury and property damage caused by our employees at a customer's desalination plant in proportion to the employee's percentage of fault for the accident. Damages incurred for these indemnifications would be covered by our general liability insurance to the extent provided by the policy limitations. We have not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the estimated fair value of these agreements is not material. Accordingly, we have no liabilities recorded for these agreements as of September 30, 2015 and December 31, 2014.

In certain cases, we issue warranty and product performance guarantees to our customers for amounts ranging from 5% to 10% of the total sales agreement to endorse the execution of product delivery and the warranty of design work, fabrication, and operating performance. These guarantees, generally in the form of stand-by letters of credit or bank guarantees secured by stand-by letters of credit, typically remain in place for periods ranging up to 24 months and in some cases up to 65 months, and relate to the underlying product warranty period. The stand-by letters of credit are collateralized by restricted cash and our credit facility. All of the \$3.6 million in outstanding stand-by letters of credit as of September 30, 2015 were issued under the 2012 Agreement. The stand-by letters of credit outstanding as of September 30, 2015 were collateralized by restricted cash of \$3.6 million.

Litigation

On September 10, 2014, the Company terminated the employment of its Senior Vice President, Sales, Borja Blanco, on the basis of breach of duty of trust and conduct leading to conflict of interest. On October 3, 2014, Mr. Blanco filed a labor claim against ERI Iberia in Madrid, Spain alleging breach of contract and termination without cause. The claim seeks wages (salary and bonus) of €567,000 and alleged stock option gains of €630,000. The matter has been delayed until November 2015. At this time, the Company has not determined that an award to Mr. Blanco is probable.

In January 2015, two stockholder class action complaints were filed against the Company in the Northern District of California, on behalf of Energy Recovery stockholders under the captions, *Joseph Sabatino v. Energy Recovery, Inc. et al.* and *Thomas C. Mowdy v. Energy Recovery, Inc. et al.* The complaints have now been consolidated under the caption *In Re Energy Recovery Inc. Securities Litigation*. The complaint alleges violations of Section 10(b), Rule 10b-5, and Section 20(a) of the Securities Exchange Act of 1934 and seeks the recovery of unspecified monetary damages. We are not able to estimate the possible loss, if any, due to the early state of this matter.

Note 10 — Business Segment and Geographic Information

We manufacture and sell high-efficiency energy recovery devices and pumps as well as related products and services. Our chief operating decision-maker ("CODM") is the chief executive officer ("CEO").

Following the appointment of a new CEO in April 2015, new internal reporting was developed for making operating decisions and assessing financial performance. Beginning July 1, 2015, a new internal organizational and reporting structure was implemented and we began reporting segment information on a basis reflecting this new structure. Prior period amounts have been adjusted retrospectively to reflect this new internal reporting structure starting in the quarter ended September 30, 2015.

Our reportable operating segments consist of the Water Segment and the Oil & Gas Segment. These segments are based on the industries in which the products are sold, the type of energy recovery device sold, and the related products and services. The Water Segment consists of revenue associated with products sold for use in reverse osmosis water desalination, as well as the related identifiable expenses. The Oil & Gas Segment consists of revenue associated with products sold for use in gas processing, chemical processing, and hydraulic fracturing, as well as related identifiable expenses. Operating income for each segment excludes other income and expenses and certain expenses managed outside the operating segment. Costs excluded from operating income include various corporate expenses such as certain share-based compensation expenses, income taxes, and other separately managed general and administrative expenses not related to the identified segments. Assets and liabilities are reviewed at the consolidated level by the CODM and are not accounted for by segment. The CODM allocates resources to and assesses the performance of each operating segment using information about its revenue and operating income (loss),

The following summaries financial information by segment for the periods presented (in thousands):

| | Three Months Ended September 30, 2015 | | | Three Months Ended September 30, 2014 | | |
|------------------------------|---------------------------------------|-----------|-----------|---------------------------------------|-----------|------------|
| | Water | Oil & Gas | Total | Water | Oil & Gas | Total |
| Net revenue | \$ 12,112 | \$ — | \$ 12,112 | \$ 5,149 | \$ 193 | \$ 5,342 |
| Cost of revenue | 4,948 | — | 4,948 | 3,007 | — | 3,007 |
| Gross profit | 7,164 | — | 7,164 | 2,142 | 193 | 2,335 |
| Operating expenses: | | | | | | |
| General and administrative | 158 | 255 | 413 | 288 | 263 | 551 |
| Sales and marketing | 1,121 | 1,061 | 2,182 | 888 | 1,291 | 2,179 |
| Research and development | 293 | 1,184 | 1,477 | 331 | 1,800 | 2,131 |
| Amortization of intangibles | 159 | — | 159 | 216 | — | 216 |
| Operating expenses | 1,731 | 2,500 | 4,231 | 1,723 | 3,354 | 5,077 |
| Operating income (loss) | 5,433 | (2,500) | 2,933 | 419 | (3,161) | (2,742) |
| Less: | | | | | | |
| Corporate operating expenses | | | 3,187 | | | 2,699 |
| Consolidated operating loss | | | (254) | | | (5,441) |
| Non-operating expenses | | | (48) | | | (2) |
| Loss before income taxes | | | \$ (302) | | | \$ (5,443) |

| | Nine Months Ended September 30, 2015 | | | Nine months Ended September 30, 2014 | | |
|---------------------------------|--------------------------------------|-----------|-------------|--------------------------------------|-----------|-------------|
| | Water | Oil & Gas | Total | Water | Oil & Gas | Total |
| Net revenue | \$ 28,319 | \$ 141 | \$ 28,460 | \$ 15,111 | \$ 535 | \$ 15,646 |
| Cost of revenue | 12,287 | 28 | 12,315 | 7,991 | — | 7,991 |
| Gross profit | 16,032 | 113 | 16,145 | 7,120 | 535 | 7,655 |
| Operating expenses: | | | | | | |
| General and administrative | 745 | 978 | 1,723 | 810 | 591 | 1,401 |
| Sales and marketing | 3,222 | 3,130 | 6,352 | 3,045 | 3,950 | 6,995 |
| Research and development | 839 | 4,643 | 5,482 | 1,046 | 4,043 | 5,089 |
| Amortization of intangibles | 476 | — | 476 | 646 | — | 646 |
| Operating expenses | 5,282 | 8,751 | 14,033 | 5,547 | 8,584 | 14,131 |
| Operating income (loss) | 10,750 | (8,638) | 2,112 | 1,573 | (8,049) | (6,476) |
| Less: | | | | | | |
| Corporate operating expenses | | | 13,712 | | | 7,264 |
| Consolidated operating loss | | | (11,600) | | | (13,740) |
| Non-operating (expenses) income | | | (170) | | | 127 |
| Loss before income taxes | | | \$ (11,770) | | | \$ (13,613) |

The following geographic information includes net revenue to our domestic and international customers based on the customers' requested delivery locations, except for certain cases in which the customer directed us to deliver our products to a location that differs from the known ultimate location of use. In such cases, the ultimate location of use, rather than the delivery location, is reflected in the table below (in thousands, except percentages):

| | Three Months Ended September 30, | | Nine months Ended September 30, | |
|-----------------------|-------------------------------------|----------|------------------------------------|-----------|
| | 2015 | 2014 | 2015 | 2014 |
| Domestic revenue | \$ 355 | \$ 249 | \$ 1,439 | \$ 833 |
| International revenue | 11,757 | 5,093 | 27,021 | 14,813 |
| Total revenue | \$ 12,112 | \$ 5,342 | \$ 28,460 | \$ 15,646 |
| Revenue by country: | | | | |
| Qatar | 31% | *% | 13% | *% |
| Egypt | 4 | 13 | 7 | 9 |
| United States | 3 | 5 | 5 | 5 |
| United Arab Emirates | 2 | 5 | 14 | 4 |
| Others ** | 60 | 77 | 61 | 82 |
| Total | 100% | 100% | 100% | 100% |

* Less than 1%.

