As filed with the Securities and Exchange Commission on May 12, 2008

Registration No. 333-150007

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

AMENDMENT NO. 1
TO
FORM S-1
REGISTRATION STATEMENT
Under
The Securities Act of 1933

Energy Recovery, Inc.
(Exact Name of Registrant as Specified in its Charter)

Delaware	**3559**	**01-0616867**
(State or Other Jurisdiction of Incorporation or Organization)	**(Primary Standard Industrial Classification Code Number)**	**(I.R.S. Employer Identification Number)**

1908 Doolittle Drive
San Leandro, CA 94577
(510) 483-7370
(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

G.G. Pique
President and Chief Executive Officer
1908 Doolittle Drive
San Leandro, CA 94577
(510) 483-7370
(Name, address, including zip code, and telephone number, including area code, of agent for service)

Copies to:

Stephen J. Schrader
Jenny C. Yeh
Baker & McKenzie LLP
Two Embarcadero Center, 11th Floor
San Francisco, CA 94111
Telephone: (415) 576-3000
Facsimile: (415) 576-3099

Alan F. Denenberg
Davis Polk & Wardwell
1600 El Camino Real
Menlo Park, CA 94025
Telephone: (650) 752-2000
Facsimile: (650) 752-2111

Approximate date of commencement of proposed sale to the public: As soon as practicable after the effective date of this Registration Statement.

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

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

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

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

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 ☐

CALCULATION OF REGISTRATION FEE

Title of Each Class of Securities to be Registered	Proposed Maximum Aggregate Offering Price(1)(2)	Amount of Registration Fee(3)
Common Stock, $0.001 par value	$175,000,000	$6,877.50

(1) Estimated solely for the purpose of computing the amount of the registration fee pursuant to Rule 457(o) under the Securities Act.
(2) Includes additional shares that the underwriters have the option to purchase.
(3) Previously paid.

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

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

SUBJECT TO COMPLETION, DATED MAY 12, 2008

Shares

Energy Recovery, Inc.

Common Stock

This is the initial public offering of our common stock. We are selling shares of common stock, and the selling stockholders named in this prospectus are selling shares of common stock. We will not receive any proceeds from the shares of common stock sold by the selling stockholders. Prior to this offering, there has been no public market for our common stock. The initial public offering price of our common stock is expected to be between $ and $ per share. We intend to apply to list our common stock on the NASDAQ Global Market under the symbol "ERII."

The underwriters have an option to purchase a maximum of additional shares to cover over-allotments of shares.

Investing in our common stock involves risks. See "Risk Factors" beginning on page 7.

	Per Share	Total
Price to Public	$	$
Underwriting Discounts and Commissions	$	$
Proceeds to ERI	$	$
Proceeds to Selling Stockholders	$	$

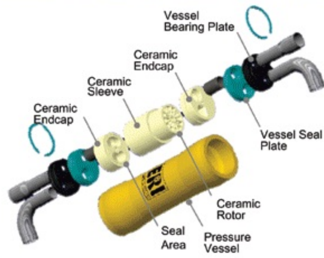
The underwriters expect to deliver the shares to purchasers on or about , 2008.

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

Citi **Credit Suisse**

The date of this prospectus is , 2008

Table of Contents



Making Desalination Affordable℠

TABLE OF CONTENTS

	Page		Page
Prospectus Summary	1	Certain Relationships And Related Party Transactions	76
The Offering	4	Principal And Selling Stockholders Security Ownership Of Certain Beneficial Owners And Management	78
Summary Consolidated Financial Data	5	Description Of Capital Stock	80
Risk Factors	7	Shares Eligible For Future Sale	83
Forward-Looking Statements	17	Material United States Tax Considerations For Non-U.S. Holders	85
Use Of Proceeds	19	Underwriting	88
Dividend Policy	19	Notice To Canadian Residents	92
Capitalization	20	Legal Matters	93
Dilution	22	Experts	93
Selected Consolidated Financial Data	23	Where You Can Find Additional Information	93
Management's Discussion And Analysis Of Financial Condition And Results Of Operations	25	Index To Consolidated Financial Statements	F-1
Industry	40	EXHIBIT 3.1.1	
Business	45	EXHIBIT 3.2.2	
Management	54	EXHIBIT 10.1	
Compensation Discussion And Analysis	59	EXHIBIT 10.6	
Compensation Of Executive Officers	64	EXHIBIT 10.16	
		EXHIBIT 10.16.1	
		EXHIBIT 23.1	
		EXHIBIT 99.2	

You should rely only on the information contained in this document or to which we have referred you. We have not authorized anyone to provide you with information that is different. This document may only be used where it is legal to sell these securities. The information in this document may only be accurate on the date of this document.

Corporate Information

We incorporated in Virginia in April 1992 and reincorporated in Delaware in March 2001. Our principal executive offices are located at 1908 Doolittle Drive, San Leandro, California 94577. Our telephone number is (510) 483-7370. Our website address is www.energyrecovery.com. Information contained on our website is not incorporated by reference into this prospectus, and you should not consider information contained on our website to be part of this prospectus.

"ERI," the ERI logo, "Making Desalination Affordable," "PX Pressure Exchanger," "PX" and other trademarks or service marks of ERI appearing in this prospectus are the property of ERI. This prospectus contains additional trade names, trademarks and service marks of other companies. We do not intend our use or display of other companies' trade names, trademarks or service marks to imply a relationship with, or endorsement or sponsorship of us by, these other companies.

Industry and Market Data

This prospectus includes market and industry data and forecasts that we obtained from internal research, publicly available information and industry publications and surveys. Industry publications and surveys generally state that the information contained therein has been obtained from sources believed to be reliable. Unless otherwise noted, statements as to our market position relative to our competitors are approximated and based on the above-mentioned third-party data and internal analysis and estimates as of the date of this prospectus. Although we believe the industry and market data and statements as to market position to be reliable as of the date of this prospectus, we have not independently verified this information and it could prove inaccurate. Industry and market data could be wrong because of the method by which sources obtained their data and because information cannot always be verified with certainty due to the limits on the availability and reliability of raw data, the voluntary nature of the data gathering process and other limitations and uncertainties. In addition, we do not know all of the assumptions regarding general economic conditions or growth that were used in preparing the forecasts from sources cited herein.

Dealer Prospectus Delivery Obligation

Until , 2008 (25 days after the date of this prospectus) all dealers that effect transactions in these securities, whether or not participating in this offering, may be required to deliver a prospectus. This is in addition to the dealer's obligation to deliver a prospectus when acting as an underwriter and with respect to unsold allotments or subscriptions.

PROSPECTUS SUMMARY

This summary highlights information contained elsewhere in this prospectus. You should read the following summary together with the more detailed information appearing in this prospectus, including our consolidated financial statements and the related notes, and our risk factors beginning on page 7, before deciding whether to purchase shares of our common stock. Unless the context otherwise requires, the terms "ERI," "the Company," "we," "us" and "our" in this prospectus refer to Energy Recovery, Inc. and its consolidated subsidiaries.

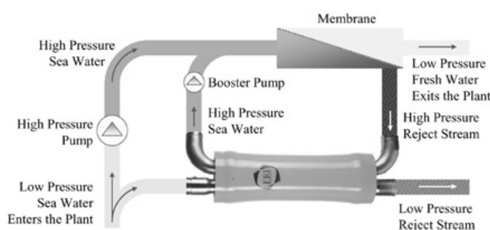
Our Business

We are a leading global developer and manufacturer of highly efficient energy recovery devices utilized in the rapidly growing water desalination industry. We operate primarily in the sea water reverse osmosis, or SWRO, segment of the industry. In the SWRO process, high pressure is used to drive sea water through filtering membranes to produce fresh water. Energy recovery devices have increased the cost-competitiveness of SWRO desalination compared to other means of fresh water supply and have enabled the ongoing rapid growth of the SWRO segment of the desalination industry worldwide. Our primary product, the PX Pressure Exchanger, or PX, helps optimize the energy intensive SWRO process by recapturing and recycling up to 98% of the energy in the high pressure reject stream, thereby reducing SWRO energy consumption by an estimated 60% as compared to the same process without any energy recovery devices.

We believe that the proven benefits of our proprietary technology have made us a leader in the SWRO energy recovery market due to the following:

- up to 98% energy recovery efficiency;
- proprietary design employing only one moving part;
- corrosion resistant, highly durable ceramic composition;
- smaller footprint, modular design and system redundancy; and
- lower life cycle cost versus competitors.

The PX device uses a corrosion resistant ceramic rotor to recapture and recycle the energy that otherwise would have been lost in the reject stream of the SWRO process and applies it to the low pressure incoming sea water. The PX device has been installed in over 300 desalination plants and specified in plant designs by over 60 original equipment manufacturers, or OEMs, and engineering, procurement and construction, or EPC, firms worldwide. We estimate that PX devices shipped as of December 31, 2007 reduce electricity consumption in SWRO desalination plants in the aggregate by approximately 300 megawatts relative to comparable plants with no energy recovery devices. Assuming a rate of $0.08 per kilowatt-hour, the deployment of PX devices in these plants would result in annual electricity cost savings of approximately $210 million in the aggregate, which would equate to a reduction in carbon dioxide emissions of approximately 1.5 million tons per year.



As of December 31, 2007, we had shipped over 4,000 PX devices to desalination plants worldwide, including in China, Europe, India, Australia, Africa, the Middle East, North America and the Caribbean. Our net revenue grew from $4.0 million in 2003 to $35.4 million in 2007.

We design, manufacture and sell various models of the PX device to serve a range of SWRO process flow rates for various plant designs and sizes. With respect to large desalination plants (greater than 50,000 cubic meters, or 13.2 million gallons, per day capacity), we sell our products to international EPCs, and with respect to smaller desalination facilities (fewer than 50,000 cubic meters per day capacity) we sell our products to OEMs for installation in hotels, power plants and municipal facilities. Our successful market penetration has resulted in a rapidly increasing installed base of PX devices globally, which we expect to lead to aftermarket part replacement and service opportunities. We also manufacture a line of booster pumps for use in conjunction with some models of the PX device.

Our research, development and manufacturing facility is located in the San Francisco Bay technology corridor, and we have direct sales offices and technical support centers in many key desalination markets, including Madrid, Dubai, Shanghai and Fort Lauderdale.

Industry Opportunity

The demand for fresh water continues to grow, driven by the need for drinking water to satisfy the world's growing population, changing weather patterns, an increasing need for water for agriculture and industry and the concentration of populations in urban areas that lack sufficient fresh water resources. The United Nations Population Fund expects the global consumption of water to double every 20 years. A study conducted by the International Water Management Institute projects that by 2025, 33% of the population of the developing world will face severe water shortages. The uneven geographic distribution of fresh water supplies compounds this problem.

The two basic processes used to desalinate sea water are thermal, or distillation, and more recently, SWRO. The most significant operating cost component for either process is energy consumption. Thermal desalination technology is highly energy inefficient and is mainly used in the Middle East where energy costs are low. Until approximately 15 years ago SWRO was also energy inefficient, in part because of the loss of energy associated with the high-pressure reject stream. Today, however, the energy cost of the SWRO process is 50% less than that of the traditional thermal desalination process due to the incorporation of energy recovery devices, including our PX device, and improved membranes.

The significant reduction in operating costs related to energy has made the SWRO desalination industry in which we compete the fastest growing segment of the desalination industry. According to Global Water Intelligence, or GWI, due to the use of SWRO technology, the cost of producing a cubic meter of fresh water from sea water, which averaged approximately $10 per cubic meter in the mid-1960's, had dropped to as low as $0.46 per cubic meter by 2005. As a result, the share of total new contracted sea water desalination capacity using SWRO has increased from 42% in 1999 to approximately 71% in 2006.

Desalination has become an economically attractive alternative in many coastal regions or other locations near a salt water source where fresh water sources are becoming increasingly stressed. According to the February/March 2008 issue of International Desalination & Water Reuse Quarterly, there are approximately 14,000 desalination plants worldwide. GWI estimates that as of December 31, 2005, there were 39.9 million cubic meters per day of installed capacity, and that the growth in the market for new total desalination capacity should increase by approximately 13% per year from 2005 to 2015. We expect SWRO's share of new total desalination capacity to grow in excess of the overall industry growth rate, particularly due to higher energy costs experienced over the past few years.

We are active in the fastest growing markets for desalination, which include China, Algeria, Australia and India. According to GWI projections, these markets are expected to grow at least 20% per year from 2005 to 2015. Other significant markets include the Middle East, North America, the Caribbean and Europe. Additionally, our PX device is currently specified in the pilot test facility for the proposed Carlsbad, California plant, which, if constructed, is expected to be the largest SWRO plant then operating in the United States. We understand that the proposed Carlsbad, California desalination plant is in the final stages of its permit procurement process and construction is expected to begin once all permits have been obtained.

Our Strengths

- ***Unique and efficient product.*** We manufacture the only commercially available rotary isobaric energy recovery device, which we believe is more effective at recovering and recycling energy than any other commercially available energy recovery device. The PX device incorporates highly-engineered corrosion resistant ceramic parts that require minimal maintenance, and a modular design that allows for system redundancy resulting in minimal plant shutdowns. Our rotary device has only one moving part and a continuous flow design, which complements the continuous flow of the SWRO process. We believe these unique benefits lead to lower life cycle costs than competing products.

- ***Leading position in a rapidly growing industry.*** The combination of decreasing fresh water supplies, increasing fresh water demand and declining SWRO desalination costs is driving growth in the SWRO desalination industry. We believe we are the largest global supplier of energy recovery devices for SWRO, the fastest growing segment of the desalination market. For example, in the last five years we believe that our PX product was selected for a significant majority of new SWRO plants commissioned in China, one of the fastest growing desalination markets.

- ***Rapid growth.*** Our net revenue increased from $4.0 million in 2003 to $35.4 million in 2007, representing a compound annual growth rate of 72%, driven by the rapid growth of the SWRO desalination industry and our increased penetration of this market. Our sales growth has enabled us to leverage our existing manufacturing cost base in order to achieve cost synergies and improved utilization, and to develop new products to provide additional cost and performance advantages.

- ***High barriers to entry.*** Historically, there has been a slow adoption rate for new technologies in the desalination industry. We have spent the last 11 years penetrating the market and establishing our company and products with major industry participants. We also have U.S. and international patents covering specific design features of the PX device, and have developed significant know-how related to ceramic processing methods essential to the manufacturing, reliability and performance of the PX device.

- ***Diversified international blue chip customer base.*** Currently, most of our revenue is generated by sales to large EPCs. As of December 31, 2007, we were specified in plant designs by over 60 OEMs and EPCs worldwide and have sold PX devices to approximately 250 other customers, including small and mid-tier OEMs, hotel operators, power plants and municipalities.

- ***Strong, experienced management team.*** Our senior management team has significant industry experience in the design, construction and operation of SWRO desalination plants and the filtration industry. Our chief executive officer, G.G. Pique, joined us in 2000 after serving for seven years as the group vice president Latin America of US Filter Corporation (subsequently acquired by Vivendi) and has over 30 years of experience in the water treatment industry.

Our Strategy

- ***Increase market penetration.*** We actively work with EPCs and OEMs to specify the PX device in the designs of their SWRO desalination plants. To further our market penetration, we are also expanding our existing sales channels through new strategic hires and by increasing our product offerings, and are continuing to increase the awareness of our technology through technical papers, trade shows, industry publications and trade association memberships.

- ***Continue to broaden our product portfolio.*** We are developing new products that we expect will continue to grow our market share and meet the increasing demands of our clients. As the SWRO market moves towards increasingly larger desalination plants, we are developing products such as the PX-1200 Titan, which are designed to address these larger volume plants. For customers who are more sensitive to up-front costs and who operate smaller plants, we are developing the Comp PX. We also intend to expand our product portfolio to include additional circulation/booster pumps and a bundled, turnkey energy recovery system solution that would include both a PX device and pump.

- ***Increase our aftermarket sales.*** Over time, components of our PX device will need to be repaired or replaced. Thus, as our installed base of PX devices ages and the number of installed units increases, we expect aftermarket sales of replacement PX parts and services to increase.

- ***Capitalize on growth opportunities in alternative power and other emerging sectors.*** We are diversifying our energy recovery offerings to capitalize on growth opportunities in emerging sectors. For example, osmotic power generation will utilize a process similar to that of SWRO and is a clean, alternate source of power currently under development. We are currently in discussions with a European utility company that is designing an osmotic power pilot test facility that may use our PX technology. In addition, our PX device could potentially be applied in any process that has a high-pressure waste stream.

Risk Factors

You should carefully consider the risks described under “Risk Factors” and elsewhere in this prospectus. These risks could materially and adversely impact our business, financial condition, operating results and cash flow, which could cause the trading price of our common stock to decline and could result in a partial or total loss of your investment. Some of these risks include:

Table of Contents

- Our reliance on the sale of our PX devices for almost all of our revenue;
- Delays or postponements in the construction of desalination plants;
- Fluctuations in demand, adoption, sales cycles and pricing levels for our products and services;
- Changes in customers' budgets for desalination plants and the timing of their purchasing decisions; and
- Our ability to develop and introduce in a timely manner new products and product enhancements that meet customer demand and requirements.

THE OFFERING

Common stock offered by ERI	shares
Common stock offered by the selling stockholders	shares
Common stock to be outstanding after this offering	shares
Use of proceeds by us	We intend to use the net proceeds to us of $ million from this offering for working capital and other general corporate purposes. We may also use a portion of the net proceeds to acquire other businesses, products or technologies. However, we do not have agreements or commitments for any specific acquisitions at this time.
Risk factors	You should read the "Risk Factors" section of this prospectus for a discussion of factors that you should consider carefully before deciding to invest in shares of our common stock.
Proposed NASDAQ Global Market symbol	ERII

The number of shares of our common stock to be outstanding after this offering is based on 39,777,446 shares of our common stock outstanding as of December 31, 2007, and excludes:

- 1,280,608 shares of common stock issuable upon exercise of options outstanding as of December 31, 2007, at a weighted average exercise price of $2.38 per share;
- 2,074,122 shares of common stock issuable upon the exercise of warrants outstanding as of December 31, 2007, at a weighted average exercise price of $0.52 per share;
- 56,879 shares of common stock that have been exercised pursuant to options but not yet vested as of December 31, 2007;
- 5,625 shares of common stock reserved as of December 31, 2007 for future grant under our 2002 Stock Option/Stock Issuance Plan;
- 8,709 shares of common stock reserved as of December 31, 2007 for future grant under our 2004 Stock Option/Stock Issuance Plan;
- 39,017 shares of common stock reserved as of December 31, 2007 for future grant under our 2006 Stock Option/Stock Issuance Plan; and
- 1,000,000 shares of common stock reserved for future issuance under our 2008 Equity Incentive Plan which will become effective immediately prior to the effectiveness of this offering.

Unless otherwise indicated, this prospectus reflects and assumes the following:

- the filing of our amended and restated certificate of incorporation immediately prior to the completion of this offering; and
- no exercise by the underwriters of their option to purchase additional shares.

SUMMARY CONSOLIDATED FINANCIAL DATA

The following tables summarize the consolidated financial data for our business. You should read this summary consolidated financial data in conjunction with the sections titled "Selected Consolidated Financial Data" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements and related notes, all included elsewhere in this prospectus. The summary financial data in this section is not intended to replace the consolidated financial statements and is qualified in its entirety by the consolidated financial statements and related notes included in this prospectus. The summary consolidated statements of operations data for each of the three years in the periods ended December 31, 2007, 2006 and 2005 is derived from our audited consolidated financial statements and related notes included elsewhere in this prospectus. Our historical results are not necessarily indicative of the results that should be expected in the future.

	Years ended December 31,		
	2007(1)	2006(1)	2005
	(in thousands, except per share data)		
Consolidated Statement of Operations Data:			
Net revenue	$ 35,414	$ 20,058	$ 10,689
Cost of revenue(2)	14,852	8,131	4,685
Gross profit	20,562	11,927	6,004
Operating expenses:			
Sales and marketing(2)	5,230	3,648	1,779
General and administrative(2)	4,299	3,372	2,458
Research and development(2)	1,705	1,267	630
Total operating expenses	11,234	8,287	4,867
Income from operations	9,328	3,640	1,137
Other income (expense):			
Interest expense	(105)	(77)	(216)
Interest and other income	517	58	35
Income before provision for income taxes	9,740	3,621	956
Provision for income taxes	3,947	1,239	62
Net income	$ 5,793	$ 2,382	$ 894
Earnings per share—basic	$ 0.15	$ 0.06	$ 0.02
Earnings per share—diluted	$ 0.14	$ 0.06	$ 0.02
Number of shares used in per share calculations:			
Basic	39,060	38,018	36,790
Diluted	41,433	40,244	38,454

	As of December 31, 2007	
	Actual	As Adjusted(3)
	(in thousands)	
Consolidated Balance Sheet Data:		
Cash, cash equivalents and short-term investments	$ 240	
Total assets	27,304	
Long-term liabilities	620	
Total liabilities	7,243	
Total stockholders' equity	20,061	

Table of Contents

(1) Effective January 1, 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123(R), using the prospective transition method, which requires the application of the provisions of SFAS 123(R) only to share-based payment awards granted, modified, repurchased or cancelled on or after the modification date. Under this method, we recognize stock-based compensation expense for all share-based payment awards granted after December 31, 2005 in accordance with SFAS 123(R).

(2) Includes employee and non-employee stock-based compensation as follows:

	Years ended December 31,		
	2007	2006	2005
		(in thousands)	
Cost of revenue	$ 117	$ 143	$ 88
Sales and marketing	372	310	86
General and administrative	388	428	731
Research and development	159	183	98
Total stock-based compensation	$ 1,036	$ 1,064	$ 1,003

(3) As adjusted to reflect the issuance of shares of common stock in this offering at an assumed initial public offering price of $ per share, which is the mid-point of the price range listed on the cover page of this prospectus. Each $1.00 increase or decrease in the assumed initial public offering price of $ per share would increase or decrease, as applicable, the amount of cash, cash equivalents and short-term investments, total assets and total stockholders' equity by approximately $ million, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same and after deducting the underwriting discounts and commissions and estimated offering expenses payable by us.

RISK FACTORS

Investing in our common stock involves a high degree of risk. You should carefully consider the risks and uncertainties described below before making a decision to buy our common stock. If any of the following risks materializes, our business, financial condition and results of operations could be harmed. Consequently, the trading price of our common stock could decline, and you may lose all or part of your investment. Before deciding to purchase any shares of our common stock, you should also refer to the other information contained in this prospectus, including "Forward-Looking Statements" and our consolidated financial statements and the related notes.

Risks Related to Our Business and Industry

We have relied and expect to continue to rely on sales of our PX devices for almost all of our revenue and a decline in sales of these products will cause our revenue to decline.

Our primary product is the PX device, and sales of our PX device historically have accounted for almost 100% of our revenue. While we sell a variety of models of the PX device depending on the design of the desalination plant and its desired output, all of our models rely on the same basic technology we have developed over the past 11 years. We expect that the revenue from our PX devices will continue to account for most of our revenue for the foreseeable future. Any factors adversely affecting the demand for the PX device, including competition, customer spending and industry regulations, would cause a significant decline in our revenue. Some of the factors that may affect sales of our PX device may be out of our control.

We depend on the construction of new desalination plants for revenue, and as a result, our operating results have experienced, and may continue to experience, significant variability due to volatility in capital spending and other factors affecting the water desalination industry.

The demand for our products may decrease if the construction of desalination plants declines. We derive substantially all of our revenue from the sale of products and services, directly or indirectly, to the municipal water supply, hotel and resort, and agricultural industries. Construction of desalination plants and subsequent installation of our products may be deferred or cancelled as a result of many factors, including changing governmental regulations, energy costs and reduced energy conservation capital spending. For instance, desalination projects on islands are often delayed due to unpredictable weather patterns. In addition, a significant amount of revenue generated by our original equipment manufacturer, or OEM, customers is dependent on long-term relationships, which are not always supported by long-term contracts. This revenue is particularly susceptible to variability based on changes in the spending patterns of such OEM customers. We have experienced and may in the future experience significant variability in our revenue, on both an annual and a quarterly basis, as a result of these factors. Pronounced variability or an extended period of reduction in spending by our customers and construction of desalination plants could negatively impact our business and make it difficult for us to accurately forecast our future sales, which could lead to increased spending by us that is not matched with equivalent or higher revenue.

New planned sea water reverse osmosis, or SWRO, projects can be cancelled and/or delayed, and cancellations and/or delays may negatively impact our revenue.

Due to delays in, or failure to obtain the approval of or permitting for, plant construction because of political factors, adverse financing conditions or other factors, especially in countries with political unrest, planned SWRO projects can be cancelled or delayed. Even though we may have a signed contract to produce a certain number of PX devices by a certain date, if a customer requests a delay of shipment and we accordingly delay shipment of our PX devices, our results of operations and revenue will be negatively impacted.

We rely on a limited number of engineering, procurement and construction, or EPC, customers for a large portion of our revenue. If our EPC customers cancel their commitments or do not purchase our products in connection with future projects, our revenue could significantly decrease, which would adversely affect our financial condition and future growth.

A limited number of our EPC customers accounts for a substantial portion of our net revenue. In 2007, three EPC customers, including their affiliated entities, accounted for 56% of our net revenue, and in 2006, two EPC customers, including their affiliated entities, accounted for 29% of our net revenue. Specifically, Acciona Water, Geida and its affiliated entities and Doosan Heavy Industries represented approximately 20%, 23% and 13% of our net revenue in 2007, respectively, and GE Ionics and Geida and its affiliated entities accounted for approximately 18% and 11% of our net revenue in 2006, respectively. We do not have long-term contracts with our EPC customers and instead sell to them on a

purchase order basis or under individual stand alone contracts. If our EPC customers reduce their purchases, our projected revenue will significantly decrease, which will adversely affect our financial condition and future growth. If one of our EPC customers delays or cancels one or more of its projects or if it fails to pay amounts due to us or delays its payments, our revenue or operating results could be negatively affected. There is a limited number of EPCs who are involved in the desalination industry. Thus, if one of our EPC customers decides not to continue to use our energy recovery devices in its future projects, we may not be able replace such a lost customer with another EPC customer and our net revenue would be negatively affected.

Our operating results may fluctuate significantly, which makes our future operating results difficult to predict and could cause our operating results to fall below expectations or our guidance.

Our operating results may fluctuate due to a variety of factors, many of which are outside of our control. Due to the fact that a single order for our PX devices for a particular desalination plant may represent significant revenue, we have experienced significant fluctuations in revenue from quarter to quarter, and we expect such fluctuations to continue. As a result, comparing our operating results on a period-to-period basis may not be meaningful. You should not rely on our past results as an indication of our future performance. If our revenue or operating results fall below the expectations of investors or securities analysts or below any guidance we may provide to the market, the price of our common stock would likely decline substantially.

In addition, factors that may affect our operating results include, among others:

- fluctuations in demand, adoption, sales cycles and pricing levels for our products and services;
- the cyclical nature of SWRO plant construction, which typically reflects a seasonal increase in shipments of PX devices in the fourth quarter;
- changes in customers' budgets for desalination plants and the timing of their purchasing decisions;
- delays or postponements in the construction of desalination plants;
- our ability to develop, introduce and ship in a timely manner new products and product enhancements that meet customer demand, certification requirements and technical requirements;
- the ability of our customers to obtain other key components of a plant such as high pressure pumps or membranes;
- our ability to implement scalable internal systems for reporting, order processing, product delivery, purchasing, billing and general accounting, among other functions;
- unpredictability of governmental regulations and political decision-making as to the approval or building of a desalination plant;
- our ability to control costs, including our operating expenses;
- our ability to purchase key PX components, principally ceramics, from third party suppliers;
- our ability to compete against other companies that offer energy recovery solutions;
- our ability to attract and retain highly skilled employees, particularly those with relevant industry experience; and
- general economic conditions in our domestic and international markets.

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

Our customer contracts generally contain holdback provisions pursuant to which the final installments to be paid under such sales contracts are due up to 24 months after the product has been shipped to the customer and revenue has been recognized. Typically, between 10 and 20 percent, and in some instances up to 30 percent, of the revenue we receive pursuant to our customer contracts are subject to such holdback provisions and are accounted for as unbilled receivables until we deliver invoices for payment. As of December 31, 2007, we had approximately $1.7 million of current unbilled receivables and approximately $2.3 million of non-current unbilled receivables. If we are unable to invoice and collect, or if our customers fail to make payments due under our sales contracts, our results of operations will be adversely affected.

If we lose key personnel upon whom we are dependent, we may not be able to execute our strategies. Our ability to increase our revenue will depend on hiring highly skilled professionals with industry-specific experience, particularly given the unique and complex nature of our devices.

Given the specialized nature of our business, we must hire highly skilled professionals with industry-specific experience. Our ability to successfully grow depends on recruiting skilled and experienced employees. We often compete with larger, better known companies for talented employees. Also, retention of key employees, such as our chief executive officer, who has over 30 years of experience in the water treatment industry, is vital to the successful execution of our growth strategies. Our failure to retain existing or attract future key personnel could harm our business.

The success of our business depends in part on our ability to develop new products and services and increase the functionality of our current products.

Since 2004, we have invested over $3 million in research and development costs associated with our PX products. From time to time, our customers have expressed a need for greater processing efficiency. In response, and as part of our strategy to enhance our energy recovery solutions and grow our business, we plan to continue to make substantial investments in the research and development of new technologies. For instance, we are in the process of developing the PX-1200 Titan as a product for use in increasingly larger desalination plants. While this product has the potential to provide greater capacity, it will be priced higher and may not perform as well as our other PX devices. It is possible that potential customers may not accept the new pricing structure. It is also possible that the release of this product may be delayed if testing reveals unexpected flaws. Our future success will depend in part on our ability to continue to design and manufacture new products, to enhance our existing products and to provide new value-added services. We may experience unforeseen problems in the performance of our existing and new technologies or products. Furthermore, we may not achieve market acceptance of our new products and solutions. If we are unable to develop competitive new products, or if the market does not accept such products, our business and results of operations will be adversely affected.

Our revenue and growth model depend upon the continued viability and growth of the SWRO industry using current technology.

If there is a downturn in the SWRO industry, our sales would be directly and adversely impacted. In addition, changes in SWRO technology could reduce the demand for our devices. For example, a reduction in the operating pressure used in SWRO plants could reduce the need for and viability of our energy recovery devices. Membrane manufacturers are actively working on lower pressure membranes for SWRO that could potentially be used on a large scale to desalinate sea water at a much lower pressure than is currently necessary. Similarly, an increase in the recovery rate would reduce the number of energy recovery devices required and would reduce the demand for our product. Any of these changes would adversely impact our revenue and growth.

The durable nature of the PX device may reduce potential aftermarket revenue opportunities.

Our PX devices utilize ceramic components that have to date demonstrated high durability, high corrosion resistance and long life in SWRO applications. Because most of our PX devices have only been installed for several years, it is difficult to accurately predict their performance or endurance over a longer period of time. Accordingly, our value proposition to customers may not be fulfilled and our opportunity to sell replacement components or units may be limited.

Our sales cycle can be long and unpredictable, and our sales efforts require considerable time and expense. As a result, our sales are difficult to predict and may vary substantially from quarter to quarter, which may cause our operating results to fluctuate.

Our sales efforts involve substantial education of our current and prospective customers about the use and benefits of our PX products. This education process can be extremely time consuming and typically involves a significant product evaluation process. While the sales cycle for our OEM customers, who are involved with smaller desalination plants, averages one to three months, the average sales cycle for our international EPC customers, who are involved with larger desalination plants, ranges from six to 16 months and has, in some cases, extended up to 24 months. Most of our EPC customers are located internationally or are themselves governmental entities. In addition, these customers generally must make a significant commitment of resources to test and evaluate our technologies. As a result, our sales process involving these customers is often subject to delays associated with lengthy approval processes that typically accompany the design, testing and adoption of new, technologically complex products. This long sales cycle makes quarter-by-quarter revenue predictions difficult and results in our investing significant resources well in advance of orders for our products.

Since a significant portion of our annual sales typically occurs during the fourth quarter, any delays could affect our annual revenue and operating results.

A significant portion of our annual sales typically occurs during the fourth quarter, which we believe generally reflects EPC customer buying patterns. Any delays or cancellation of expected sales during the fourth quarter would reduce our quarterly and annual revenue from what we anticipated. Such a reduction might cause our quarterly and annual revenue or quarterly and annual operating results to fall below the expectations of investors or securities analysts or below any guidance we may provide to the market, causing the price of our common stock to decline.

We depend on three vendors for our supply of ceramics, which is a key component of our products. If any of our ceramics vendors cancels its commitments or is unable to meet our demand and/or requirements, our business could be harmed.