** Includes remaining countries not separately disclosed. No country in this line item accounted for more than 10% of our net revenue during the periods presented.

All of our long-lived assets were located in the United States at September 30, 2015 and December 31, 2014.

Note 11 — Concentrations

Customers accounting for 10% or more of our accounts receivable and unbilled receivables were as follows:

| | September 30, 2015 | December 31, 2014 |
|------------|-----------------------|----------------------|
| Customer A | 42% | 0% |
| Customer B | 9% | 32% |
| Customer C | 2% | 11% |

Revenue from customers representing 10% or more of net revenue varies from period to period. For the periods indicated, customers representing 10% or more of net revenue were:

| | Three Months Ended September 30, | | Nine months Ended September 30, | |
|------------|-------------------------------------|------|------------------------------------|------|
| | 2015 | 2014 | 2015 | 2014 |
| Customer A | 32% | 0% | 14% | * |
| Customer D | * | 0% | 13% | 0% |

* Less than 1%

Note 12 — Fair Value Measurements

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

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

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

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

The carrying values of cash and cash equivalents, restricted cash, accounts receivable, unbilled receivables, accounts payable, and other accrued expenses approximate fair value due to the short-term maturity of those instruments. For our investments in available-for-sale securities, if quoted prices in active markets for identical investments are not available to determine fair value (Level 1), then we use quoted prices for similar assets or inputs other than quoted prices that are observable either directly or indirectly (Level 2). The investments included in Level 2 consist primarily of corporate, and agency obligations. The asset included in Level 3 consists of the premium paid for foreign currency put options. The fair value of the asset in Level 3 was determined based on the time value of the option as it was determined there was no intrinsic value of the options.

The fair value of financial assets and liabilities measured on a recurring basis for the indicated periods was as follows (in thousands):

| | September 30, 2015 | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
|--|-------------------------------|---------------------------|---------------------------|---------------------------|
| Assets: | | | | |
| Short-term available-for-sale securities | \$ 1,344 | \$ — | \$ 1,344 | \$ — |
| Foreign currency put options | 36 | — | — | 36 |
| Total assets | \$ 1,380 | \$ — | \$ 1,344 | \$ 36 |
| | | | | |
| | December 31, 2014 | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs |
| Assets: | | | | |
| Short-term available-for-sale securities | \$ 13,072 | \$ — | \$ 13,072 | \$ — |
| Long-term available-for-sale securities | 267 | — | 267 | — |
| Total assets | \$ 13,339 | \$ — | \$ 13,339 | \$ — |

The reconciliation of the beginning and ending balances for financial assets and liabilities measured on a recurring basis using significant unobservable inputs (Level 3) for the period ending September 30, 2015 was as follows:

| | Fair Value of Level 3 Assets |
|------------------------------------|---------------------------------|
| Balance, December 31, 2014 | \$ — |
| Foreign currency put options | 91 |
| Loss due to change in fair value | (55) |
| Balance, September 30, 2015 | \$ 36 |

Note 13 — Subsequent Events

On October 14, 2015, the Company through our subsidiary ERI Energy Recovery Ireland Ltd., entered into a License Agreement (the “Agreement”) with Schlumberger Technology Corporation, a subsidiary of Schlumberger Limited (NYSE:SLB). The Agreement has a term of fifteen (15) years for the exclusive right to use certain intellectual property related to our VorTeq™ technology. The Agreement provides for a \$75 million exclusivity payment in connection with the execution of the agreement, two separate \$25 million payments upon the meeting of two milestones during 2016, and recurring royalty payments throughout the term of the Agreement. The Agreement contains representations, warranties, covenants, and indemnification obligations customary for transactions of this type.

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

The discussion in this item and in other items of this Form 10-Q contains forward-looking statements within the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements in this report include, but are not limited to, statements about our expectations, objectives, anticipations, plans, hopes, beliefs, intentions, or strategies regarding the future.

Forward-looking statements that represent our current expectations about future events are based on assumptions and involve risks and uncertainties. If the risks or uncertainties occur or the assumptions prove incorrect, then our results may differ materially from those set forth or implied by the forward-looking statements. Our forward-looking statements are not guarantees of future performance or events.

Words such as "expects," "anticipates," "believes," "estimates," variations of such words, and similar expressions are also intended to identify such forward-looking statements. These forward-looking statements are subject to risks, uncertainties, and assumptions that are difficult to predict; therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Forward-looking statements in this report include, without limitation, statements about the following:

- our expectation that sales outside of the United States will remain a significant portion of our net revenue;*
- our expectation that we will meet the two key milestones associated with our VorTeq licensing agreement with Schlumberger Technology Corporation and will receive annual royalties under said agreement;*
- our expectation that oil price fluctuations may impact the acceptance or rate of adoption of our oil & gas and hydraulic fracturing products;*
- our belief that levels of gross profit margin for our Water Segment are sustainable to the extent that volume grows, we experience a favorable product mix, pricing remains stable, and we continue to realize cost savings through production efficiencies and enhanced yields;*
- our expectation that, as we expand our international sales, a portion of our revenue could continue to be denominated in foreign currencies;*
- our expectation that our expenses for research and development and sales and marketing may increase as a result of the diversification into markets outside of water and hydraulic fracturing; and*
- our belief that our existing cash balances and cash generated from our operations will be sufficient to meet our anticipated liquidity needs for the foreseeable future, with the exception of a decision to enter into an acquisition and/or fund investments in newly developed technologies or product offerings arising from rapid market adoption that could require us to seek additional equity or debt financing.*

You should not place undue reliance on these forward-looking statements, which reflect management's opinions only as of the date of the filing of this Quarterly Report on Form 10-Q. All forward-looking statements included in this document are subject to certain risks and uncertainties, which could cause actual results to differ materially from those projected in the forward-looking statements, as disclosed from time to time in our reports on Forms 10-K, 10-Q, and 8-K as well as in our Annual Reports to Stockholders and, if necessary, updated in "Part II, Item 1A: Risk Factors." We assume no obligation to update any such forward-looking statements. It is important to note that our actual results could differ materially from the results set forth or implied by our forward-looking statements.

Overview

We are an energy solutions technology provider. We convert wasted pressure energy into a reusable asset and preserve or eliminate pumping technology in hostile processing environments. Our core competencies are fluid dynamics and advanced material science. Our company was founded in 1992, and we introduced the initial version of our Pressure Exchanger[®] energy recovery device in early 1997. In December 2009, we acquired Pump Engineering, LLC, which manufactured centrifugal energy recovery devices known as turbochargers as well as high-pressure pumps.

Following the appointment of a new Chief Executive Officer in April 2015, new internal reporting was developed for making operating decisions and assessing financial performance. Beginning July 1, 2015, a new internal organizational and reporting structure was implemented and we began reporting segment information on a basis reflecting this new structure. Prior period amounts have been adjusted retrospectively to reflect this new internal reporting structure starting in the quarter ended September 30, 2015.