We rely on a limited number of vendors to produce the ceramics used in our products. For the years ended December 31, 2007, 2006 and 2005, our three ceramics suppliers represented approximately 66%, 71% and 62%, respectively, of our total purchases. From time to time our demand has grown faster than the supply capabilities of these vendors. If any of our suppliers were to cancel or materially change its commitment with us or fail to meet the quality or delivery requirements needed to satisfy customer orders for our products, we could lose customer orders, be unable to develop or sell our products cost-effectively or on a timely basis, if at all, and have significantly decreased revenue, which would harm our business, operating results and financial condition. We are currently in the process of qualifying a fourth supplier of ceramics. However, our qualification process is rigorous and there is no assurance that such additional supplier will be approved as a qualifying supplier. If we are unable to qualify this additional supplier, we may be exposed to increased risk of supply chain disruption and capacity shortages.

We depend on a single supplier for our supply of stainless steel castings. If our supplier is not able to meet our demand and/or requirements, it could harm our business.

We rely on a single foundry to produce all of our stainless steel castings for use in our PX products. Our reliance on a single manufacturer of stainless steel castings involves a number of significant risks, including reduced control over delivery schedules, quality assurance, manufacturing yields, production costs and lack of guaranteed production capacity or product supply. We do not have a long term supply agreement with our supplier and instead secure manufacturing availability on a purchase order basis. Our supplier has no obligation to supply products to us for any specific period, in any specific quantity or at any specific price, except as set forth in a particular purchase order. Our requirements represent a small portion of the total production capacities of our supplier and our supplier may reallocate capacity to other customers, even during periods of high demand for our products. We have in the past experienced and may in the future experience quality control issues and delivery delays with our supplier due to factors such as high industry demand or the inability of our vendor to consistently meet our quality or delivery requirements. If our supplier were to cancel or materially change its commitment with us or fail to meet the quality or delivery requirements needed to satisfy customer orders for our products, we could lose time-sensitive customer orders, be unable to develop or sell our products cost-effectively or on a timely basis, if at all, and have significantly decreased revenue, which would harm our business, operating results and financial condition. We may qualify additional suppliers in the future which would require time and resources. If we do not qualify additional suppliers, we may be exposed to increased risk of capacity shortages due to our complete dependence on our current supplier.

We face competition from a number of companies that offers competing energy recovery solutions. If any of these companies produces superior technology or offers more cost effective products, our competitive position in the market could be harmed and our profits may decline.

The market for energy recovery devices for desalination plants is competitive and continually evolving. The PX device competes with slow cycle isobarics, Pelton wheels and hydraulic turbochargers. Our three primary competitors are Calder AG, Fluid Equipment Development Company and Pump Engineering Incorporated. We expect competition to persist and intensify as the desalination market opportunity grows. Many of our current and potential competitors may have significantly greater financial, technical, marketing and other resources than we do and may be able to devote greater resources to the development, promotion, sale and support of their products. Also, our competitors may have more extensive customer bases and broader customer relationships than we do, including long-standing relationships or exclusive contracts with our current or potential customers. For instance, we have had difficulties penetrating some of the Caribbean markets because Consolidated Water Co. Ltd., a major builder of SWRO desalination plants in that area, has an exclusive license with Calder AG to use Calder's technology. In addition, these companies may have longer operating histories and greater name recognition than we do. Our competitors may be in a stronger position to respond quickly to new technologies and may be able to market and sell their products more effectively. Moreover, if one or more of our competitors were to merge

or partner with another of our competitors or with current or potential customers, the change in the competitive landscape could adversely affect our ability to compete effectively.

We are subject to risks related to product defects, which could lead to warranty claims in excess of our warranty provisions or result in a large number of warranty claims in any given year.

We warrant our products for up to five years. We test our products in our manufacturing facilities through a variety of means. However, there can be no assurance that our testing will reveal latent defects in our products, which may not become apparent until after the products have been sold into the market. Accordingly, there is a risk that warranty claims may be filed due to product defects. We may incur additional operating expenses if our warranty provisions do not reflect the actual cost of resolving issues related to defects in our products. If these additional expenses are significant, they could adversely affect our business, financial condition and results of operations. While the number of warranty claims has not been significant to date, we are in the initial stages of offering such warranties to our customers. Accordingly, we cannot quantify the error rate of our products and cannot assure that a large number of warranty claims will not be filed in a given year. As a result, our operating expenses may increase if a large number of warranty claims are filed in any specific year, particularly towards the end of any given warranty period.

If we are unable to protect or enforce our intellectual property rights, our competitive position could be harmed and we could be required to incur significant expenses to enforce our rights.

We depend on our ability to protect our proprietary technology. We rely on trade secrets, patent, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which offer only limited protection. We hold five United States patents and nine counterpart international patents relating to specific proprietary design features of our PX technology. The terms of these patents will begin to expire in 2011, at which time we could become more vulnerable to increased competition. In addition, we have applied for two new United States patents and 14 international counterpart patents covering our current and anticipated future PX designs. We do not hold patents in many of the countries into which we sell our PX devices, including Saudi Arabia, Algeria and China, and accordingly, the protection of our intellectual property in those countries may be limited. We also do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims, and even if patents are issued, they may be contested, circumvented or invalidated. Moreover, while we believe our remaining issued patents are essential to the protection of the PX technology, the rights granted under any of our issued patents or patents that may be issued in the future may not provide us with proprietary protection or competitive advantages, and, as with any technology, competitors may be able to develop similar or superior technologies to our own now or in the future. In addition, our granted patents may not prevent misappropriation of our technology, particularly in foreign countries where intellectual property laws may not protect our proprietary rights as fully as those in the United States. This may render our patents impaired or useless and ultimately expose us to currently unanticipated competition. Protecting against the unauthorized use of our products, trademarks and other proprietary rights is expensive, difficult and, in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual property rights or to determine the validity and scope of the proprietary rights of others. This litigation could result in substantial costs and diversion of management resources, either of which could harm our business.

Claims by others that we infringe their proprietary rights could harm our business.

Third parties could claim that our technology infringes their proprietary rights. In addition, we may be contacted by third parties suggesting that we obtain a license to certain of their intellectual property rights they may believe we are infringing. We expect that infringement claims against us may increase as the number of products and competitors in our market increases and overlaps occur. In addition, to the extent that we gain greater visibility, we believe that we will face a higher risk of being the subject of intellectual property infringement claims. Any claim of infringement by a third party, even those without merit, could cause us to incur substantial costs defending against the claim, and could distract our management from our business. Furthermore, a party making such a claim, if successful, could secure a judgment that requires us to pay substantial damages. A judgment against us could also include an injunction or other court order that could prevent us from offering our products. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms, or at all. Alternatively, we may be required to develop non-infringing technology, which could require significant effort and expense and may ultimately not be successful. Any of these events could seriously harm our business. Third parties may also assert infringement claims against our customers and OEMs. Because we generally indemnify our customers and OEMs if our products infringe the proprietary rights of third parties, any such claims would require us to initiate or defend protracted and costly litigation on their behalf, regardless of the merits of these claims. If any of these claims succeeds, we may be forced to pay damages on behalf of our customers and OEMs.

If we fail to expand our manufacturing facilities to meet our future growth, our operating results could be adversely affected.

Our existing manufacturing facilities are capable of meeting current demand and demand for the foreseeable future. However, the future growth of our business depends on our ability to successfully expand our manufacturing, research and development and technical testing facilities. Larger products currently under development will require the design and construction of new manufacturing capacity. We intend to add new facilities or expand existing facilities as the demand for our devices increases. However, we cannot ensure that suitable additional or substitute space will be available to accommodate any such expansion of our operations.

If we need additional capital to fund future growth, it may not be available on favorable terms, or at all.

We have historically relied on outside financing to fund our operations, capital expenditures and expansion. We may require additional capital from equity or debt financing in the future to fund our operations, or respond to competitive pressures or strategic opportunities. We may not be able to secure such additional financing on favorable terms, or at all. The terms of additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer significant dilution in their percentage ownership of our company, and any new securities we issue could have rights, preferences or privileges senior to those of existing or future holders of our common stock, including shares of common stock sold in this offering. If we are unable to obtain necessary financing on terms satisfactory to us, if and when we require it, our ability to grow or support our business and to respond to business challenges could be significantly limited.

If foreign and local governments no longer subsidize or are willing to engage in the construction and maintenance of desalination plants and projects, the demand for our products would decline and adversely affect our business.

Our products are used in SWRO desalination plants which are often times constructed and maintained through government subsidies. The rate of construction of desalination plants depends on each government's willingness and ability to allocate funds for such projects. For instance, some desalination projects in the Middle East and North Africa are funded by budget surpluses driven by high crude oil and natural gas prices. If governments divert funds allocated for such projects to other projects or do not have budget surpluses, the demand for our products could decline and negatively affect our revenue base, which could harm the overall profitability of our business.

In addition, various water management agencies could alter demand for fresh water by investing in water reuse initiatives or limiting the use of water for certain agricultural purposes. Certain uses of water considered to be wasteful could be curtailed, resulting in more available water and less demand for alternative solutions such as desalination.

Our products are highly technical and may contain undetected flaws or defects which could harm our business and our reputation and adversely affect our financial condition.

The manufacture of our products is highly technical, and our products may contain latent defects or flaws. We test our products prior to commercial release and during such testing have discovered and may in the future discover flaws and defects that need to be resolved prior to release. Resolving these flaws and defects can take a significant amount of time and prevent our technical personnel from working on other important tasks. In addition, our products have contained and may in the future contain one or more flaws that were not detected prior to commercial release to our customers. Some flaws in our products may only be discovered after a product has been installed and used by customers. Any flaws or defects discovered in our products after commercial release could result in loss of revenue or delay in revenue recognition, loss of customers and increased service and warranty cost, any of which could adversely affect our business, operating results and financial condition. In addition, we could face claims for product liability, tort or breach of warranty. Our contracts with our customers contain provisions relating to warranty disclaimers and liability limitations, which may not be upheld. Defending a lawsuit, regardless of its merit, is costly and may divert management's attention and adversely affect the market's perception of us and our products. In addition, if our business liability insurance coverage proves inadequate or future coverage is unavailable on acceptable terms or at all, our business, operating results and financial condition could be harmed.

Our international sales and operations subject us to additional risks that may adversely affect our operating results.

Historically, we have derived a significant portion of our revenue from customers whose SWRO facilities utilizing the PX device are outside the United States. Many of such customers' projects are in emerging growth countries with relatively young and unstable market economies and volatile political environments. We also have sales and technical support personnel stationed in Africa, Asia and the Middle East, among other regions, and we expect to continue to add personnel in additional countries. As a result, any governmental changes or reforms or disruptions in the business, regulatory or political

environment in the countries in which we operate or sell our products could have a material adverse effect on our business, financial condition and results of operations.

Sales of our products have to date been denominated principally in U.S. dollars. Over the last several years, the U.S. dollar has weakened against most other currencies. Future increases in the value of the U.S. dollar, if any, would increase the price of our products in the currency of the countries in which our customers are located. This may result in our customers seeking lower-priced suppliers, which could adversely impact our operating results. A larger portion of our international revenue may be denominated in foreign currencies in the future, which would subject us to increased risks associated with fluctuations in foreign exchange rates.

Our international contracts and operations subject us to a variety of additional risks, including:

- political and economic uncertainties;
- reduced protection for intellectual property rights;
- trade barriers and other regulatory or contractual limitations on our ability to sell and service our products in certain foreign markets;
- difficulties in enforcing contracts, beginning operations as scheduled and collecting accounts receivable, especially in emerging markets;
- increased travel, infrastructure and legal compliance costs associated with multiple international locations;
- competing with non-U.S. companies not subject to the U.S. Foreign Corrupt Practices Act; and
- difficulty in attracting, hiring and retaining qualified personnel.

As we continue to expand our business globally, our success will depend, in large part, on our ability to anticipate and effectively manage these and other risks associated with our international operations. Our failure to manage any of these risks successfully could harm our international operations and reduce our international sales, which in turn could adversely affect our business, operating results and financial condition.

If we fail to manage future growth effectively, our business would be harmed.

Future growth in our business, if it occurs, will place significant demands on our management, infrastructure and other resources. To manage any future growth, we will need to hire, integrate and retain highly skilled and motivated employees. We will also need to continue to improve our financial and management controls, reporting and operational systems and procedures. If we do not effectively manage our growth, our business, operating results and financial condition would be adversely affected.

Our failure to achieve or maintain adequate internal control over financial reporting in accordance with U.S. Securities and Exchange Commission, or SEC, rules or prevent or detect material misstatements in our annual or interim consolidated financial statements in the future could materially harm our business and cause our stock price to decline.

As a public company, SEC rules require that we maintain internal control over financial reporting that provides reasonable assurance regarding the reliability of financial reporting and preparation of published financial statements in accordance with generally accepted accounting principles. Accordingly, we will be required to document and test our internal controls and procedures to assess the effectiveness of our internal control over financial reporting. In addition, our independent registered public accounting firm will be required to report on the effectiveness of our internal control over financial reporting. In the future, we may identify material weaknesses and deficiencies which we may not be able to remediate in a timely manner. Material weaknesses may exist when we report on the effectiveness of our internal control over financial reporting for purposes of our attestation required by reporting requirements under the Securities Exchange Act of 1934 after this offering, with our first reporting obligation being in our Annual Report on Form 10-K for the year ending December 31, 2009. If we fail to achieve or maintain effective internal control over financial reporting, we will not be able to conclude that we have maintained effective internal control over financial reporting or our independent registered public accounting firm may not be able to issue an unqualified report on the effectiveness of our internal control over financial reporting. As a result our ability to report our financial results on a timely and accurate basis may be adversely affected and investors may lose confidence in our financial information, which in turn could cause the market price of our common stock to decrease. We may also be required to restate our financial statements from prior periods. In addition, testing and maintaining internal control will require increased management time and resources. Any failure to maintain effective internal control over financial reporting could impair the success of our business and harm our financial results, and you could lose

all or a significant portion of your investment. If we have material weaknesses in our internal control over financial reporting, the accuracy and timing of our financial reporting may be adversely affected.

Changes to financial accounting standards may affect our results of operations and cause us to change our business practices.

We prepare our financial statements to conform with generally accepted accounting principles, or GAAP, in the United States. These accounting principles are subject to interpretation by the SEC and various other bodies. A change in those policies can have a significant effect on our reported results and may affect our reporting of transactions completed before a change is announced. Changes to those rules or the interpretation of our current practices may adversely affect our reported financial results or the way we conduct our business.

We may engage in future acquisitions that could disrupt our business, cause dilution to our stockholders and harm our financial condition and operating results.

In the future, we may acquire companies or assets that we believe may enhance our market position. We may not be able to find suitable acquisition candidates and we may not be able to complete acquisitions on favorable terms, if at all. If we do complete acquisitions, we cannot assure you that they will ultimately strengthen our competitive position or that they will not be viewed negatively by customers, financial markets or investors. In addition, any acquisitions that we make could lead to difficulties in integrating personnel and operations from the acquired businesses and in retaining and motivating key personnel from these businesses. Acquisitions may disrupt our ongoing operations, divert management from day-to-day responsibilities, increase our expenses and harm our operating results or financial condition. Future acquisitions may reduce our cash available for operations and other uses and could result in an increase in amortization expense related to identifiable assets acquired, potentially dilutive issuances of equity securities or the incurrence of debt, any of which could harm our business, operating results and financial condition.

Risks Related to this Offering

We will incur significant increased costs as a result of operating as a public company, and our management will be required to devote substantial time to compliance requirements.

As a public company, we will incur significant legal, accounting and other expenses that we did not incur as a private company. In addition, the Sarbanes-Oxley Act of 2002, or Sarbanes-Oxley, as well as rules subsequently implemented by the SEC and the NASDAQ Global Market, or NASDAQ, have imposed various requirements on public companies, including requiring changes in corporate governance practices. Our management and other personnel will need to devote a substantial amount of time to these compliance requirements. Moreover, these rules and regulations will increase our legal and financial compliance costs and will make some activities more time-consuming and costly. For example, we expect these rules and regulations to make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced policy limits and coverage or incur substantial costs to maintain the same or similar coverage. These rules and regulations could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, our board committees or as executive officers.

The trading price of our common stock may be volatile, and you might not be able to sell your shares at or above the initial public offering price.

There are no directly comparable U.S. companies known to us whose securities are currently being publicly traded in the U.S. stock market. Additionally, our common stock has no prior trading history. Factors affecting the trading price of our common stock will include:

- factors discussed in this risk factors section and elsewhere in this prospectus;
- variations in our operating results;
- announcements of technological innovations, new or enhanced products, or significant agreements by us or by our competitors;
- gain or loss of significant customers;
- recruitment or departure of our key personnel;
- changes in the estimates of our operating results or changes in recommendations by any securities analysts who elect to follow our common stock;

- market conditions in our industry, the industries of our customers and the economy as a whole; and
- adoption or modification of regulations, policies, procedures or programs applicable to our business.