Our reportable operating segments consist of the Water Segment and the Oil & Gas Segment. These segments are based on the industries in which the products are sold, the type of energy recovery device sold, and the related products and services. The Water Segment consists of revenue associated with products sold for use in reverse osmosis water desalination, as well as the related identifiable expenses. The Oil & Gas Segment consists of revenue associated with products sold for use in gas processing, chemical processing, and hydraulic fracturing, as well as related identifiable expenses.

Water Segment

Our Water Segment revenue is principally derived from the sale of our energy recovery devices for use in water desalination plants worldwide. We also derive revenue from the sale of our high-pressure and circulation pumps which we manufacture and sell both separately and in connection with our energy recovery devices for use in water desalination plants. Additionally, we receive revenue from the sale of spare parts and services, including start-up and commissioning services that we provide to our customers.

With respect to revenue from our energy recovery devices in our Water Segment, a significant portion of our net revenue typically has been generated from sales to a limited number of large engineering, procurement, and construction, or EPC, firms that are involved with the design and construction of large desalination plants. Sales to these firms often involve a long sales cycle that can range from 6 to 16 months, and in some cases, up to 24 months. A single large desalination project can generate an order for numerous energy recovery devices and generally represents a significant revenue opportunity. We also sell our devices to many small- to medium-sized original equipment manufacturers, or OEMs, which commission smaller desalination plants, order fewer energy recovery devices per plant, and have shorter sales cycles.

We often experience substantial fluctuations in our Water Segment net revenue from quarter to quarter and from year to year because a single order for our energy recovery devices by a large EPC firm for a particular plant may represent significant revenue. In addition, historically our EPC customers tend to order a significant amount of equipment for delivery in the fourth quarter, and as a consequence, a significant portion of our annual sales typically occurs during that quarter. This historical trend was reflected in the fourth quarter of the last several years. Normal seasonality trends also generally show our lowest revenue in the first quarter of the year.

A limited number of our customers account for a substantial portion of our net revenue and of our accounts receivable and unbilled receivables. Revenue from customers representing 10% or more of net revenue varies from period to period. For the three months ended September 30, 2015, one customer accounted for 32% of our net revenue. For the nine months ended September 30, 2015 two customers accounted for 14% and 13%, respectively, of our net revenue. For the three and nine months ended September 30, 2014, no customer accounted for 10% or more of our net revenue. No other customer accounted for more than 10% of our net revenue during any of these periods.

At September 30, 2015, one customer accounted for 42% of our accounts receivable and unbilled receivable balance. At December 31, 2014, two customers accounted for 32% and 11%, respectively, of our accounts receivable and unbilled receivable balance.

During the three and nine months ended September 30, 2015 and 2014, most of our net revenue and accounts receivable were attributable to sales outside of the United States. We expect sales and accounts receivable outside of the United States to remain a significant portion of our Water Segment net revenue and accounts receivable for the next few years.

Oil & Gas Segment

In the past several years, we have invested significant research and development costs to expand our business into pressurized fluid flow industries within the oil & gas industry. In 2014, we introduced a new product for the hydraulic fracturing industry, the VorTeq[™] hydraulic fracturing system. In 2014, we recognized oil & gas revenue of \$784,000 from the operating lease and lease buy-out of an IsoGen[®] system. In the first quarter of 2015, we recognized oil & gas revenue of \$60,000 from oil & gas commissioning services and \$81,000 from fees related to the cancellation of a ConocoPhillips sales order. No additional oil & gas revenue has been recognized during the remainder of the nine months ended September 30, 2015.

On October 14, 2015, the Company through our subsidiary ERI Energy Recovery Ireland Ltd., entered into a License Agreement (the "Agreement") with Schlumberger Technology Corporation, a subsidiary of Schlumberger Limited (NYSE:SLB). The Agreement has a term of fifteen (15) years for the exclusive right to use certain intellectual property related to our VorTeq™ Hydraulic Fracturing System technology. The Agreement provides for a \$75 million exclusivity payment in connection with the execution of the agreement, two separate \$25 million payments upon the meeting of two milestones during 2016, and recurring royalty payments throughout the term of the Agreement. The Agreement contains representations, warranties, covenants, and indemnification obligations customary for transactions of this type.

Our condensed consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States, or GAAP. These accounting principles require us to make estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the condensed consolidated financial statements as well as the reported amounts of revenue and expense during the periods presented. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that we make these estimates and judgments. To the extent that there are material differences between these estimates and actual results, our consolidated financial results will be affected. The accounting policies that reflect our more significant estimates and judgments and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition; allowance for doubtful accounts; allowance for product warranty; valuation of stock options; valuation and impairment of goodwill, long-lived assets, and acquired intangible assets; useful lives for depreciation and amortization; valuation adjustments for excess and obsolete inventory; and deferred taxes and valuation allowances on deferred tax assets.

Three months Ended September 30, 2015 Compared to Three months Ended September 30, 2014

Results of Operations

The following table sets forth certain data from our operating results as a percentage of net revenue for the periods indicated (in thousands, except percentages):

| | Three Months Ended September 30, | | | | | |
|---|----------------------------------|------|------------|--------|---------------------------------|---------|
| | 2015 | | 2014 | | Change Increase / (Decrease) | |
| Results of Operations:* | | | | | | |
| Net revenue | \$ 12,112 | 100% | \$ 5,342 | 100% | \$ 6,770 | 127% |
| Cost of revenue | 4,948 | 41% | 3,007 | 56% | 1,941 | 65% |
| Gross profit | 7,164 | 59% | 2,335 | 44% | 4,829 | 207% |
| Operating expenses: | | | | | | |
| General and administrative | 3,590 | 30% | 3,078 | 58% | 512 | 17% |
| Sales and marketing | 2,195 | 18% | 2,351 | 44% | (156) | (7%) |
| Research and development | 1,474 | 12% | 2,131 | 40% | (657) | (31%) |
| Amortization of intangible assets | 159 | 1% | 216 | 4% | (57) | (26%) |
| Total operating expenses | 7,418 | 61% | 7,776 | 146% | (358) | (5%) |
| Loss from operations | (254) | (2%) | (5,441) | (102%) | 5,187 | 95% |
| Other non-operating (expense) income | (48) | 0% | (2) | 0% | (46) | (2300%) |
| Loss before income taxes | (302) | (2%) | (5,443) | (102%) | 5,141 | 94% |
| Provision for income taxes | 38 | 0% | 63 | 1% | (25) | (40%) |
| Net loss | \$ (340) | (3%) | \$ (5,506) | (103%) | \$ 5,166 | 94% |

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

Net Revenue

| Segment | Three Months Ended September 30, | | | |
|-------------|-------------------------------------|----------|-----------|----------|
| | 2015 | 2014 | \$ Change | % Change |
| Water | \$ 12,112 | \$ 5,149 | \$ 6,963 | 135% |
| Oil & Gas | — | 193 | (193) | (100%) |
| Net revenue | \$ 12,112 | \$ 5,342 | \$ 6,770 | 127% |

Net revenue in the Water Segment increased by \$7.0 million, or 135%, to \$12.1 million for the three months ended September 30, 2015 from \$5.1 million for the three months ended September 30, 2014. The increase was primarily due to increased mega project shipments of \$3.8 million, higher OEM shipments of \$1.7 million, and higher aftermarket shipments of \$1.5 million.