In addition, if the market for stocks of companies in industries related or similar to ours, or the stock market in general, experiences loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business. The trading price of our common stock might also decline as a result of events that affect other companies in our industry even if these events do not directly affect us. Some companies that have had volatile market prices for their securities have had securities class actions filed against them. If a suit were filed against us, regardless of its merits or outcome, it could result in substantial costs and divert management's attention and resources. This could harm our business, operating results and financial condition.

There has been no prior market for our common stock and our stock price may decline after this offering.

Prior to this offering, there has been no public market for shares of our common stock. Although we expect to apply to list our common stock on NASDAQ, an active public trading market for our common stock may not develop or, if it develops, may not be maintained after this offering. Our company and the representatives of the underwriters will negotiate to determine the initial public offering price. The initial public offering price may be higher than the trading price of our common stock following this offering. As a result, you could lose all or part of your investment.

Future sales of shares by our existing stockholders could cause our stock price to decline.

If our existing stockholders sell, or indicate an intention to sell, substantial amounts of our common stock in the public market after the lock-up agreements and other legal restrictions on resale discussed in this prospectus lapse, the trading price of our common stock could decline. See "Shares Eligible for Future Sale" below. Based upon shares outstanding as of , 2008, we will have outstanding a total of shares of common stock upon completion of this offering, an increase of % from the number of shares outstanding prior to this offering. Of these shares, only the shares of common stock sold in this offering will be freely tradeable, without restriction, in the public market. Our underwriters, however, may, in their sole discretion, permit our officers, directors and other current stockholders who are subject to the contractual lock-up to sell shares prior to the expiration of the lock-up agreements.

The lock-up agreements pertaining to this offering will expire 180 days from the date of this prospectus, although those lock-up agreements may be extended under certain circumstances. After the lock-up agreements expire, up to an additional shares of common stock will be eligible for sale in the public market, based upon shares outstanding as of , 2008, of which are held by our directors, executive officers and other affiliates and will be subject to volume limitations under Rule 144 under the Securities Act and various vesting agreements. In addition, as of , 2008, the shares of common stock that are either subject to outstanding warrants or options or reserved for future issuance under our employee benefit plans will become eligible for sale in the public market to the extent permitted by the provisions of various vesting agreements, the lock-up agreements and Rules 144 and 701 under the Securities Act. If these additional shares are sold, or if it is perceived that they will be sold, in the public market, the trading price of our common stock could decline.

If securities or industry analysts do not publish research or publish inaccurate or unfavorable research about us or our business, or publish projections for our business that exceed our actual results, our stock price and trading volume could decline.

The trading market for our common stock may be affected by the research and reports that securities or industry analysts publish about us or our business. We do not currently have, and may never obtain, research coverage by securities and industry analysts. If no securities or industry analysts commence coverage of our company, the trading price for our stock and the trading volume could decline. In the event we obtain securities or industry analyst coverage, if one or more of the analysts who covers us downgrades our stock or publishes inaccurate or unfavorable research about our business, our stock price could decline. In addition, if we obtain analyst coverage, the analysts' projections may have little or no relationship to the results we actually achieve and could cause our stock price to decline if we fail to meet their projections. If one or more of these analysts ceases coverage of our company or fails to publish reports on us regularly our stock price or trading volume could decline.

Insiders will continue to have substantial control over us after this offering and will be able to influence corporate matters.

Upon completion of this offering, our directors and executive officers and their affiliates will beneficially own, in the aggregate, approximately % of our outstanding common stock, assuming no exercise of the underwriters' option to

purchase additional shares, compared to % represented by the shares sold in this offering, assuming no exercise of the underwriters' option to purchase additional shares. As a result, these stockholders will be able to exercise significant influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, such as a merger or other sale of our company or its assets. This concentration of ownership will limit your ability to influence corporate matters and may have the effect of delaying or preventing a third party from acquiring control over us. For more information regarding the ownership of our outstanding stock by our executive officers and directors and their affiliates, please see the section titled "Security Ownership of Certain Beneficial Owners and Management" below.

As a new investor, you will experience substantial dilution as a result of this offering and future equity issuances.

The initial public offering price per share will be substantially higher than the net tangible book value per share of our common stock outstanding prior to this offering. As a result, investors purchasing common stock in this offering will experience immediate dilution of $ per share. In addition, we have issued options and warrants to acquire common stock at prices significantly below the initial public offering price. To the extent outstanding options are ultimately exercised, there will be further dilution to investors in this offering. This dilution is due in large part to the fact that our earlier investors paid substantially less than the initial public offering price when they purchased their shares of our stock. In addition, if the underwriters exercise their option to purchase additional shares, if outstanding warrants to purchase our common stock are exercised or if we issue additional equity securities, you will experience additional dilution.

We will have broad discretion to determine how to use the proceeds raised in this offering, and we may use the proceeds in ways that may not enhance our operating results or the price of our common stock.

We could spend the proceeds from this offering in ways our stockholders may not agree with or that do not yield a favorable return. We intend to use the net proceeds from this offering for general corporate purposes, which may include expansion of our sales and marketing and research and development efforts, capital expenditures, and potential acquisitions of, or investments in, complementary businesses, products and technologies. However, we do not have more specific plans for the net proceeds from this offering and will have broad discretion in how we use the net proceeds of this offering. If we do not invest or apply the proceeds of this offering in ways that improve our operating results, we may fail to achieve expected financial results, which could cause our stock price to decline.

After the completion of this offering, we do not expect to declare any dividends in the foreseeable future.

After the completion of this offering, we do not anticipate declaring any cash dividends to holders of our common stock in the foreseeable future. Consequently, investors must rely on sales of their common stock after price appreciation, which may never occur, as the only way to realize any future gains on their investment. Investors seeking cash dividends should not purchase our common stock.

Anti-takeover provisions in our charter documents and under Delaware law could discourage, delay or prevent a change in control of our company and may affect the trading price of our common stock.

Provisions in our certificate of incorporation and bylaws, as amended and restated upon the closing of this offering, may have the effect of delaying or preventing a change of control or changes in our management. Our amended and restated certificate of incorporation and amended and restated bylaws to become effective upon completion of this offering include provisions that:

- authorize our board of directors to issue, without further action by the stockholders, up to 10,000,000 shares of undesignated preferred stock;
- require that any action to be taken by our stockholders be effected at a duly called annual or special meeting and not by written consent;
- specify that special meetings of our stockholders can be called only by our board of directors, the chairman of the board, the chief executive officer or the president;
- establish an advance notice procedure for stockholder approvals to be brought before an annual meeting of our stockholders, including proposed nominations of persons for election to our board of directors;
- establish that our board of directors is divided into three classes, Class I, Class II and Class III, with each class serving staggered terms;
- provide that our directors may be removed only for cause;

- provide that vacancies on our board of directors may be filled only by a majority of directors then in office, even though less than a quorum;
- specify that no stockholder is permitted to cumulate votes at any election of directors; and
- require a super-majority of votes to amend certain of the above-mentioned provisions.

In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law regulating corporate takeovers. Section 203 generally prohibits us from engaging in a business combination with an interested stockholder subject to certain exceptions.

For information regarding these and other provisions, please see the section titled “Description of Capital Stock” below.

FORWARD-LOOKING STATEMENTS

This prospectus includes forward-looking statements that relate to future events or our future financial performance and involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to differ materially from any future results, levels of activity, performance or achievements expressed or implied by these forward-looking statements. Words such as “believe,” “expect,” “anticipate,” “estimate,” “intend,” “plan,” “likely,” “will,” “would,” “could” and similar expressions or phrases identify these forward-looking statements.

All forward-looking statements involve risks and uncertainties. The occurrence of the events described, and the achievement of the expected results, depend on many events, some or all of which are not predictable or within our control. Actual results may differ materially from expected results.

Factors that may cause actual results to differ from expected results include:

- fluctuations in demand, adoption, sales cycles and pricing levels for our products and services;
- the cyclical nature of SWRO plant construction, which typically reflects a seasonal increase in shipments of PX devices in the fourth quarter;
- changes in customers’ budgets for desalination plants and the timing of their purchasing decisions;
- delays or postponements in the construction of desalination plants;
- our ability to develop, introduce and ship in a timely manner new products and product enhancements that meet customer demand, certification requirements and technical requirements;
- the ability of our customers to obtain other key components of a plant such as high pressure pumps or membranes;
- our ability to implement scalable internal systems for reporting, order processing, product delivery, purchasing, billing and general accounting, among other functions;
- unpredictability of governmental regulations and political decision-making as to the approval or building of a desalination plant;
- our ability to control costs, including our operating expenses;
- our ability to purchase key PX components, principally ceramics, from third party suppliers;
- our ability to compete against companies that offer energy recovery solutions;
- our ability to attract and retain highly skilled employees, particularly those with relevant industry experience; and
- general economic conditions in our domestic and international markets.

See the section above titled “Risk Factors” for a more complete discussion of these risks and uncertainties and for other risks and uncertainties. These factors and the other risk factors described in this prospectus are not necessarily all of the important factors that could cause our actual results to differ materially from those expressed in any of our forward-looking statements. Other unknown or unpredictable factors also could harm our results. Consequently, actual results or developments anticipated by us may not be realized or, even if substantially realized, may not have the expected consequences to, or effects on, us. Given these uncertainties, we caution you not to place undue reliance on such forward-looking statements.

All future written and verbal forward-looking statements attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section. We undertake no obligation to update publicly or revise any forward-looking statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the forward-looking events discussed in this prospectus might not occur.

USE OF PROCEEDS

We estimate that our net proceeds from this offering will be approximately $ million, assuming an initial public offering price of $ per share, which is the midpoint of the range set forth on the cover page of this prospectus, and after deducting underwriting discounts and commissions and estimated offering expenses. Each $1.00 increase or decrease in the assumed initial public offering price of $ per share would increase or decrease, as applicable, the net proceeds to us by approximately $ million, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same and after deducting the underwriting discounts and commissions payable to us. If the underwriters' option to purchase additional shares in this offering is exercised in full, we estimate that our net proceeds will be approximately $ million. We will not receive any proceeds from the sale of shares of our common stock by the selling stockholders.

We intend to use the net proceeds to us from this offering for working capital and other general corporate purposes, including to finance our growth, develop new products and fund capital expenditures. Additionally, we may expand our current business through acquisitions of other businesses, products or technologies. However, we do not have agreements or commitments for any specific acquisitions at this time.

Pending our use of the net proceeds from this offering, we intend to invest the proceeds in short-term, investment-grade interest-bearing instruments.

DIVIDEND POLICY

We have never declared nor paid cash dividends on our common stock. We currently intend to retain all available funds and any future earnings for use in the operation of our business and do not anticipate paying any dividends on our common stock in the foreseeable future. Any future determination to declare dividends will be made at the discretion of our board of directors and will depend on our financial condition, operating results, capital requirements, general business conditions and other factors that our board of directors may deem relevant.

CAPITALIZATION

The following table sets forth our capitalization as of December 31, 2007:

- on an actual basis; and
- on an as adjusted basis to reflect the issuance of shares of common stock in this offering at an assumed initial public offering price of $ per share, which is the mid-point of the price range listed on the cover page of this prospectus.

The information set forth in the table should be read together with the information set forth under "Management's Discussion and Analysis of Financial Condition and Results of Operations," and our consolidated financial statements and accompanying notes, each appearing elsewhere in this prospectus.

	As of December 31, 2007	
	Actual	As Adjusted(1)
	(in thousands, except share data)	
Total debt, including current portion		
Total borrowings	729	
Capital lease obligations	101	
Total debt	$ 830	$
Stockholders' equity (deficit):		
Common stock, par value $0.001 per share; 45,000,000 shares authorized; 39,777,446 shares issued and outstanding, actual; shares authorized and shares issued and outstanding, as adjusted	40	
Additional paid-in capital	20,762	
Notes receivable from stockholders	(835)	
Accumulated other comprehensive loss	(5)	
Retained earnings (accumulated deficit)	99	
Total stockholders' equity	20,061	
Total capitalization	$20,891	$

(1) Each $1.00 increase or decrease in the assumed initial public offering price of $ per share would increase or decrease, as applicable, the amount of additional paid-in capital, total stockholders' equity and total capitalization by approximately $ million, assuming the number of shares offered by us, as set forth on the cover page of this prospectus, remains the same and after deducting the underwriting discounts and commissions and estimated offering expenses payable by us.

The share information set forth in the table above is based on 39,777,446 shares of common stock outstanding as of December 31, 2007, and excludes:

- 1,280,608 shares of common stock issuable upon exercise of options outstanding as of December 31, 2007, at a weighted average exercise price of $2.38 per share;
- 2,074,122 shares of common stock issuable upon the exercise of warrants outstanding as of December 31, 2007, at a weighted average exercise price of $0.52 per share;
- 56,879 shares of common stock that have been exercised pursuant to options but not yet vested as of December 31, 2007.
- 5,625 shares of common stock reserved as of December 31, 2007 for future issuance under our 2002 Stock Option/Issuance Plan;

- 8,709 shares of common stock reserved as of December 31, 2007 for future issuance under our 2004 Stock Option/Issuance Plan;
- 39,017 shares of common stock reserved as of December 31, 2007 for future issuance under our 2006 Stock Option/Issuance Plan; and
- 1,000,000 shares of common stock reserved for future issuance under our new 2008 Equity Incentive Plan, which will become effective immediately prior to the effectiveness of the completion of this offering.

Table of Contents

DILUTION

Our net tangible book value as of December 31, 2007 was $19.7 million, or approximately $0.50 per share. Net tangible book value per share represents the amount of total tangible assets, less our total liabilities, divided by 39,777,446 shares of common stock outstanding.

Net tangible book value dilution per share to new investors represents the difference between the amount per share paid by purchasers of shares of common stock in this offering and the as adjusted net tangible book value per share of common stock immediately after completion of this offering. After giving effect to our sale of shares of common stock in this offering at an assumed initial public offering price of $ per share, which is the midpoint of the range listed on the cover page of this prospectus, and after deducting the underwriting discounts and commissions and estimated offering expenses, our net tangible book value as of December 31, 2007 would have been $ million, or $ per share. This represents an immediate increase in net tangible book value of $ per share to existing stockholders and an immediate decrease in net tangible book value of $ per share to purchasers of common stock in this offering, as illustrated in the following table:

Assumed initial public offering price per share		$
Net tangible book value per share as of December 31, 2007	$ 0.50	
Increase in net tangible book value per share attributable to new investors		
As adjusted net tangible book value per share after this offering		
Decrease in as adjusted net tangible book value per share to new investors in this offering		$

A $1.00 increase or decrease in the assumed initial public offering price of $ would increase or decrease, as applicable, our as adjusted net tangible book value per share after this offering by $ per share and the decrease in as adjusted net tangible book value per share to new investors in this offering by $ per share, assuming the number of shares offered by us, as set forth on the cover of this prospectus, remains the same and after deducting the estimated underwriting discounts and commissions and offering expenses payable by us.

If the underwriters exercise their option to purchase additional shares of our common stock in full in this offering, the net tangible book value per share after this offering would be $ per share, the increase in net tangible book value per share to existing stockholders would be $ per share and the decrease in net tangible book value per share to new investors purchasing shares in this offering would be $ per share.

The following table presents as of December 31, 2007 the differences between the existing stockholders and the purchasers of shares in this offering with respect to the number of shares purchased from us, the total consideration paid and the average price paid per share:

	Shares Purchased		Total Consideration		Average Price
	Number	Percent	Amount	Percent	Per Share
Existing stockholders		%	$	%	$
New investors					
Total		100.0%		100.0%	

The above discussion and tables assume no exercise of 1,280,608 shares of common stock issuable upon the exercise of stock options outstanding as of December 31, 2007 with a weighted average exercise price of $2.38 per share and 2,074,122 shares of common stock issuable upon the exercise of warrants outstanding as of December 31, 2007 with a weighted average exercise price of $0.52 per share. If all of these options and warrants were exercised, new investors ownership would be diluted by approximately 1% and total consideration would increase by approximately $4.1 million. In addition, if all these options and warrants were exercised, then as adjusted net tangible book value per share would increase from $ to $, resulting in a reduction in the decrease in as adjusted net tangible book value per share to new investors in this offering of $ per share.