Net revenue in the Oil & Gas Segment decreased by \$0.2 million, or 100%, to zero for the three months ended September 30, 2015 from \$0.2 million for the three months ended September 30, 2014. The decrease was due to the lease buy-out of an IsoGen™ system at the end of 2014, which resulted in no lease revenue in 2015.

The following table reflects revenue by product category and as a percentage of total net revenue (in thousands, except percentages):

| | Three Months Ended September 30, | | | |
|---|----------------------------------|------|----------|------|
| | 2015 | | 2014 | |
| PX devices and related products and services | \$ 8,281 | 68% | \$ 2,351 | 44% |
| Turbochargers, pumps, and related products and services | 3,831 | 32% | 2,798 | 52% |
| Oil & gas product lease and related services | — | — | 193 | 4% |
| Net revenue | \$ 12,112 | 100% | \$ 5,342 | 100% |

During the three months ended September 30, 2015 and 2014, a significant portion of our net revenue was attributable to sales outside of the United States. Revenue attributable to domestic and international sales as a percentage of net revenue was as follows:

| | Three Months Ended September 30, | |
|-----------------------|----------------------------------|------|
| | 2015 | 2014 |
| Domestic revenue | 3% | 5% |
| International revenue | 97% | 95% |
| Net revenue | 100% | 100% |

Gross Profit

| | Three Months Ended September 30, 2015 | | | Three months Ended September 30, 2014 | | |
|--------------|---------------------------------------|-----------|-------|---------------------------------------|-----------|-------|
| | Water | Oil & Gas | Total | Water | Oil & Gas | Total |
| Gross profit | 7,164 | — | 7,164 | 2,142 | 193 | 2,335 |
| Gross margin | 59% | — | 59% | 42% | 100% | 44% |

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, manufactured components, personnel costs (including share-based compensation), manufacturing overhead, warranty costs, and depreciation expense. For the three months ended September 30, 2015, gross profit as a percentage of net revenue was 59%. For the three months ended September 30, 2014, total gross profit as a percentage of net revenue was 44%. The increase was attributable to a favorable shift in product mix toward PX devices, which have a higher profit margin, and the release of an accrual related to an expired warranty.

Future gross profit is highly dependent on the product and customer mix of our net revenues, overall market demand and competition, volume of production in our manufacturing plant that determines our operating leverage, and the costs of purchased components. Accordingly, we are not able to predict our future gross profit levels with certainty. We believe that the current levels of gross profit margin are sustainable to the extent that volume remains healthy, our product mix favors PX devices, and we continue to realize cost savings through production efficiencies and enhanced yields.

Manufacturing headcount increased to 40 at the end of the third quarter of 2015 from 37 at the end of the third quarter of 2014.

Share-based compensation expense included in cost of revenue was \$32,000 and \$27,000 for the three months ended September 30, 2015 and 2014, respectively.

General and Administrative Expense

General and administrative expense increased by \$0.5 million, or 17%, to \$3.6 million for the three months ended September 30, 2015 from \$3.1 million for the three months ended September 30, 2014. As a percentage of net revenue, general and administrative expense decreased to 30% for the three months ended September 30, 2015 from 58% for the three months ended September 30, 2014.

General and administrative headcount decreased to 27 at the end of the third quarter of 2015 from 28 at the end of the third quarter of 2014.

Of the \$0.5 million increase in general and administrative expense for the three months ended September 30, 2015 compared to the same quarter of 2014, \$235,000 related to compensation and employee related benefits, \$131,000 related to occupancy and other costs, \$101,000 related to professional and legal costs, and \$58,000 related to stock based compensation expense. These changes were primarily offset by a decrease of \$14,000 related to bad debt expense and other taxes.

Share-based compensation expense included in general and administrative expense was \$280,000 and \$222,000 for the three months ended September 30, 2015 and 2014, respectively.

Sales and Marketing Expense

Sales and marketing expense decreased by \$156,000, or 7%, to \$2.2 million for the three months ended September 30, 2015 from \$2.4 million for the three months ended September 30, 2014. As a percentage of net revenue, sales and marketing expense decreased to 18% for the three months ended September 30, 2015 from 44% for the three months ended September 30, 2014.

Sales and marketing headcount decreased to 28 at the end of the third quarter of 2015 from 35 at the end of the third quarter of 2014.

Of the \$156,000 decrease in sales and marketing expense for the three months ended September 30, 2015 compared to the same quarter of 2014, \$221,000 related to professional and other sales and marketing services, \$101,000 related to marketing costs, occupancy, and other costs, and \$12,000 related to compensation and employee related benefits. The decreases were offset by an increase of \$176,000 related to commissions, bonus accruals, and stock based compensation.

Share-based compensation expense included in sales and marketing expense was \$114,000 and \$80,000 for the three months ended September 30, 2015 and 2014, respectively.

Research and Development Expense

Research and development expense decreased by \$0.6 million, or 31%, to \$1.5 million for the three months ended September 30, 2015 from \$2.1 million for the three months ended September 30, 2014. As a percentage of net revenue, research and development expense decreased to 12% for the three months ended September 30, 2015 from 40% for the three months ended September 30, 2014.

Research and development headcount decreased to 18 at the end of the third quarter of 2015 from 22 at the end of the third quarter of 2014.

Of the \$0.6 million decrease in research and development expense for the three months ended September 30, 2015 compared to the same quarter of 2014, \$326,000 related to costs associated with the Company's investment in product development for oil & gas applications, \$286,000 related to compensation and employee related benefits, \$40,000 related to outside consulting and professional fees and \$14,000 related to stock based compensation. The decreases were offset by slightly higher occupancy cost of \$12,000.

Share-based compensation expense included in research and development expense was \$70,000 and \$84,000 for the three months ended September 30, 2015 and 2014, respectively.

As we continue to advance our existing technologies and develop new energy recovery and efficiency-enhancing solutions for the oil & gas and other markets, we anticipate that our research and development expenses may increase in the future.

Amortization of Intangible Assets

Amortization of intangible assets is primarily related to finite-lived intangible assets acquired as a result of our purchase of Pump Engineering, LLC in December 2009. Amortization expense decreased by \$57,000, or 26%, to \$159,000 for the three months ended September 30, 2015 from \$216,000 for the three months ended September 30, 2014. The decrease was due to the full amortization of all intangibles, except developed technology, in the fourth quarter of 2014.

Non-Operating Income (Expense), Net

Non-operating income (expense), net, including interest expense, increased by \$46,000 to expense of \$48,000 in the three months ended September 30, 2015 from expense of \$2,000 in the three months ended September 30, 2014. The increase in expenses was primarily due to a loss on the fair value of put options of \$55,000 and a \$19,000 decrease in interest income related to interest receivable on investments. The expenses were offset by lower net foreign currency gains of \$27,000.

Income Taxes

The income tax provision was \$38,000 in the three months ended September 30, 2015 compared to \$63,000 in the three months ended September 30, 2014. This change is primarily due to an adjustment related to a change in the average state tax rate from 2014 to 2015. The tax expense for the three months ended September 30, 2015 and September 30, 2014 primarily relate to the tax basis amortization of goodwill and state and other taxes. The three months ended September 30, 2015 also includes a state tax benefit of approximately \$6,000.

Nine months Ended September 30, 2015 Compared to Nine months Ended September 30, 2014

Results of Operations

The following table sets forth certain data from our operating results as a percentage of net revenue for the periods indicated (in thousands, except percentages):

| | Nine months Ended September 30, | | | | Change | |
|--------------------------------------|---------------------------------|-------|-------------|-------|-----------------------|--------|
| | 2015 | | 2014 | | Increase / (Decrease) | |
| Results of Operations:* | | | | | | |
| Net revenue | \$ 28,460 | 100% | \$ 15,646 | 100% | \$ 12,814 | 82% |
| Cost of revenue | 12,315 | 43% | 7,991 | 51% | 4,324 | 54% |
| Gross profit | 16,145 | 57% | 7,655 | 49% | 8,490 | 111% |
| Operating expenses: | | | | | | |
| General and administrative | 15,230 | 54% | 8,112 | 52% | 7,118 | 88% |
| Sales and marketing | 6,622 | 23% | 7,548 | 48% | (926) | (12%) |
| Research and development | 5,417 | 19% | 5,089 | 33% | 328 | 6% |
| Amortization of intangible assets | 476 | 2% | 646 | 4% | (170) | (26%) |
| Total operating expenses | 27,745 | 97% | 21,395 | 137% | 6,350 | 30% |
| Loss from operations | (11,600) | (41%) | (13,740) | (88%) | 2,140 | 16% |
| Interest expense | 40 | 0% | — | — | (40) | ** |
| Other non-operating (expense) income | (130) | (0%) | 127 | 1% | (257) | (202%) |
| Loss before income taxes | (11,770) | (41%) | (13,613) | (87%) | 1,843 | 14% |
| Provision for income taxes | 180 | 1% | 187 | 1% | (7) | (4%) |
| Net loss | \$ (11,950) | (42%) | \$ (13,800) | (88%) | \$ 1,850 | 13% |

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

** Not meaningful

Net Revenue

| Segment | Nine Months Ended September 30, | | | |
|-------------|---------------------------------|-----------|-----------|----------|
| | 2015 | 2014 | \$ Change | % Change |
| Water | \$ 28,319 | \$ 15,111 | \$ 13,208 | 87% |
| Oil & Gas | 141 | 535 | (394) | (74%) |
| Net revenue | \$ 28,460 | \$ 15,646 | \$ 12,814 | 82% |

Net revenue in the Water Segment increased by \$13.2 million, or 87%, to \$28.3 million for the nine months ended September 30, 2015 from \$15.1 million for the nine months ended September 30, 2014. The increase was primarily due to increased mega project shipments of \$7.6 million, higher OEM shipments of \$3.8 million, and higher aftermarket shipments of \$1.8 million.

Net revenue in the Oil & Gas Segment decreased by \$394,000 or 74%, to \$141,000 for the nine months ended September 30, 2015 from \$0.5 million for the nine months ended September 30, 2014. The decrease was due to the lease buy-out of an IsoGen™ system at the end of 2014, which resulted in no lease revenue in 2015. The decrease was offset by \$60,000 from oil & gas commissioning services and \$81,000 from fees related to the cancellation of a ConocoPhillips sales order.

The following table reflects revenue by product category and as a percentage of total net revenue (in thousands, except percentages):

| | Nine months Ended September 30, | | | |
|---|---------------------------------|-------------|------------------|-------------|
| | 2015 | | 2014 | |
| PX devices and related products and services | \$ 19,786 | 69% | \$ 8,790 | 57% |
| Turbochargers, pumps, and related products and services | 8,533 | 30% | 6,321 | 40% |
| Oil & gas product lease and related services | 141 | 1% | 535 | 3% |
| Net revenue | <u>\$ 28,460</u> | <u>100%</u> | <u>\$ 15,646</u> | <u>100%</u> |

During the nine months ended September 30, 2015 and 2014, a significant portion of our net revenue was attributable to sales outside of the United States. Revenue attributable to domestic and international sales as a percentage of net revenue was as follows:

| | Nine months Ended September 30, | |
|-----------------------|---------------------------------|-------------|
| | 2015 | 2014 |
| Domestic revenue | 5% | 5% |
| International revenue | 95% | 95% |
| Net revenue | <u>100%</u> | <u>100%</u> |

Gross Profit

| | Nine Months Ended September 30, 2015 | | | Nine months Ended September 30, 2014 | | |
|--------------|--------------------------------------|-----------|--------|--------------------------------------|-----------|-------|
| | Water | Oil & Gas | Total | Water | Oil & Gas | Total |
| Gross profit | 16,032 | 113 | 16,145 | 7,120 | 535 | 7,655 |
| Gross margin | 57% | 80% | 57% | 47% | 100% | 49% |

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, manufactured components, personnel costs (including share-based compensation), manufacturing overhead, warranty costs, and depreciation expense. For the nine months ended September 30, 2015, total gross profit as a percentage of net revenue was 57%. For the nine months ended September 30, 2014, total gross profit as a percentage of net revenue was 49%. The increase was attributable to a favorable shift in product mix and the release of an accrual related to an expired warranty.

Future gross profit is highly dependent on the product and customer mix of our net revenues, overall market demand and competition, volume of production in our manufacturing plant that determines our operating leverage, and the costs of purchased components. Accordingly, we are not able to predict our future gross profit levels with certainty. We believe that the current levels of gross profit margin are sustainable to the extent that volume remains healthy, our product mix favors PX devices, and we continue to realize cost savings through production efficiencies and enhanced yields.

Manufacturing headcount increased to 40 at September 30, 2015 from 37 at September 30, 2014.

Share-based compensation expense included in cost of revenue was \$104,000 and \$75,000 for the nine months ended September 30, 2015 and 2014, respectively.

General and Administrative Expense

General and administrative expense increased by \$7.1 million, or 88%, to \$15.2 million for the nine months ended September 30, 2015 from \$8.1 million for the nine months ended September 30, 2014. As a percentage of net revenue, general and administrative expense increased to 54% for the nine months ended September 30, 2015 from 52% for the nine months ended September 30, 2014.

General and administrative headcount decreased to 27 at September 30, 2015 from 28 at September 30, 2014.

Of the \$7.1 million increase in general and administrative expense for the nine months ended September 30, 2015 compared to the same period of 2014, \$2.6 million related to professional, legal and other administrative costs, including that related to the termination of the former Senior Vice President of Sales in 2014, \$1.9 million related to increased stock based compensation expense, including that associated with the resignation of the Chief Executive Officer in January 2015, \$1.3 million related to compensation and employee related benefits, which also includes termination benefits associated with a reduction in force in the first quarter of 2015, \$0.9 million related to the reversal of VAT in the first quarter of 2014 that was expensed in 2011 and in prior years, and \$438,000 related to the fair value remeasurement of a contingent consideration, occupancy, and other administrative costs.

Share-based compensation expense included in general and administrative expense was \$2.9 million and \$916,000 for the nine months ended September 30, 2015 and 2014, respectively. The increase in share-based compensation is primarily related to increased value of options granted to non-employee directors in February 2015 (see Note 7 – Equity), the full vesting of restricted shares granted to a non-employee director on December 31, 2014, and the accelerated vesting and modification of options associated with the resignation of the Chief Executive Officer.

Sales and Marketing Expense

Sales and marketing expense decreased by \$0.9 million, or 12%, to \$6.6 million for the nine months ended September 30, 2015 from \$7.5 million for the nine months ended September 30, 2014. As a percentage of net revenue, sales and marketing expense decreased to 23% for the nine months ended September 30, 2015 from 48% for the nine months ended September 30, 2014.