SELECTED CONSOLIDATED FINANCIAL DATA

You should read the following selected consolidated historical financial data below in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements, related notes and other financial information included in this prospectus. The selected financial data in this section is not intended to replace the consolidated financial statements and is qualified in its entirety by the consolidated financial statements and related notes included in this prospectus.

The selected consolidated statements of operations data for each of the three years in the periods ended December 31, 2007, 2006 and 2005 and the consolidated balance sheet data as of December 31, 2007 and 2006 are derived from our audited consolidated financial statements and related notes included elsewhere in this prospectus, and the selected consolidated statements of operations data for each of the two years ended December 31, 2004 and 2003 and the consolidated balance sheet data as of December 31, 2005, 2004 and 2003 are derived from our audited consolidated financial statements and related notes not included in this prospectus. Our historical results are not necessarily indicative of the results that should be expected in the future.

	Years ended December 31,				
	2007(1)	2006(1)	2005	2004	2003
	(in thousands except per share data)				
Consolidated Statement of Operations Data:					
Net revenue	$ 35,414	$ 20,058	$ 10,689	$ 4,047	$ 4,045
Cost of revenue(2)	14,852	8,131	4,685	2,015	2,012
Gross profit	20,562	11,927	6,004	2,032	2,033
Operating expenses:					
Sales and marketing(2)	5,230	3,648	1,779	1,037	915
General and administrative(2)	4,299	3,372	2,458	1,055	892
Research and development(2)	1,705	1,267	630	340	25
Total operating expenses	11,234	8,287	4,867	2,432	1,832
Income from operations	9,328	3,640	1,137	(400)	201
Other income (expense):					
Interest expense	(105)	(77)	(216)	(54)	(38)
Interest and other income	517	58	35	1	—
Income before provision for income taxes	9,740	3,621	956	(453)	163
Provision for income taxes	3,947	1,239	62	53	(11)
Net income (loss)	$ 5,793	$ 2,382	$ 894	$ (506)	$ 174
Earnings per share-basic	$ 0.15	$ 0.06	$ 0.02	$ (0.02)	$ 0.01
Earnings per share-diluted	$ 0.14	$ 0.06	$ 0.02	$ (0.02)	$ 0.01
Number of shares used in per share calculations:					
Basic	39,060	38,018	36,790	32,161	30,279
Diluted	41,433	40,244	38,454	32,161	32,936

	As of December 31,				
	2007	2006	2005	2004	2003
			(in thousands)		
Consolidated Balance Sheet Data:					
Cash, cash equivalents and short-term investments	$ 240	$ 42	$ 261	$ 140	$ 251
Total assets	27,304	13,539	8,496	3,054	2,445
Long-term liabilities	620	234	306	11	32
Total liabilities	7,243	5,412	3,795	2,061	1,210
Total stockholders' equity	20,061	8,127	4,701	993	1,235

(1) Effective January 1, 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123(R), using the prospective transition method, which requires the application of the provisions of SFAS 123(R) only to share-based payment awards granted, modified, repurchased or cancelled on or after the modification date. Under this method, we recognize stock-based compensation expense for all share-based payment awards granted after December 31, 2005 in accordance with SFAS 123(R).

(2) Includes employee and non-employee stock-based compensation as follows:

	Years ended December 31,				
	2007	2006	2005	2004(3)	2003(3)
			(in thousands)		
Cost of revenue	$ 117	$ 143	$ 88	—	—
Sales and marketing	372	310	86	—	—
General and administrative	388	428	731	—	—
Research and development	159	183	98	—	—
Total stock-based compensation	$ 1,036	$ 1,064	$ 1,003	—	—

(3) No stock-based compensation expense was recognized as we used the intrinsic method of accounting and the options were granted with an exercise price equal to the fair market value.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this prospectus. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those discussed below. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled "Risk Factors" included elsewhere in this prospectus.

Overview

We were founded in 1992 and are in the business of designing, developing and manufacturing energy recovery devices for sea water reverse osmosis, or SWRO, desalination plants. In early 1997, we introduced the initial version of our energy recovery device, the PX. In November 1997, we introduced and marketed our first ceramic-based PX device. As of December 31, 2007, we had shipped over 4,000 PX devices to desalination plants worldwide, including in China, Europe, India, Australia, Africa, the Middle East, North America and the Caribbean.

A majority of our net revenue has been generated by sales to large engineering, procurement and construction firms, or EPCs, who are involved with the design and construction of larger desalination plants. Sales to EPCs often involve a long sales cycle, or the time between the initial project tender and the time the PX device is shipped to the client, which can range from six to 16 months. A single EPC desalination project can generate an order for numerous PX devices and generally represents an opportunity for significant revenue. We also sell PX devices to original equipment manufacturers, or OEMs, which commission smaller desalination plants, order fewer PX devices per plant and have shorter sales cycles.

Due to the fact that a single order for PX devices by an EPC for a particular plant may represent significant revenue, we often experience significant fluctuations in net revenue from quarter to quarter. In addition, 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.

In 2007, three customers represented approximately 56% of our net revenue, and in 2006, two customers represented approximately 29% of our net revenue. Specifically, Acciona Water, Geida and its affiliates and Doosan Heavy Industries represented 20%, 23% and 13% of our total sales in 2007, respectively, and GE Ionics and Geida and its affiliates accounted for 18% and 11% of our total sales in 2006, respectively. We do not have long-term contracts with our EPC or our OEM customers and instead sell to them on a purchase order basis or under individual stand alone contracts. Orders may be postponed or delayed by our customers on short or no notice.

In 2007 and 2006, most of our revenue was attributable to sales outside of the United States. We expect sales outside of the United States to remain a significant portion of our revenue for the foreseeable future.

Our revenue is principally derived from the sales of our PX devices. We receive a small amount of revenue from the sale of booster pumps, which we manufacture and sell in connection with PX devices to smaller desalination plants. We also receive incidental revenue from services, such as product support, that we provide to our PX customers.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States, or GAAP. These accounting principles require us to make estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the consolidated financial statements as well as the reported amounts of revenue and expense during the periods presented. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that we make these estimates and judgments. To the extent there are material differences between these estimates and actual results, our consolidated financial results will be affected. The accounting policies that reflect our more significant estimates and judgments and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition, warranty costs, stock-based compensation, inventory valuation, allowances for doubtful accounts and income taxes.

Revenue Recognition

We recognize revenue in accordance with SEC Staff Accounting Bulletin No. 104, *Revenue Recognition*. Revenue is recognized when the earnings process is complete, as evidenced by an agreement with the customer, transfer of title occurs, fixed pricing is determinable and collection is probable. Transfer of title typically occurs upon shipment of the equipment pursuant to a written purchase order or contract. Emerging Issues Task Force No. 00-21, *Revenue Arrangements with Multiple Deliverables* requires us to allocate the purchase price between the device and the value of the undelivered services

by applying the residual value method. Under this method, revenue allocated to undelivered elements is based on vendor-specific objective evidence of fair value of such undelivered elements, and the residual revenue is allocated to the delivered elements. Vendor specific objective evidence of fair value for such undelivered elements is based upon the price we charge for such product or service when it is sold separately. We may modify our pricing practices in the future, which could result in changes to our vendor specific objective evidence of fair value for such undelivered elements. Our purchase agreements typically provide for the provision by us of field services and training for commissioning of a desalination plant. Recognition of the revenue in respect of those services is deferred until provision of those services is complete. The services element of our contracts represent an incidental portion of the total contract price.

Under our revenue recognition policy, evidence of an arrangement has been met when we have an executed purchase order or a standalone contract. Typically, our smaller projects utilize purchase orders that conform to our standard terms and conditions that require the customer to remit payment generally within 30 to 90 days from product delivery. In some cases, if credit worthiness cannot be determined, prepayment is required from the smaller customers.

For our large projects, standalone contracts are utilized. For these contracts, consistent with industry practice, the customers typically require their suppliers, including our company, to accept contractual holdback provisions whereby the final amounts due under the sales contract are remitted over extended periods of time. These retention payments typically range between 10% and 20%, and in some instances up to 30%, of the total contract amount and are due and payable when the customer is satisfied that certain specified product performance criteria have been met upon commissioning of the desalinization plant, which in the case of our PX device may be 12 months to 24 months from the date of product delivery as described further below.

The specified product performance criteria for our PX device generally pertains to the ability of our products to meet our published performance specifications and warranty provisions, which our products have demonstrated on a consistent basis. This factor, combined with our historical performance metrics measured over the past 10 years, provides us with a reasonable basis to conclude that the PX device will perform satisfactorily upon commissioning of the plant. To help ensure this successful product performance, we provide service, consisting principally of supervision of customer personnel, and training to the customers during the commissioning of the plant. The installation of the PX device is relatively simple, requires no customization and is performed by the customer under the supervision of our personnel. We defer the fair value of the service and training component of the contract and recognize such revenue as services are rendered. Based on these factors, we have concluded that delivery and performance have been completed when the product has been delivered (title transfers) to the customer.

We perform an evaluation of credit worthiness on an individual contract basis to assess whether collectibility is reasonably assured. As part of this evaluation, we consider many factors about the individual customer, including the underlying financial strength of the customer and/or partnership consortium and our prior history or industry specific knowledge about the customer and its supplier relationships. To date, we have been able to conclude that collectibility was reasonably assured on our sales contracts at the time the product was delivered and title has transferred; however, to the extent that we conclude that we are unable to determine that collectibility is reasonably assured at the time of product delivery, we will defer all or a portion of the contract amount based on the specific facts and circumstances of the contract and the customer.

Under the stand-alone contracts, the usual payment arrangements are summarized as follows:

- An advance payment, typically 10% to 20% of the total contract amount, is due upon execution of the contract;
- A payment upon delivery of the product, typically in the range of 50% to 70% of the total contract amount, is due on average between 120 and 150 days from product delivery, and in some cases up to 180 days;
- A retention payment, typically in the range of 10% to 20%, and in some cases up to 30%, of the total contract amount is due subsequent to product delivery as described further below.

Under the terms of the retention payment component, we are generally required to issue to the customer a product performance guarantee in the form of a collateralized letter of credit, which is issued to the customer approximately 12 to 24 months after the product delivery date. The letter of credit is collateralized by restricted cash on deposit with our financial institution (see Restricted Cash under "Summary of Significant Accounting Policies"). The letter of credit remains in place for the performance period as specified in the contract, which is generally 24 months and which runs concurrent with our standard product warranty period. Once the letter of credit has been put in place, we invoice the customer for this final retention payment under the sales contract. During the time between the product delivery and the issuance of the letter of credit, the amount of the final retention is classified on the balance sheet as unbilled receivable, of which a portion may be classified as long term to the extent that the billable period extends beyond one year. Once the letter of credit is issued, we

invoice the customer and reclassify the retention amount from unbilled receivable to accounts receivable where it remains until payment, typically 120 to 150 days after invoicing (see Note 3—Balance Sheet Information: Unbilled Receivables).

Shipping and handling charges billed to customers are included in sales. The cost of shipping to customers is included in cost of revenue.

We do not provide our customers with a right to return our products. However, we accept returns of products that are deemed to be damaged or defective when delivered, subject to the provisions of the product warranty. Historically, product returns have not been significant.

We sell our products to EPC companies that are not subject to sales tax. Accordingly, the adoption of EITF Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation)*, does not have an impact on our consolidated financial statements.

Warranty Costs

We sell products with a limited warranty for a period of one to two years. In August 2007, we modified the warranty to offer a five-year term on the ceramic components for new sales agreements executed after August 7, 2007. We accrue for warranty costs based on estimated product failure rates, historical activity and expectations of future costs. We periodically evaluate and adjust the warranty costs to the extent actual warranty costs vary from the original estimates.

We may offer extended warranties on an exception basis and these are accounted for in accordance with Financial Accounting Standards Board Technical Bulletin 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts for Sales of Extended Warranties.*

Stock-Based Compensation

Prior to January 1, 2006, we accounted for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, or APB 25, and FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, an Interpretation of APB Opinion No. 25, or FIN 44, and had adopted the disclosure provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, or SFAS 123, and SFAS No. 148, *Accounting for Share-Based Compensation—Transition and Disclosure*, or SFAS 148.

In February 2005, we offered to each of our employees the option to borrow from us an amount equal to the aggregate exercise price for all of their outstanding options pursuant to full recourse promissory notes at 3.76% interest, which are due in February 2010. The interest rate on the notes was deemed to be below market rate, resulting in a change in the deemed exercise price for the options. As a result, we are accounting for these options as variable option awards. For 2007, 2006 and 2005, we recorded $783,000, $1.1 million and $1.0 million, respectively, of stock-based compensation related to the options exercised with promissory notes. All of our executive officers and directors have subsequently repaid their notes.

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123(R), *Share-Based Payment*, using the prospective transition method, which requires us to apply the provisions of SFAS 123(R) only to awards granted, modified, repurchased or cancelled after the adoption date. Upon adoption of SFAS 123(R), we selected the Black-Scholes option pricing model as the most appropriate method for determining the estimated fair value for stock-based awards. The Black-Scholes model requires the use of highly subjective and complex assumptions to determine the fair value of stock-based awards, including the option's expected term and the price volatility of the underlying stock. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite vesting period on a straight-line basis in our consolidated statements of operations and the expense is reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. For the years ended December 31, 2007 and 2006 we recognized stock-based compensation under SFAS 123(R) of $251,000 and $13,000, respectively.

To determine the inputs for the Black-Scholes option pricing model, we are required to develop several assumptions, which are highly subjective. These assumptions include:

- the length of our options' lives, which is based on anticipated future exercises;
- our common stock's volatility;
- the number of shares of common stock pursuant to which options will ultimately be forfeited;

- the risk-free rate of return; and
- future dividends.

We use comparable public company data to determine volatility, as our common stock has not yet been publicly traded. We use a weighted average calculation to estimate the time our options will be outstanding as prescribed by Staff Accounting Bulletin No. 107, *Share-Based Payment*. We estimate the number of options that are expected to be forfeited based on our historical experience and expected future forfeiture patterns. The risk-free rate is based on the U.S. Treasury yield curve in effect at the time of grant for the estimated life of the option. We use our judgment and expectations in setting future dividend rates, which is currently expected to be zero.

The absence of an active market for our common stock also requires our management and board of directors to estimate the fair value of our common stock for purposes of granting options and for determining stock-based compensation expense. In response to these requirements, our management and board of directors estimate the fair market value of common stock on an annual basis, based on factors such as the price of the most recent common stock sales to investors, the valuations of comparable companies, the status of our development and sales efforts, our cash and working capital amounts, revenue growth and additional objective and subjective factors relating to our business.

The following table shows the stock option grants during 2007:

Grants Made During the Quarter Ended,	Number of Options	Exercise Price
March 31, 2007	—	—
June 30, 2007	69,200	$ 5.00
September 30, 2007	—	—
December 31, 2007	112,700	$ 5.00

In 2007, our board of directors determined that the fair market value of common stock for options granted that year was $5.00 per share. The fair value of the common stock for options granted was estimated by our board of directors with input from management and by reference to our stock price in conjunction with the sale of 1,000,000 shares of our common stock at $5.00 per share in a private placement to third parties in May 2007. In March 2008, we retained an independent valuations firm that prepared the valuation of our common stock for 2007, 2006 and 2005. The valuation firm utilized the discounted cash flow methodology as well as trading multiples of companies based on revenue and cash generation to estimate the value of the options as of each valuation date. The discounted cash flow methodology was used as confirming evidence of the reasonableness of the comparable company trading multiple estimates. The valuation firm's conclusion was that as of June 30, 2007, 2006 and 2005, the fair market value of our common stock was not materially above or below the prices we used to estimate the value of the options during those years.

Based on the estimated initial public offering price of $_____ per share, which is the mid-point of the price range listed on the cover page of this prospectus, the aggregate intrinsic value of options outstanding as of March 31, 2008 was $_____, of which $_____ related to vested options and $_____ related to unvested options.

For options granted during 2007, we determined the fair value at date of grant using the Black-Scholes option pricing model. The following table summarizes the assumptions used in determining the fair value of stock options granted.

	Year Ended December 31, 2007
Risk-free interest rate	3.45%
Expected term	5 years
Dividend yield	0%
Expected volatility	50%

We account for equity instruments issued in exchange for the receipt of goods or services from non-employees in accordance with the consensus reached by the Emerging Issues Task Force, or EITF, in Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. Costs are measured at the fair market value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. The value of equity instruments issued for consideration other than employee services is determined on the earlier of the date on which there first exists a firm commitment for performance by the provider of goods or services or on the date performance is complete, using the Black-Scholes pricing model.