Sales and marketing headcount decreased to 28 at September 30, 2015 from 35 at September 30, 2014.

Of the \$0.9 million decrease in sales and marketing expense for the nine months ended September 30, 2015 compared to the same period of 2014, \$427,000 related to marketing costs, \$353,000 related to compensation and employee related benefits, stock-based compensation expense, and lower annual incentive bonus accruals, and \$353,000 related to professional and other sales and marketing services. The decreases were primarily offset by an increase of \$216,000 related to commissions to certain sales representatives accrued at premium rates.

Share-based compensation expense included in sales and marketing expense was \$321,000 and \$388,000 for the nine months ended September 30, 2015 and 2014, respectively.

Research and Development Expense

Research and development expense increased by \$328,000 or 6%, to \$5.4 million for the nine months ended September 30, 2015 from \$5.1 million for the nine months ended September 30, 2014. As a percentage of net revenue, research and development expense decreased to 19% for the nine months ended September 30, 2015 from 33% for the nine months ended September 30, 2014.

Research and development headcount decreased to 18 at September 30, 2015 from 22 at September 30, 2014.

Of the \$328,000 increase in research and development expense for the nine months ended September 30, 2015 compared to the same period of 2014, \$346,000 related to costs associated with the Company's investment in product development for oil & gas applications, \$178,000 related to compensation and employee-related benefits, including termination benefits associated with a reduction in force in the first quarter of 2015, and \$53,000 primarily related to stock based compensation and occupancy cost. The increases were offset by a decrease of \$247,000 related to outside consulting and professional services.

Share-based compensation expense included in research and development expense was \$268,000 and \$249,000 for the nine months ended September 30, 2015 and 2014, respectively.

As we continue to advance our existing technologies and develop new energy recovery and efficiency enhancing solutions for markets outside of water desalination, we anticipate that our research and development expenses may increase in the future.

Amortization of Intangible Assets

Amortization of intangible assets is primarily related to finite-lived intangible assets acquired as a result of our purchase of Pump Engineering, LLC in December 2009. Amortization expense decreased by \$170,000, or 26%, to \$476,000 for the nine months ended September 30, 2015 from \$646,000 for the nine months ended September 30, 2014. The decrease was due to the full amortization of all intangibles, except developed technology, in the fourth quarter of 2014.

Non-Operating Income (Expense), Net

Non-operating income (expense), net, including interest expense, decreased by \$297,000 to an expense of (\$170,000) in the nine months ended September 30, 2015 from income of \$127,000 in the nine months ended September 30, 2014. The decrease was primarily due to a \$166,000 decrease in interest income related to interest receivable on investments, \$36,000 higher net foreign currency losses recorded during the first nine months of 2015 compared to the same period last year, a loss on the fair value of put options of \$55,000, and an increase in interest expense of \$40,000.

Income Taxes

The income tax provision was \$180,000 in the nine months ended September 30, 2015 compared to \$187,000 in the nine months ended September 30, 2014. The tax expense for the nine months ended September 30, 2015 and September 30, 2014 primarily relate to the tax basis amortization of goodwill and state and other taxes.

Liquidity and Capital Resources

Overview

Our primary source of cash historically has been proceeds from the issuance of common stock and customer payments for our products and services. From January 1, 2005 through September 30, 2015, we issued common stock for aggregate net proceeds of \$87.4 million, excluding common stock issued in exchange for promissory notes. The proceeds from the sales of common stock have been used to fund our operations and capital expenditures.

In March 2015, we entered into a loan agreement with a financial institution for a \$55,000 fixed-rate installment loan carrying an annual interest rate of 6.35%. The loan is payable in monthly installments and matures on April 2, 2020.

As of September 30, 2015, our principal sources of liquidity consisted of unrestricted cash and cash equivalents of \$21.5 million that are invested primarily in money market funds; short-term investments of \$1.3 million that are primarily invested in marketable debt securities; and accounts receivable of \$8.1 million. We invest cash not needed for current operations predominantly in high-quality, investment-grade, and marketable debt instruments with the intent to make such funds available for operating purposes as needed.

We currently have unbilled receivables pertaining to customer contractual holdback provisions, whereby we will invoice the final installment due under a sales contract, in general, six to 24 months after the product has been shipped to the customer and revenue has been recognized. The customer holdbacks represent amounts intended to provide a form of security to the customer during the warranty period; accordingly, these receivables have not been discounted to present value. At September 30, 2015 we had \$1.2 million of short- and long-term unbilled receivables.

In 2009, we entered into a loan and security agreement (the "2009 Agreement") with a financial institution. The 2009 Agreement, as amended, provided a total available credit line of \$16.0 million. Under the 2009 Agreement, we were allowed to draw advances of up to \$10.0 million on a revolving line of credit or utilize up to \$15.9 million as collateral for stand-by letters of credit, provided that the aggregate of the outstanding advances and collateral did not exceed the total available credit line of \$16.0 million. Advances under the revolving line of credit incurred interest based on a prime rate index or on LIBOR plus 1.375%. The amended 2009 Agreement also required us to maintain a cash collateral balance equal to at least 101% of the face amount of all outstanding stand-by letters of credit collateralized by the line of credit and 100% of the amount of all outstanding advances.

During the periods presented, we provided certain customers with stand-by letters of credit to secure our obligations for the delivery and performance of products in accordance with sales arrangements. Some of these stand-by letters of credit were issued under our 2009 Agreement. The stand-by letters of credit remain in place generally for periods ranging up to 24 months and in some cases up to 65 months. As of September 30, 2015, there were no outstanding stand-by letters of credit collateralized under our 2009 Agreement and no cash was restricted related to the stand-by letters of credit issued under the 2009 Agreement. There were no advances drawn on the line of credit under the 2009 Agreement at the time of its expiration.

In June 2012, we entered into a loan agreement (the "2012 Agreement") with another financial institution. The 2012 Agreement, as amended, provides for a total available credit line of \$16.0 million. Under the 2012 Agreement, as amended, we are allowed to draw advances not to exceed, at any time, \$10.0 million as revolving loans. The total stand-by letters of credit issued under the 2012 Agreement, as amended, may not exceed the lesser of the \$16.0 million credit line or the credit line minus all outstanding revolving loans. At no time may the aggregate of the revolving loans and stand-by letters of credit exceed the total available credit line of \$16.0 million. Revolving loans may be in the form of a base rate loan that bears interest equal to the prime rate plus 0% or a Eurodollar loan that bears interest equal to the adjusted LIBO rate plus 1.25%. Stand-by letters of credit are subject to customary fees and expenses for issuance or renewal. The unused portion of the credit facility is subject to a fee in an amount equal to 0.25% per annum of the average unused portion of the revolving line.

We are subject to certain financial and administrative covenants under the 2012 Agreement, as amended. As of September 30, 2015, we were in compliance with these covenants.

The 2012 Agreement, as amended, also requires us to maintain a cash collateral balance equal to 101% of all outstanding advances and all outstanding stand-by letters of credit collateralized by the line of credit. The 2012 Agreement, as amended, matures on June 5, 2018 and is collateralized by substantially all of our assets. As of September 30, 2015 there were no advances drawn under the 2012 Agreement's line of credit. The amounts outstanding on stand-by letters of credit collateralized under the 2012 Agreement, as amended, totaled approximately \$3.6 million, and restricted cash related to these stand-by letters of credit issued under the 2012 Agreement, as amended, was approximately \$3.6 million as of September 30, 2015. Of this \$3.6 million of restricted cash, \$1.4 million was classified as current and \$2.2 million was classified as non-current.