Inventories

Inventories are stated at the lower of cost (using the weighted average cost method) or market. We calculate inventory reserve for excess and obsolete inventories based on estimated future demand of the products and spare parts. Cost of inventory is determined in accordance with Statement of Financial Accounting Standards No. 151, *Inventory Costs*, an amendment of ARB No. 43, Chapter 4, or SFAS 151.

Allowances for Doubtful Accounts

We record a provision for doubtful accounts based on our historical experience and a detailed assessment of the collectability of our accounts receivable. In estimating the allowance for doubtful accounts, our management considers, among other factors, (1) the aging of the accounts receivable, (2) our historical write-offs, (3) the credit worthiness of each customer and (4) general economic conditions. Our allowance for doubtful accounts was $121,000, $230,000 and $150,000 at December 31, 2007, 2006 and 2005, respectively. If we were to experience unanticipated collections issues, it could have an adverse affect on our operating results in future periods.

Income Taxes

We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*, or SFAS 109, issued by the Financial Accounting Standards Board, or FASB. SFAS 109 requires an entity to recognize deferred tax liabilities and assets. Deferred tax assets and liabilities are recognized for the future tax consequence attributable to the difference between the tax bases of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are measured using the enacted tax rate expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that included the enactment date. Valuation allowances are provided if, based upon the available evidence, management believes it is more likely than not that some or all of the deferred assets will not be realized or the use of prior years' net operating losses may be limited.

On July 13, 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109*, or FIN 48. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in any entity's financial statements in accordance with SFAS 109 and prescribes a recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Under FIN 48, the impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more likely than not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Additionally, FIN 48 provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. We adopted the provisions of FIN 48 on January 1, 2007. Measurement under FIN 48 is based on judgment regarding the largest amount that is greater than 50% likely of being realized upon ultimate settlement with a taxing authority. The total amount of unrecognized tax benefits as of the date of adoption was immaterial. As a result of the implementation of FIN 48, there was no change to our tax liability.

We adopted the accounting policy that interest recognized in accordance with Paragraph 15 of FIN 48 and penalty recognized in accordance with Paragraph 16 of FIN 48 are classified as part of income taxes. The amounts of interest and penalty recognized in the statement of operations and statement of financial position for 2007 were insignificant.

Our operations are subject to income and transaction taxes in the United States and in foreign jurisdictions. Significant estimates and judgments are required in determining our worldwide provision for income taxes. Some of these estimates are based on interpretations of existing tax laws or regulations. The ultimate amount of tax liability may be uncertain as a result.

We are subject to taxation in the U.S. and various states and foreign jurisdictions. There are no ongoing examinations by taxing authorities at this time. Our various tax years from 1997 through 2007 remain open in various taxing jurisdictions.

Results of Operations

The following table sets forth certain data from our historical operating results as a percentage of revenue for the years indicated:

	Years ended December 31,		
	2007	2006	2005
Results of Operations (as a % of Net Revenue*):			
Net revenue	100%	100%	100%
Cost of revenue	42	41	44
Gross profit	58	59	56
Operating expenses:			
Sales and marketing	15	18	17
General and administrative	12	17	23
Research and development	5	6	6
Total operating expenses	32	41	46
Income from operations	26	18	11
Other income (expense):			
Interest expense	—	—	(2)
Interest and other income	2	0	0
Income before provision for income taxes	28	18	9
Provision for income taxes	11	6	1
Net income	16%	12%	8%

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

2007 Compared to 2006 and 2005

Net Revenue

Net revenue is reported net of volume discounts. We derive our revenue principally from sales of our PX devices. Our net revenue increased by $15.4 million, or 77%, to $35.4 million in 2007 from $20.1 million in 2006, and by $9.4 million in 2006, or 88%, from $10.7 million in 2005. These increases were principally due to higher sales of our PX-220 device, which resulted primarily from increased market acceptance of the device and the overall growth of the desalination market. Prices were relatively constant for our PX devices in 2007, 2006 and 2005. In 2007, the sales of PX devices accounted for approximately 96% of our revenue increase with pump sales accounting for approximately 4% of the increase. In 2006, the sales of PX devices accounted for approximately 92% of the increase, with pump sales accounting for approximately 4% of the increase and spare parts and services accounting for the remainder of the increase.

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 is reflected in the table below instead of the delivery location.

	Years Ended December 31, (in thousands)		
	2007	2006	2005
Domestic net revenue	$ 2,125	$ 1,003	$ 1,710
International net revenue	33,289	19,055	8,979
Total net revenue	$ 35,414	$ 20,058	$ 10,689
Revenue by country:			
Spain	35%	9%	5%
Saudi Arabia	13	*	*
Algeria	12	30	18
United States	6	5	16
United Arab Emirates	2	10	9
China	8	5	14
Australia	*	9	17
Others	24	32	21
Total	100%	100%	100%

* Less than 1%.

Gross Profit

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including stock-based compensation), manufacturing overhead, warranty costs, capital costs, excess and obsolete inventory expense, and manufactured components. The largest component of our cost of revenue is raw materials, principally ceramic materials, which we obtain from several suppliers. Gross profit, as a percentage of net revenue, remained relatively constant at 58% in 2007 as compared to 59% in 2006 and 56% in 2005. Stock compensation expense included in cost of revenue was $117,000 in 2007, $143,000 in 2006 and $88,000 in 2005.

Sales and Marketing Expense

Sales and marketing expense consists primarily of personnel costs (including stock-based compensation), sales commissions, marketing programs and facilities cost associated with sales and marketing activities. Sales and marketing expense increased by $1.6 million, or 43%, to $5.2 million in 2007 from $3.6 million in 2006, and by $1.9 million in 2006, or 105%, from $1.8 million in 2005. These increases were primarily related to growth in our sales that resulted in higher headcount with sales and marketing employees increasing to seven at December 31, 2007 from six at December 31, 2006 and four at December 31, 2005. In addition, our sales team is compensated in part by commissions, resulting in increased sales expense as our sales levels increase.

As a percentage of our net revenue, sales and marketing expense decreased to 15% in 2007 from 18% in 2006 and 17% in 2005. The decrease in 2007 was attributable principally to the significant increase in our net revenue that year, which grew at a greater rate than our sales and marketing expenses.

With respect to the $1.6 million increase in sales and marketing expenses in 2007, $734,000 of such increase related to compensation and employee related benefits, $259,000 related to consultant fees, $249,000 related to travel and related expenses, $151,000 related to increased occupancy costs and $125,000 related to sales and marketing efforts. From 2005 to 2006, $1.1 million of the $1.9 million increase related to compensation and employee related benefits, while the remaining increase was primarily comprised of $645,000 related to outside marketing costs and $89,000 in increased lease facilities. Stock-based compensation expense included in sales and marketing expense was $372,000 in 2007, $310,000 in 2006 and $86,000 in 2005.

We plan to continue to invest heavily in sales and marketing by increasing the number of our sales personnel and we expect sales and marketing expenses in absolute dollars to increase in future periods. Our sales personnel are not immediately productive and therefore the increase in sales expense that we incur when we add new sales personnel is not immediately offset by increased revenue and may never result in increased revenue. The timing of our hiring of new sales

personnel and the rate at which they generate incremental revenue could therefore affect our future period-to-period financial performance.

General and Administrative Expense

General and administrative expense consists primarily of personnel (including stock-based compensation) and facilities costs related to our executive, finance and human resources organizations, as well as fees for professional services. Professional services consist of fees for outside legal and audit services and preparation for operating as a public company.

General and administrative expense increased by $927,000, or 28%, to $4.3 million in 2007 from $3.4 million in 2006, and by $915,000 in 2006, or 37%, from $2.5 million in 2005. These increases reflected in part the increase in general and administrative employees to 13 at December 31, 2007 from eight at December 31, 2006 and from six at December 31, 2005.

As a percentage of our net revenue, general and administrative expense was 12% in 2007, 17% in 2006 and 23% in 2005. The decrease of general and administrative expense as a percentage of net revenue was attributable principally to the significant increases in our net revenue.

The primary reason for the increase in general and administrative expenses was the growth in our operations that resulted in higher headcount including the recruitment of an officer, renting of additional facility space, increased travel and increased bank fees. With respect to the $927,000 increase in such expenses in 2007, $513,000 related to compensation, employee-related benefits and professional services fees, $139,000 related to bank charges, $46,000 related to office supplies and equipment, $89,000 related to occupancy costs, and $349,000 related to other expenses (general recruiting, patent amortization and travel), offset by $184,000 related to bad debt. With respect to the $915,000 increase in 2006, $870,000 related to compensation, employee-related benefits and professional service fees. Stock based compensation expense included in general and administrative expense was $388,000 in 2007, $428,000 in 2006 and $731,000 in 2005.

We expect to incur significant additional accounting and legal costs after this offering related to compliance with rules and regulations implemented by the SEC and NASDAQ, as well as additional insurance, investor relations and other costs associated with being a public company. Consequently, we expect general and administrative expenses in absolute dollars to increase in future periods.

Research and Development Expense

Research and development expenses include costs associated with the design, development, testing and enhancement of our products. Research and development expenses include employee compensation (including stock-based compensation), supplies and materials, consulting expenses, travel and facilities overhead. All research and development expenses are expensed as incurred.

Research and development expense increased by $438,000, or 35%, to $1.7 million in 2007 from $1.3 million in 2006, and by $637,000 in 2006, or 101%, from $630,000 in 2005. As a percentage of our net revenue, research and development expense decreased to 5% in 2007, from 6% in 2006 and in 2005.

Compensation, employee-related benefits, consulting services and depreciation of development equipment accounted for $151,000 of the $438,000 increase from 2006 to 2007. The remainder of the increase in 2007 was primarily attributable to $173,000 in product development costs and $98,000 in travel expense. Compensation, employee-related benefits, consulting services and depreciation of development equipment accounted for $413,000 of the $637,000 increase from 2005 to 2006. Stock-based compensation expense included in research and development expense was $159,000 in 2007, $183,000 in 2006 and $98,000 in 2005.

We believe that continued spending on research and development to develop new PX devices and other products is critical to our success and, consequently, we expect to increase research and development expenses in absolute dollars in future periods.

Other Income (Expense), Net

Other income (expense), net includes interest income on cash balances and short-term investments, and losses or gains on conversion of non-United States dollar transactions into United States dollars. Our losses or gains on currency conversions have not been material to date because our international sales have been denominated principally in United States dollars, and our foreign currency exposure risk has been limited to expense incurred in our overseas operations. If we are successful in increasing our international sales we may be subject to currency conversion risks because some of the

international sales could be denominated in foreign currencies. We have historically invested our available cash balances in money market funds, short-term United States Treasury obligations and commercial paper.

Other income (expense), net increased by $432,000 to $413,000 in 2007 from $(19,000) in 2006, and decreased by $162,000 to $(19,000) in 2006 from $(182,000) in 2005. The increase in net interest and other income from 2006 to 2007 was primarily attributable to gains on foreign currency transactions of $355,000 in 2007 and higher average cash balances, which resulted in higher interest income in 2007. The decrease in net interest expense from 2005 to 2006 was primarily attributable to a reduction in the use of the line of credit and associated interest expense due to increased profitability.

Quarterly Results of Operations

The following table sets forth our unaudited quarterly consolidated statement of operations data for each of our eight fiscal quarters in the period ended December 31, 2007. The quarterly data have been prepared on the same basis as the audited consolidated financial statements included elsewhere in this prospectus, and reflect all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of this information. Our results for these quarterly periods are not necessarily indicative of the operating results for a full year or any future period.

	Three Months Ended,							
	Dec. 31, 2007	Sept. 30, 2007	June 30, 2007	March 31, 2007	Dec. 31, 2006	Sept. 30, 2006	June 30, 2006	March 31, 2006
	(in thousands)							
Quarterly Results of Operations*								
Net revenue	$ 13,845	$ 10,978	$ 3,452	$ 7,139	$ 9,277	$ 1,314	$ 4,559	$ 4,908
Gross profit	7,517	6,882	1,878	4,285	5,643	568	2,735	2,981
Operating expenses:								
Sales and marketing	1,443	1,372	1,224	1,191	1,348	836	772	692
General administrative	1,513	1,053	960	773	1,376	677	727	592
Research and development	484	392	440	389	540	224	270	233
Total operating expenses	3,440	2,817	2,624	2,353	3,264	1,737	1,769	1,517
Income (loss) from operations	4,077	4,065	(746)	1,932	2,379	(1,169)	966	1,464
Net income (loss)	$ 2,701	$ 2,397	$ (424)	$ 1,119	$ 1,557	$ (782)	$ 648	$ 959
Net income per common share:								
Basic	$ 0.07	$ 0.06	$ (0.01)	$ 0.03	$ 0.04	$ (0.02)	$ 0.02	$ 0.02
Diluted	$ 0.06	$ 0.06	$ (0.01)	$ 0.03	$ 0.04	$ (0.02)	$ 0.02	$ 0.02

* Quarterly results may not add up to annual results due to rounding.

The following table sets forth our historical quarterly operating results as a percentage of net revenue for the periods indicated:

	Three Months Ended,							
	Dec. 31, 2007	Sept. 30, 2007	June 30, 2007	March 31, 2007	Dec. 31, 2006	Sept. 30, 2006	June 30, 2006	March 31, 2006
	(as a % of Net Revenue*)							
Quarterly Income Summary								
Net revenue	100%	100%	100%	100%	100%	100%	100%	100%
Gross profit	54	63	54	60	61	43	60	61
Operating expenses:								
Sales and marketing	10	13	35	17	14	64	17	14
General administrative	11	10	28	11	15	51	16	12
Research and development	4	4	13	5	6	17	6	5
Total operating expenses	25	26	76	33	35	132	39	31
Income (loss) from operations	30	37	(22)	27	26	(89)	21	30
Net income (loss)	20%	22%	(12)%	16%	17%	(60)%	14%	20%

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

Net Revenue. Although annual net revenue increased by $15.3 million, or 77%, to $35.4 million in 2007 from $20.1 million in 2006, there were significant fluctuations in quarterly revenue in 2007 and 2006. Such fluctuations are due to the fact that a particular order from an EPC customer can represent significant revenue and that the postponement or cancellation of a large order can have a significant impact. In addition, as a result of EPC buying patterns, a higher proportion of our sales occurs in the fourth quarter compared to other quarters of the year. EPCs recognize revenue and services fees as a function of the equipment they procure and install. Because the fiscal year of most of these companies ends on December 31, EPCs tend to increase their purchase of our PX units and other plant equipment in the fourth quarter.

Gross Profit. The quarterly changes in gross profit were mainly a result of the fluctuations in net revenue. From quarter to quarter, our fixed costs have generally remained constant, and thus changes to revenue caused corresponding changes to our gross profit. Some of the more significant components of our fixed costs are salaries, manufacturing overhead and insurance. Because our variable costs make up a significant percentage of our cost of revenue, the largest components of which are materials, incremental labor costs and overtime, our variable costs mitigated somewhat the effects of revenue fluctuations on our gross profit.

Sales and Marketing Expenses. Sales and marketing expenses generally grew incrementally as a result of growth in our sales organization. Due to commissions, such expenses are generally highest in the fourth quarter as sales are typically greatest in that quarter.

Fluctuations in Quarterly Results. Our quarterly results of operation have fluctuated significantly in the past and are expected to fluctuate significantly in the future due to a number of factors, many of which are not in our control. We believe period to period comparisons are not necessarily meaningful and should not be relied upon as indicative of future results. See "Risk Factors—Our operating results may fluctuate significantly, which makes our future operating results difficult to predict and could cause our operating results to fall below expectations or our guidance."

Liquidity and Capital Resources

As of December 31, 2007, our principal sources of liquidity consisted of cash, cash equivalents and short-term investments of $240,000 and accounts receivable of $14.8 million. Our cash equivalents and short-term investments are invested primarily in money market funds, short-term United States Treasury obligations and commercial paper.

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 December 31, 2007, we issued common stock for aggregate net proceeds of $6.5 million. The proceeds from the sales of common stock have been used to fund our operations and capital expenditures.

On December 1, 2005, we entered into an agreement with a financial institution for a $2.0 million revolving note, or revolving note, and a $222,000 fixed rate-installment note, or fixed note, with maturity dates of December 1, 2006, subsequently extended to March 1, 2007, and December 15, 2010, respectively. The revolving note bears interest of base rate or LIBOR-based rate as elected by us. The interest rate was amended on April 26, 2006 to modify the definition of base rate and increase the rate to base rate plus 1% or LIBOR plus 2.5%. The fixed note bears an annual interest rate of 10%. These notes are secured by our accounts receivable, inventories, property, equipment and other general intangibles except for intellectual property.

On April 26, 2006, we also entered into a loan and security agreement with the financial institution for an additional $2.0 million credit facility with a maturity date of December 1, 2006, subsequently extended to March 1, 2007. The credit facility advances bear interest rates of base rate plus 1% or LIBOR plus 2.5%. The credit facility is secured by our cash and cash equivalents, accounts receivable, inventory, property and other general intangibles except for intellectual property.

On December 7, 2006, the revolving note was amended to increase the face amount of the note to $3.5 million.

On March 1, 2007, we renewed the revolving note and the loan and security agreement, or the first modification, to a maturity date of March 31, 2008. Additional amended terms under the first modification were an interest rate change to base rate or LIBOR plus 2.5%, limitation of advances to a borrowing base, various reporting requirements and our satisfaction of certain financial ratios and covenants.

On March 28, 2007, we modified the loan and security agreement, or the second modification, to add a $1.0 million equipment promissory note. The equipment promissory note bears an interest rate of cost of funds plus 3% and matures August 31, 2012. Additional amended terms under the second modification were changes to the financial ratios and covenants that we are required to maintain.

As of December 31, 2006, borrowings outstanding on the revolving note and the fixed note were $438,000 and $178,000, respectively. There were no borrowings under the credit facility. The interest rate for the revolving note elected by us was the base rate at 9.25%. We were in compliance with all covenants under the loan and security agreement.

As of December 31, 2007 there were no borrowings under the revolving note and the credit facility. The amounts outstanding on the fixed note and the equipment promissory note were $133,000 and $596,000, respectively at December 31, 2007. The interest rate for the equipment promissory note at December 31, 2007 was 7.81%. We were in compliance with all covenants under the loan and security agreement.

On March 27, 2008, we entered into a new credit agreement with our existing financial institution that replaced the $2.0 million credit facility and the $3.5 million revolving note. The new credit facility allows borrowings of up to $9.0 million on a revolving basis at LIBOR plus 2.75%. This new credit facility expires on September 30, 2008 and is secured by our accounts receivable, inventories, property, equipment and other intangibles except intellectual property.

During 2007, 2006 and 2005, we provided certain customers with irrevocable standby letters of credit to secure our obligations for the delivery of products in accordance with sales arrangements. These letters of credit were issued under our revolving note credit facility and generally terminate within eight months from issuance. At December 31, 2007 the amounts outstanding on the letters of credit totaled approximately $2.2 million.

We have unbilled receivables pertaining to customer contractual holdback provisions, whereby we invoice the final installment due under a sales contract six to 24 months after the product has been shipped to the customer and revenue has been recognized. Long-term unbilled receivables as of December 31, 2007 and 2006 consisted of unbilled receivables from customers due more than one year subsequent to period end. The customer holdbacks represent amounts intended to provide a form of security for the customer rather than a form of long-term financing; accordingly, these receivables have not been discounted to present value. At December 31, 2007, we had $1.7 million of current unbilled receivables and $2.3 million of non-current unbilled receivables.

Cash Flows from Operating Activities

Net cash provided by (used in) operating activities was $(2.8) million and $822,000 in 2007 and 2006, respectively. The $3.7 million increase in net cash used in operating activities from 2006 to 2007 was primarily attributable to increases in accounts and unbilled receivables.

Within changes in assets and liabilities, changes in accounts and unbilled receivables used $(9.2) million in cash in 2007 compared to $(3.2) million used in 2006 due to the timing of invoices for large projects at the end of 2007, along with a 77%, or $15.4 million, increase in net sales for the year. Changes in inventory used $(2.0) million in cash in 2007 compared to $(960,000) in 2006 primarily as a result of the growth of our business. Changes in accounts payable provided $583,000 in 2007 compared to $270,000 in 2006 due to the timing of payments. Changes in accrued liabilities provided $214,000 in 2007 compared to $1.0 million in 2006, primarily due to timing of payments. Changes in deferred revenue provided $343,000 in 2007 compared to $115,000 in 2006, primarily due to increased sales.

Net cash provided by (used in) operating activities was $822,000 in 2006 and $(694,000) in 2005. The $1.5 million decrease in net cash used in operating activities from 2005 to 2006 was primarily attributable to a $1.5 million increase in net income.

Within changes in assets and liabilities, changes in accounts and unbilled receivables used $(3.2) million in cash in 2006 compared to $(3.1) million in 2005. Changes in inventory used $(960,000) in cash in 2006 compared to $(901,000) in 2005 primarily as a result of the growth of our business. Changes in accounts payable provided $270,000 in cash in 2006 compared to $346,000 in 2005 due to the timing of payments. Changes in accrued liabilities provided $1.0 million in cash in 2006 compared to $(23,000) in 2005, primarily due to increased accrued bonuses and deferred revenue. Changes in deferred revenue provided $115,000 in cash in 2006 compared to $30,000 in 2005, primarily due to increased business.

Cash Flows from Investing Activities

Cash flows from investing activities primarily relate to capital expenditures to support our growth, as well as increases in our restricted cash used to collateralize our letters of credit.

Net cash provided by (used in) investing activities was $(2.0) million in 2007, $(511,000) in 2006 and $(1.0) million in 2005. $1.0 million of the increase in net cash used in investing activities from 2006 to 2007 was attributable to the increase in restricted cash balances along with $918,000 used for the purchase of property and equipment. The decrease in net cash used in investing activities from 2005 to 2006 was primarily attributable to fewer purchases of property, plant and equipment.

Cash Flows from Financing Activities

Net cash provided by financing activities was $5.1 million in 2007 and net cash used was $(530,000) in 2006. Net cash provided by financing activities was $1.9 million in 2005. The increase in net cash provided by financing activities in 2007 was primarily attributable to our issuance of common stock in a private placement.

We believe that our existing cash balances, together with the anticipated net proceeds from this offering and cash generated from our operations, will be sufficient to meet our anticipated capital requirements for at least the next 12 months.

However, we may need to raise additional capital or incur additional indebtedness to continue to fund our operations in the future. Our future capital requirements will depend on many factors, including our rate of revenue growth, if any, the expansion of our sales and marketing and research and development activities, the timing and extent of our expansion into new geographic territories, the timing of introductions of new products and the continuing market acceptance of our products. Although we currently are not a party to any agreement or letter of intent with respect to potential material investments in, or acquisitions of, complementary businesses, services or technologies, we may enter into these types of arrangements 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

The following is a summary of our contractual obligations as of December 31, 2007 (in thousands):

	Payments Due by Period				
	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Notes payable	$ 729	$ 172	$ 472	$ 85	$ —
Operating lease obligations	862	411	451	—	—
Capital lease obligations (including interest)*	120	50	70	—	—
Total	$1,691	$ 633	$ 993	$ 85	$ —

* Present value of net minimum capital lease payments is $101, as reflected on the balance sheet.

In the course of our normal operations, we also entered into purchase commitments with our suppliers for various key raw materials and component parts. The purchase commitments covered by these arrangements are subject to change based on our sales forecasts for future deliveries. As of December 31, 2007 purchase commitments with our suppliers were approximately $8.1 million.

This table excludes agreements with guarantees or indemnity provisions that we have entered into with, among others, customers and OEMs in the ordinary course of business. Based on our historical experience and information known to us as of December 31, 2007, we believe that our exposure related to these guarantees and indemnities as of December 31, 2007 was not material.

Supplier Concentration

Certain of the raw materials and components that we use in the manufacturing of our products are available from a limited number of suppliers. We do not enter into long-term supply contracts with these suppliers. For instance, we purchase the ceramic components for the PX device pursuant to standard purchase orders that specify the quantity and price of various component parts to be delivered over a three-month period. We then update the pricing and quantity of our purchase orders based upon our most current forecast on a quarterly basis. Shortages could occur in these essential materials and components due to an interruption of supply or increased demand in the industry. If we are unable to procure certain of such materials or components, we would be required to reduce our manufacturing operations, which could have a material adverse effect on our results of operations.

For the years ended December 31, 2007, 2006 and 2005, three suppliers represented approximately 66%, 71% and 62%, respectively, of our total purchases. As of December 31, 2007 and 2006, approximately 60% and 77%, respectively, of our accounts payable were due to these suppliers.

Off-Balance Sheet Arrangements

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

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, or SFAS 157. SFAS 157 defines fair value, establishes a framework for measuring fair value, and enhances fair value measurement disclosure. In February 2008,

the FASB issued FASB Staff Position 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13, or FSP 157-1, and FSP 157-2, Effective Date of FASB Statement No. 157, or FSP 157-2. FSP 157-1 amends SFAS 157 to remove certain leasing transactions from its scope. FSP 157-2 delays the effective date of SFAS 157 for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the first quarter of 2009. The measurement and disclosure requirements related to financial assets and financial liabilities are effective for us beginning in the first quarter of 2008. The adoption of SFAS 157 for financial assets and financial liabilities will not have a significant impact on our consolidated financial statements. However, the resulting fair values calculated under SFAS 157 after adoption may be different from the fair values that would have been calculated under previous guidance. We are currently evaluating the impact that SFAS 157 will have on our consolidated financial statements when it is applied to non-financial assets and non-financial liabilities beginning in the first quarter of 2009.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, or SFAS 159. SFAS 159 permits companies to choose to measure certain financial instruments and other items at fair value. The standard requires that unrealized gains and losses are reported in earnings for items measured using the fair value option. SFAS 159 is effective for us beginning in the first quarter of 2008. The adoption of SFAS 159 is not expected to have a significant impact on our consolidated financial statements.

In June 2007, the FASB ratified EITF Issue No. 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities*, or EITF 07-3. EITF 07-3 requires non-refundable advance payments for goods and services to be used in future research and development activities to be recorded as assets and the payments to be expensed when the research and development activities are performed. EITF 07-3 applies prospectively to new contractual arrangements entered into beginning in the first quarter of 2008. Prior to adoption, we recognized these non-refundable advance payments as an expense upon payment. The adoption of EITF 07-3 is not expected to have a significant impact on our consolidated financial statements.

In December 2007, the SEC issued SAB 110 to amend the SEC's views discussed in SAB 107 regarding the use of the simplified method in developing an estimate of expected life of share options in accordance with SFAS 123R. SAB 110 is effective for us beginning in the first quarter of 2008. As of December 31, 2007, we did not use the simplified method and the adoption of SAB 107, as amended by SAB 110, is not expected to have a significant impact on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations*, or FAS 141(R). FAS 141(R) will change how business acquisitions are accounted for. FAS 141(R) is effective for fiscal years beginning on or after December 15, 2008. The adoption of FAS 141(R) is not expected to have a material impact on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements — an amendment of Accounting Research Bulletin No. 51*. SFAS No. 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest, and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS No. 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008. The adoption of SFAS No. 160 is not expected to have a material impact on our consolidated financial statements.

Quantitative and Qualitative Disclosure About Market Risk

Foreign Currency Risk

Most of our sales contracts have been denominated in United States dollars, and therefore our revenue historically has not been subject to foreign currency risk. As we expand our international sales, we expect that an increasing portion of our revenue could be denominated in foreign currencies. As a result, our cash and cash equivalents and operating results could be increasingly affected by changes in exchange rates. Our international sales and marketing operations incur expense that is denominated in foreign currencies. This expense could be materially affected by currency fluctuations. Our exposures are to fluctuations in exchange rates for the United States dollar versus the Euro. Changes in currency exchange rates could adversely affect our consolidated operating results or financial position. Additionally, our international sales and marketing operations maintain cash balances denominated in foreign currencies. In order to decrease the inherent risk associated with translation of foreign cash balances into our reporting currency, we have not maintained excess cash balances in foreign currencies. We have not hedged our exposure to changes in foreign currency exchange rates because expenses in foreign

currencies have been insignificant to date, and exchange rate fluctuations have had little impact on our operating results and cash flows.

Interest Rate Risk

We had cash, cash equivalents and short-term investments totaling $240,000, $42,000 and $261,000 at December 31, 2007, 2006 and 2005, respectively. These amounts were invested primarily in money market funds, short-term United States Treasury obligations and commercial paper. The unrestricted cash, cash equivalents and short-term investments are held for working capital purposes. We do not enter into investments for trading or speculative purposes. We believe that we do not have any material exposure to changes in the fair value as a result of changes in interest rates due to the short term nature of our cash equivalents and short-term investments. Declines in interest rates, however, would reduce future investment income.

Table of Contents

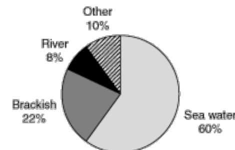
INDUSTRY

The demand for fresh water continues to escalate, driven by the need for drinking water to satisfy the world's growing population, changing weather patterns, an increasing need for water for agriculture and industry and the concentration of populations in urban areas that lack sufficient fresh water resources. For example, according to the World Water Council, approximately 260 gallons of water are needed to produce 2.2 pounds of wheat and 3,380 gallons of water are needed to produce 2.2 pounds of beef. The power industry is also a large consumer of water, as water is critical to the cooling processes used in fossil fuel and nuclear plants and in the production of biofuels. The United Nations Population Fund expects the global consumption of water to double every 20 years. A study conducted by the International Water Management Institute projects that by 2025, 33% of the population of the developing world will face severe water shortages. The uneven geographic distribution of fresh water supplies compounds this problem. Even in water-rich nations, population growth, environmental regulation and irrigation needs are placing constraints on existing water resources.

The United Nations Environmental Program estimates that by 2010, 80% of the world's population will live within 100 kilometers of a sea coast. With the growth of population centers along coastal areas and improvements in technology, desalination, once a luxury of oil-rich Middle Eastern countries and large-scale resorts, is rapidly becoming an economically viable alternative in many regions where traditional fresh water sources are becoming increasingly stressed. According to the February/March 2008 issue of International Desalination & Water Reuse Quarterly, there are approximately 14,000 desalination plants installed worldwide. Global Water Intelligence, or GWI, estimates that as of December 31, 2005, there were 39.9 million cubic meters per day of installed capacity, and that the growth in the market for new total desalination capacity should increase by approximately 13% per year from 2005-2015. We expect SWRO's share of new total desalination capacity to grow in excess of the overall industry growth rate particularly due to higher energy costs.

Desalination is the process of removing salt and other minerals and solids from water. The process is most commonly used to derive fresh water from sea water or brackish water. Brackish water is water that has more salinity than fresh water, but not as much as sea water, and is found in certain lakes, marshes, deltas, rivers and bays. The higher the salinity of the source water, the greater the energy required in the desalination process. We target the sea water segment of the desalination industry, which is the dominant segment of the market. More specifically, we operate primarily in the sea water reverse osmosis, or SWRO, sector of the sea water desalination market.

Desalination Market by Feedwater



Source: GWI, Desalination Markets 2007

Sea Water Desalination

Currently there are two basic methods of sea water desalination:

- thermal, which uses heat to evaporate fresh water from salt water; and
- SWRO, which uses high pressure to drive salt water through membranes, leaving concentrate behind.

The choice of processes depends largely on the cost of power. Thermal processes require more energy than SWRO processes because of the high energy required to boil water. Advances in SWRO processes, such as the use of more efficient energy recovery devices and membranes, have dramatically decreased the associated energy cost, making it the preferred method in regions where energy costs are high.

Thermal Desalination

Thermal desalination is the process of boiling water and condensing the vapor into fresh water. Because thermal desalination processes are energy intensive, the process is generally only viable for large-scale plants built primarily in oil-rich regions such as the Middle East where the cost of power is low. Although in recent years thermal technologies have evolved to require less net power consumption, these advances have not been able to achieve the reduced levels of energy consumption associated with SWRO. As a result, thermal plants continue to be constructed primarily in regions with low energy costs.

SWRO Desalination

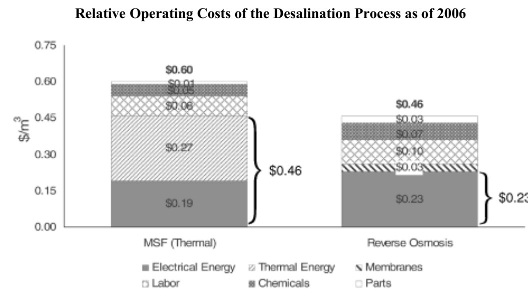
SWRO desalination uses high pressure to drive fresh water from sea water through reverse osmosis membranes. The pressure required for this process depends upon the permeability of the membranes and salinity of the water. As an example, brackish water desalination requires less pressure than sea water desalination due to its lower salinity. Technology advances have increased membrane permeability, lowering the pressure required while improving salt filtration. However, without an energy recovery device a significant amount of energy would be lost in the reject stream. Effective recovery of the energy contained within the reject stream has made the SWRO process significantly more energy efficient and economically attractive. The evolution of energy recovery devices for SWRO began with the use of the Pelton wheel in 1984, followed by the hydraulic turbocharger in 1992 and most recently isobaric technologies, including our PX device, which became commercially available in 1997.