Cash Flows from Operating Activities

Net cash used in operating activities was \$(7.7) million and \$(268,000) for the nine months ended September 30, 2015 and 2014, respectively. For the nine months ended September 30, 2015, a net loss of \$(11.9) million was adjusted to \$(5.2) million by non-cash items totaling \$6.7 million. For the nine months ended September 30, 2014, a net loss of \$(13.8) million was adjusted to \$(8.4) million by non-cash items totaling \$5.4 million. Non-cash adjustments during the nine months ended September 30, 2015, primarily include share-based compensation of \$3.5 million; depreciation and amortization of \$2.9 million; and unrealized losses on foreign currency transactions, amortization of premiums/discounts on investments, deferred income taxes, and other non-cash items of \$0.3 million.

Non-cash adjustments during the nine months ended September 30, 2014, primarily included depreciation and amortization of \$3.0 million, share-based compensation of \$1.6 million, provision for doubtful accounts and amortization of premiums/discounts on investments of \$0.3 million, and provisions for doubtful accounts of \$0.3 million.

The net cash impact from changes in assets and liabilities was approximately \$(2.5) million and \$8.1 million for the nine months ended September 30, 2015 and 2014, respectively. Net changes in assets and liabilities during the nine months ended September 30, 2015 are primarily attributable to a decrease of \$3.3 million in accounts receivable and unbilled receivables as a result of the collections and the timing of invoices for projects shipped previously and a decrease of \$0.4 million in deferred revenue due to the timing of invoices. These changes were offset by an increase of \$3.6 million in accrued expense, and other liabilities due to the timing of payments to other third parties; the settlement of a litigation case for \$1.7 million; an increase of \$0.6 million in inventories due to the timing of shipments; an increase in prepaid and other assets and unbilled receivables of \$0.2 million; and a decrease in accounts payable of \$0.1 million due to timing of payments to vendors.

Net changes in assets and liabilities during the nine months ended September 30, 2014 are primarily attributable to a decrease of \$16.6 million in accounts receivable and unbilled receivables as a result of the timing of invoices and collections for large projects that were shipped in the fourth quarter of 2013. This change was offset by an increase in inventory of \$5.5 million as a result of inventory buildup for future shipments, a decrease in accrued expenses and other liabilities of \$2.3 million as a result of a VAT settlement in Spain and the timing of payments to employees, vendors, and other third parties, a decrease in accrued expenses and other liabilities of \$2.3 million, primarily related to the decrease in the fair value of our contingent consideration due to the settlement of the litigation related to it, and an increase of \$1.0 million in prepaid expenses.

Cash Flows from Investing Activities

Cash flows provided by investing activities primarily relate to maturities of investments in marketable securities and the release of restricted cash used to collateralize our stand-by letters of credit offset by capital expenditures to support our growth and additional investments in marketable securities.

Net cash provided by investing activities was \$13.1 million and \$5.1 million for the nine months ended September 30, 2015 and 2014, respectively. Cash flows provided by investing activities for the nine months ended September 30, 2015 were primarily due to the maturity of marketable securities of \$11.8 million and the release of \$1.8 million of restricted cash used to collateralize stand-by letters of credit. These sources of cash were offset by the use of \$0.6 million to purchase fixed assets.

Cash flows provided by investing activities for the nine months ended September 30, 2014 was primarily due to the maturity of marketable securities of \$4.4 million and the release of \$3.3 million of restricted cash mostly due to the settlement of a litigation case. These sources of cash provided by investing activities were offset by \$2.3 million of additions to property and equipment and the purchase of \$0.3 million of marketable securities.

Cash Flows from Financing Activities

Net cash provided by (used in) financing activities was \$0.6 million and \$(1.8) million the nine months ended September 30, 2015 and 2014, respectively. Net cash provided during the nine months ended September 30, 2015 consisted of \$0.6 million received for the issuance of common stock due to option and warrant exercises and \$55,000 of borrowings offset by the use of \$5,000 for repayment of borrowings.

Net cash used in financing activities for the nine months ended September 30, 2014 was the result of \$1.6 million used to repurchase the Company common stock for treasury and \$1.4 million used to pay a contingent consideration. The uses were offset by \$1.2 million received for the issuance of common stock due to option and warrant exercises.

Liquidity and Capital Resource Requirements

We believe that our existing cash balances and cash generated from operations will be sufficient to meet our anticipated capital requirements over the next twelve months. We may need to raise additional capital or incur additional indebtedness to continue to fund our operations or to support acquisitions in the future. Our future capital requirements will depend on many factors, including our rate of revenue growth, if any, the expansion of our sales and marketing and research and development activities, the amount and timing of cash used for stock repurchases, the timing and extent of our expansion into new geographic territories, the timing of new product introductions, and the continuing market acceptance of our products. We may enter into potential material investments in, or acquisitions of, complementary businesses, services, or technologies in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

Contractual Obligations

In March 2015, we entered into a loan agreement that matures in April 2020. The total of future minimum installment payment under this agreement as of September 30, 2015 was \$55,000. For additional information, see Note 6 — “Long-Term Debt and Lines of Credit” to the unaudited condensed consolidated financial statements in this quarterly report on Form 10-Q.

We lease facilities under fixed non-cancellable operating leases that expire on various dates through 2019. The total of the future minimum lease payments under these leases as of September 30, 2015 was \$6.6 million. For additional information, see Note 9 — “Commitments and Contingencies” to the unaudited condensed consolidated financial statements in this quarterly report on Form 10-Q.

In the course of our normal operations, we also enter into purchase commitments with our suppliers for various raw materials and components parts. The purchase commitments covered by these arrangements are subject to change based on sales forecasts for future deliveries. As of September 30, 2015, we had approximately \$2.4 million of cancellable open purchase order arrangements related primarily to materials and parts.

We have agreements with guarantees or indemnity provisions that we have entered into with customers and others in the ordinary course of business. Based on our historical experience and information known to us as of September 30, 2015, we believe that our exposure related to these guarantees and indemnities was not material.

The following is a summary of our contractual obligations as of September 30, 2015 (in thousands):

| Payments Due During Year Ending December 31, | Payments Due by Period | | | |
|--|------------------------|----------------------|--------------|-----------------|
| | Operating Leases | Purchase Obligations | Loan | Total |
| 2015 | \$ 439 | \$ 2,368 | \$ 2 | \$ 2,809 |
| 2016 | 1,581 | — | 11 | 1,592 |
| 2017 | 1,567 | — | 11 | 1,578 |
| 2018 | 1,591 | — | 11 | 1,602 |
| 2019 | 1,398 | — | 11 | 1,409 |
| Thereafter | — | — | 4 | 4 |
| | <u>\$ 6,576</u> | <u>\$ 2,368</u> | <u>\$ 50</u> | <u>\$ 8,994</u> |

Off-Balance Sheet Arrangements

During the periods presented, we did not have any relationships with unconsolidated entities or financial partnerships such as entities often referred to as structured finance or special purpose entities that would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Recent Accounting Pronouncements

See Note 1 — “The Company and Summary of Significant Accounting Policies” to the condensed consolidated financial statements regarding the impact of certain recent accounting pronouncements on our condensed consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

The information in this section should be read in connection with the information on financial market risk related to changes in currency exchange rates and interest rates in Part II, Item 7A, “Quantitative and Qualitative Disclosure About Market Risk,” in our Annual Report on Form 10-K for the year ended December 31, 2014.

Foreign Currency Risk

The majority of our revenue contracts have been denominated in United States Dollars. In some circumstances, we have priced certain international sales in Euros. In June 2015, we entered into a sales contract denominated in Euros to be paid in three milestone payments over the next two years. As a result of this transaction, we purchased three foreign-currency put options to offset the downside foreign exchange risk associated with the corresponding sale. For future sales denominated in non U.S. currencies, the Company is likely to enter into similar arrangements.

As we expand our international sales, we expect that a portion of our net revenue could continue to be denominated in foreign currencies. As a result, our cash and cash equivalents and operating results could be increasingly affected by changes in exchange rates. Our international sales and marketing operations incur expenses that are denominated in foreign currencies. These expenses could be materially affected by currency fluctuations. Our exposures are to fluctuations in exchange rates for the United States Dollar versus the Euro, AED, CNY, and CAD. Changes in currency exchange rates could adversely affect our consolidated operating results or financial position. Additionally, our international sales and marketing operations maintain cash balances denominated in foreign currencies. To decrease the inherent risk associated with translation of foreign cash balances into our reporting currency, we have not maintained excess cash balances in foreign currencies. We have not hedged our exposure to changes in foreign currency exchange rates as they relate to our cash balances and operating expenses because expenses and cash balances in foreign currencies have been insignificant to date and exchange rate fluctuations have had little impact on our operating results and cash flows.

Interest Rate Risk

We have an investment portfolio of fixed income marketable debt securities, including amounts classified as cash equivalents, short-term investments, and long-term investments. At September 30, 2015, our short- and long-term investments totaled \$1.3 million. The primary objective of our investment activities is to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk. Our current investments are primarily in high-quality, short-term and long-term debt instruments of high-quality corporate issuers. These investments are subject to interest rate fluctuations and will decrease in market value if interest rates increase. To minimize the exposure due to adverse shifts in interest rates, we maintain investments with an average maturity of less than eighteen months. A hypothetical 1% increase in interest rates would have resulted in an approximately \$3,000 decrease in the fair value of our fixed-income debt securities as of September 30, 2015.

Concentration of Credit Rate Risk

Our investments in marketable debt securities are subject to potential loss of value due to counterparty credit risk. To minimize this risk, we invest pursuant to a Board-approved investment policy. The policy mandates high-credit-rating requirements and restricts our exposure to any single corporate issuer or sector by imposing concentration limits.

Item 4. Controls and Procedures.

(a) *Evaluation of disclosure controls and procedures.* Under the supervision and with the participation of our management, including the President and Chief Executive Officer and the Principal Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 as of the end of the period covered by this report.

Based on that evaluation, the Chief Executive Officer and the Principal Financial Officer have concluded that these disclosure controls and procedures are effective.

(b) *Changes in internal controls.* There were no changes in our internal control over financial reporting during the quarter ended September 30, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. Legal Proceedings

Note 9 – “Commitments and Contingencies”, under the caption “Litigation” of our Annual Report on Form 10-K filed with the SEC on March 6, 2015, provides information on certain litigation in which we are involved.

For an update on the litigation matters previously disclosed in our Form 10-K, see the discussion in Note 9 – “Commitments and Contingencies”, under the caption “Litigation” of this quarterly report on Form 10-Q, which discussion is incorporated by reference into this Item 1.

Item 1A. Risk Factors

Additional risk factors to those disclosed in Part I, Item 1A, of our Annual Report on Form 10-K filed on March 6, 2015 are:

- *We may not meet the key performance indicators necessary to meet the two milestones in the Schlumberger agreement.*

The Schlumberger agreement calls for certain milestone key performance indicators that if met will entitle the Company to payments of \$25 million for each milestone. While we believe we can meet the milestones, if we are unable to do so, the milestone payments will be delayed until such time as the milestones are met. Failure to meet said milestones may also jeopardize the rate of adoption of our VorTeq hydraulic fracturing system.

- *Schlumberger may not adopt the VorTeq hydraulic fracturing system at the rate prescribed in the agreement.*

The agreement prescribes a rate of adoption that if not met could significantly affect the projected revenues resulting from annual royalties. The rate of adoption may be affected for reasons attributable, or not, to the Company. Additionally, deflationary oil pricing could have a negative impact on the adoption rate of the VorTeq hydraulic fracturing system.

Item 6. Exhibits

| <u>Exhibit No.</u> | <u>Description</u> |
|--------------------|--|
| 31.1 | Certification of Principal Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002 |
| 31.2 | Certification of Principal Financial Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002 |
| 32.1 | Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |

SIGNATURES

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

Registrant: Energy Recovery, Inc.

By: /s/ JOEL GAY President and Chief Executive Officer November 5, 2015
Joel Gay (Principal Executive Officer)

/s/ CHRIS GANNON Chief Financial Officer November 5, 2015
Chris Gannon (Principal Financial Officer)

Exhibit List

| <u>Exhibit No.</u> | <u>Description</u> |
|--------------------|--|
| 31.1 | Certification of Principal Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002 |
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**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER
PURSUANT TO EXCHANGE ACT RULE 13a-14(a) OR 15d-14(a), AS ADOPTED PURSUANT TO
SECTION 302 OF THE SARBANES OXLEY ACT OF 2002**

I, Joel Gay, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Energy Recovery, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations, and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2015

/s/ JOEL GAY
Name: Joel Gay
Title: President and Chief Executive Officer
(Principal Executive Officer)

**CERTIFICATION OF PRINCIPAL FINANCIAL OFFICER
PURSUANT TO EXCHANGE ACT RULE 13a-14(a) OR 15d-14(a), AS ADOPTED PURSUANT TO
SECTION 302 OF THE SARBANES OXLEY ACT OF 2002**

I, Chris Gannon, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Energy Recovery, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations, and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 5, 2015

/s/ CHRIS GANNON
Name: Chris Gannon
Title: Chief Financial Officer
(Principal Financial Officer)

**CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER AND PRINCIPAL FINANCIAL OFFICER,
PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE
SARBANES-OXLEY ACT OF 2002***

Pursuant to the requirement set forth in Rule 13a-14(b) of the Securities and Exchange Act of 1934, as amended (the "Exchange Act"), and Section 1350 of Chapter 63 of Title 18 of the United States Code, Joel Gay, President and Chief Executive Officer of Energy Recovery, Inc. (the "Company"), and Chris Gannon, Chief Financial Officer of the Company, each hereby certify that, to the best of their knowledge:

1. The Company's Quarterly Report on Form 10-Q for the period ended September 30, 2015, to which this Certification is attached as Exhibit 32.1 (the "Quarterly Report") fully complies with the requirements of Section 13(a) or Section 15(d) of the Exchange Act, and
2. The information contained in the Quarterly Report fairly presents, in all material respects, the financial condition of the Company at the end of the period covered by the Quarterly Report and results of operations of the Company for the period covered by the Quarterly Report.

/s/ JOEL GAY
President and Chief Executive Officer

/s/ CHRIS GANNON
Chief Financial Officer

Dated: November 5, 2015

Dated: November 5, 2015

* This certification accompanies the Form 10-Q to which it relates, is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of Energy Recovery, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (whether made before or after the date of the Form 10-Q), irrespective of any general incorporation language contained in such filing.