SWRO versus Thermal

Declining SWRO desalination costs due to improved technology and increasing energy costs have made SWRO desalination the preferred method of water production in regions where the cost of energy is high and fresh water is scarce. Consequently, according to GWI, the share of total new contracted desalination capacity using SWRO has increased from approximately 42% in 1999 to approximately 71% in 2006, and is expected to continue to increase.

The surge in desalination project activity since 1990 is primarily due to advances in SWRO technology, including energy recovery devices and membranes, which have significantly reduced the cost of producing fresh water from sea water. According to GWI, using SWRO technology, the cost of producing a cubic meter of fresh water from sea water, which averaged approximately $10 per cubic meter in the mid-1960's, had dropped to as low as $0.46 per cubic meter by 2005. As shown below, energy costs associated with the SWRO process are approximately 50% less than those associated with the traditional thermal desalination process.

Relative Operating Costs of the Desalination Process as of 2006



Source: GWI, Desalination Markets 2007

Energy Recovery Devices

Wheel Technology

When SWRO was first commercialized on a large scale in 1984, engineers used existing water wheel technology, the Pelton wheel, which was first developed in 1880 in connection with gold mining, to recover the pressure energy from the reject stream. The Pelton wheel works by directing the high-pressure reject stream at a bucket wheel mounted on the same shaft as the high-pressure feed water pump, thereby recycling energy back into the SWRO process. However, as energy is transferred from the reject stream back into the feed water stream utilizing the Pelton wheel and pump system, energy is lost.

In the late 1980's, the hydraulic turbocharger was developed as an alternate energy recovery device for SWRO plants. Similar to the Pelton wheel, the hydraulic turbocharger uses a turbine to recover energy and transfers the energy back into the SWRO process with a high-pressure pump. While the hydraulic turbocharger was slightly more efficient than the Pelton wheel because of its higher rotating speed, it suffered from similar inefficiencies due to similar design characteristics.

Isobaric Technology

In 1975, the first isobaric technology device was piloted in Bermuda. In contrast to the Pelton wheel and turbocharger technology, isobaric technology employs a pressure equalizing method to transfer energy from the membrane reject stream directly to the membrane feed stream, bypassing the need to convert energy from the high pressure rejection stream into mechanical form. This direct positive displacement approach results in significantly higher transfer efficiency rates.

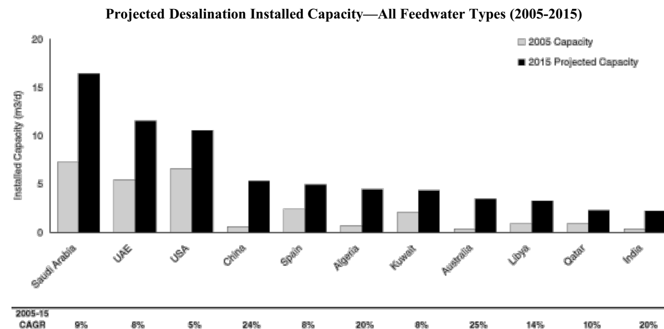
During the 1990's, the Dual Work Exchanger Energy Recovery, or DWEER, was developed and initially used in the manufacturer's SWRO plants in the Caribbean as a slow cycle isobaric energy recovery device. According to its manufacturer, Calder AG, the DWEER system attains efficiency rates of up to 97%. The DWEER system utilizes a piston and valve system in a high pressure batch process with large pressure vessels, similar to a steam locomotive, to capture and transfer the energy lost in the membrane reject stream. While the DWEER attains high rates of efficiency, it suffers from its large size, mechanical complexity with numerous moving parts that undergo millions of cycles per year, and corrosion potential due to its metal composition.

In early 1997, we introduced the initial version of our energy recovery device, the PX. In November 1997, we introduced and marketed our first ceramic-based PX device. Our PX device represented an advance in the available technology by utilizing ceramic construction and a rotating chamber design with only one moving part.

Desalination Growth Regions

Significant growth is forecasted in the broader desalination industry, which includes sea water, brackish and all other types of feedwater. According to GWI, countries such as Australia, Algeria, China and India are expected to achieve compound annual growth of at least 20% from 2005 to 2015.

Projected Desalination Installed Capacity—All Feedwater Types (2005-2015)



Source: GWI, Desalination Markets 2007

Middle East and North Africa

The Middle East dominates the desalination industry, accounting for approximately 70% of total contracted capacity in 2005, according to GWI 19th Annual Desalting Plant Inventory. As reported by ULTRAPURE WATER, the Arab states alone will need to spend $100 billion on desalination over the next 10 years. During 2007, several SWRO plants were contracted in Kuwait, Oman, Israel and the United Arab Emirates. Algeria and Saudi Arabia accounted for almost half of 2005 contracted capacity. All of Algeria's 2005 contracted capacity was SWRO while Saudi Arabia's SWRO capacity made up 17% of its total 2005 contracted capacity. This statistic demonstrates that in many oil rich Middle East countries traditional thermal desalination persists due to the abundance of subsidized power.

The recent emergence of large SWRO desalination plant projects in the Middle East, such as Al Fujairiah in the United Arab Emirates (170,000 cubic meters per day) and Shoiaba in Saudi Arabia (150,000 cubic meters per day), may demonstrate the beginning of a shift to SWRO, even where power has been historically inexpensive. Thermal desalination plants, typically located adjacent to power plants, pose an efficiency constraint for power generators. Power generators that would otherwise reduce power generation during off-peak seasons to cut costs, must continue operating at peak because the thermal desalination process necessitates continuity of operations. Many Middle East operators are turning to hybrid SWRO/thermal plants to accommodate off-peak usage periods. In addition, high maintenance and building costs associated with thermal plant construction may shift preferences to SWRO plants which are less expensive to build and operate. Specifically, thermal desalination plants are constructed of nickel/chromium based alloy metals to avoid corrosion, and these metals have experienced price increases in recent years.

Algeria is currently one of the most active desalination markets outside the Persian Gulf region. GWI predicts that Algeria will install 2.6 million cubic meters per day by 2010 and 4.5 million cubic meters per day by 2015.

Europe

The most significant European market to date has been Spain. Spain utilizes SWRO plants built by large Spanish EPC consortiums. Spain's Plan Hidrológico Nacional, which initially favored transferring water from the Ebro River to Spain's dry southern Mediterranean coast, changed its strategy in 2004 in favor of the construction of multiple SWRO desalination sites under a fast-track development program called Acuamed.

United States

While the U.S. market currently utilizes reverse osmosis primarily for brackish water, 1.2 to 1.7 million cubic meters of SWRO capacity are under consideration, according to GWI. However, permits, environmental impact studies and project financing present steep initial hurdles for U.S. municipalities. The most promising regions for SWRO are populated coastal areas, particularly California, Texas and Florida. California, in particular, is a potential locus for SWRO desalination. Population growth on the West Coast and environmental pressures place continued strain on the Colorado River.

The Affordable Desalination Collaboration, or ADC, project seeks to demonstrate to California municipalities that with state of the art technology, SWRO desalination is a cost effective alternative to traditional water sources. ADC also promotes the use of the PX technology in SWRO water projects.

Asia Pacific

Australia, China and India all represent large-scale SWRO opportunities. Asia Pacific countries have large populations in water stressed regions that border oceans. In particular, India, with its high population growth, offers a significant SWRO opportunity due to an accelerated use of water for irrigation, rapid industrialization and improving living standards. At the same time, existing water resources are diminishing. According to GWI, India currently accounts for 31% of the Asia Pacific region's contracted capacity.

In Australia, drought has played a significant role in the political decision to move forward on large SWRO plants. Australia's major population centers border the coast. The commissioning of a desalination plant in Perth (143,000 cubic meters per day) marked a major milestone for Australia. According to GWI, Australia built approximately 100,000 cubic meters per day of new capacity in the 2001–2005 period, and it is expected to add approximately 1.4 million cubic meters per day between 2006 and 2010.

GWI expects that China's desalination capacity will grow approximately 24% per annum from approximately 600,000 cubic meters per day in 2005 to over 5.3 million cubic meters per day by 2015. As the Chinese economy moves towards a free market, the water sector is expected to operate on a more commercial basis. For example, in Shanghai and Pudong the water utilities have become privatized. We believe that as such privatization continues, considerations of water production costs will lead to the commissioning of further SWRO plants that utilize our PX technology. Over the last five years, our PX device was selected for 14 new SWRO plants, which we believe represent a majority of the new SWRO plants commissioned during the same period.

BUSINESS

Overview

We are a leading global developer and manufacturer of highly efficient energy recovery devices utilized in the rapidly growing water desalination industry. We operate primarily in the sea water reverse osmosis, or SWRO, segment of the industry. SWRO uses pressure to drive salt water through filtering membranes to produce fresh water. Energy recovery devices have increased the cost-competitiveness of SWRO desalination compared to other means of fresh water supply and has enabled the ongoing rapid growth of the SWRO segment of the desalination industry worldwide. Our primary product, the PX Pressure Exchanger, or PX, helps optimize the energy intensive SWRO process by recapturing and recycling up to 98% of the energy in the high pressure reject stream, thereby reducing energy consumption by an estimated 60% as compared to a plant without any energy recovery devices.

We believe that the proven benefits of our proprietary technology have made us a leader in the SWRO energy recovery market due to the following:

- *Up to 98% energy recovery efficiency.* The PX device achieves high efficiency by minimizing energy loss. The tight fit between the ceramic components in a PX device minimizes leakage inside the device. In addition, the flow paths through the device are relatively open such that losses due to friction are minimized. Because losses are minimized, the energy output of the PX device is only slightly less than the energy input. This ratio is measured in terms of efficiency.
- *Proprietary design employing only one moving part.* The only moving part in the PX device is the ceramic rotor, which is surrounded by a ceramic sleeve and two end covers. The narrow gap between the rotor and surrounding components fills with high-pressure water which serves as a nearly frictionless hydrodynamic bearing. The combination of the extreme durability of ceramic and the low-friction bearing design results in very little wear over time.
- *Corrosion resistant, highly durable ceramic composition*. The advanced ceramic material used in the PX device is corrosion resistant, rigid and three times stronger than steel. This allows us to design the rotor and the sleeve to have and maintain narrow clearances despite the high operating pressures to which these devices are exposed and speeds at which they operate. These narrow clearances allow sea water to act as a lubricant, minimizing wear and leakage losses.
- *Small footprint, modular design and system redundancy.* Our PX devices are available in a range of standard product sizes. Higher capacities are achieved by arranging multiple devices in parallel. Customers specify the number of devices necessary for a given application, and additional capacity is provided by adding units. Further, due to the parallel arrangement of the PX devices, if one PX unit in an array should fail, the desalination plant can continue to operate.
- *Lower life cycle cost versus competitors.* Some of our competitors may price their energy recovery devices below that of our product. However, because of the PX device’s high efficiency, durability, corrosion resistance, and modular design that allows for system redundancy, resulting in minimal plant shutdowns for PX device maintenance, we believe our product is the most cost effective energy recovery device alternative in the long term.

The PX device uses highly durable, ceramic components to capture and recycle the energy that otherwise would have been lost in the high pressure reject stream of the SWRO process and applies it to the low pressure sea water feed stream. The PX device has become a leading energy recovery solution in the sea water desalination industry, installed in over 300 desalination plants and specified in plant designs by over 60 original equipment manufacturers, or OEMs, and engineering, procurement and construction, or EPC, firms worldwide. We estimate that PX devices shipped as of December 31, 2007 will reduce electricity consumption in SWRO desalination plants by approximately 300 megawatts relative to comparable plants with no energy recovery devices. Assuming a rate of $0.08 per kilowatt hour, the deployment of PX devices in plants that otherwise had no energy recovery devices would result in annual electricity cost savings of approximately $210 million in the aggregate, which would equate to a reduction in carbon dioxide emissions of approximately 1.5 million tons per year.

Our successful market penetration has resulted in a rapidly increasing installed base of PX devices globally, which we expect to lead to aftermarket part replacement and service opportunities. We also manufacture a line of booster pumps for use in conjunction with same models of the PX device. As of December 31, 2007, we had shipped over 4,000 PX devices to desalination plants worldwide, including in China, Europe, India, Australia, Africa, the Middle East, North America and the Caribbean.

We design, manufacture and sell various PX models to serve a range of SWRO process flow rates for various plant designs and sizes. With respect to large desalination plants (greater than 50,000 cubic meters, or 13.2 million gallons, per day capacity), we sell our products to international EPCs, and with respect to smaller desalination facilities (fewer than 50,000 cubic meters per day capacity) we sell our products to OEMs for installation in hotels, power plants and municipal facilities. Our research, development and manufacturing facility is located in the San Francisco Bay technology corridor, and we have direct sales offices and technical support centers in many key desalination markets, including Madrid, Dubai, Shanghai and Fort Lauderdale.

Our Strengths

- ***Unique and efficient product.*** Our uniquely designed product offers several significant benefits to our customers and advantages over competing products. We manufacture the only commercially available rotary isobaric energy recovery device, which we believe is more effective at recovering and recycling energy than any other commercially available energy recovery device. The PX device incorporates highly-engineered corrosion resistant ceramic parts and a modular design that minimizes product maintenance and helps prevent plant shutdowns. Our rotary device has only one moving part and a continuous flow design, which complements the continuous flow of the SWRO process. This contrasts with competing isobaric energy recovery devices that utilize an alternating flow process with various moving parts more susceptible to wear, and which may require plant shutdowns for maintenance and part replacement. We believe these unique benefits lead to lower life cycle costs than competing products.
- ***Leading position in a rapidly growing industry.*** The combination of decreasing fresh water supplies, increasing fresh water demand and declining SWRO desalination costs is driving growth in the SWRO desalination industry. We believe we are the largest global supplier of energy recovery devices for SWRO, the fastest growing segment of the desalination market. According to GWI, the share of total new contracted sea water desalination capacity using SWRO has increased from approximately 42% in 1999 to approximately 71% in 2006.
- ***Rapid growth.*** Our net revenue increased from $4.0 million in 2003 to $35.4 million in 2007, representing a compound annual growth rate of 72%, driven by the rapid growth of the SWRO desalination industry and our increased penetration of this market. Our sales growth has enabled us to leverage our existing manufacturing cost base. We are developing several new products to provide additional cost and performance advantages. Additionally, as our installed base of PX devices ages and the number of installed units increases, we expect sales of replacement PX parts and services to increase.
- ***High barriers to entry.*** Historically, there has been a slow adoption rate for new technologies in the desalination industry. We have spent the last 11 years penetrating the market and establishing our company and product with major industry participants. Over this period, our PX device has been increasingly adopted into the standard plant specifications of many of the leading SWRO desalination plant designers. We have five U.S. and nine international counterpart patents covering specific design features of the PX device. In addition, we have developed significant know-how related to ceramic processing methods essential to the manufacturing, reliability and performance of the PX device.
- ***Diversified international blue chip customer base.*** Currently, most of our revenue has been derived from sales to large EPCs such as Acciona Water, Doosan Heavy Industries, Geida and GE Ionics. In addition, we are specified in plant designs by over 60 OEMs and EPCs worldwide and have sold PX devices to approximately 250 other customers, including small and mid-tier OEMs, hotel operators, power plants and municipalities.
- ***Strong, experienced management team.*** Our senior management team has significant industry experience in the design, construction and operation of SWRO desalination plants and the filtration industry. Our chief executive officer, G.G. Pique, joined us in 2000 after serving for seven years as the group vice president Latin America of US Filter Corporation (subsequently acquired by Vivendi) and has over 30 years of experience in the water treatment industry. He has built the management team, driven the “customer first” corporate culture and engineered the strategy leading to global acceptance of PX technology.

Our Strategy

- ***Increase market penetration.*** We actively work with EPCs and OEMs to specify our PX device in the designs of their SWRO desalination plant. For example, we believe our PX device is gaining acceptance in the Middle East where SWRO continues to displace thermal desalination, and we are very active in China where our PX device has been installed in 28 desalination plants. To further our market penetration, we are also expanding our existing sales channels and coverage footprint through new strategic hires and by increasing our product offerings. Additionally, we are continuing to increase the awareness of our technology through technical papers, trade shows, seminars, industry publications and trade association memberships.

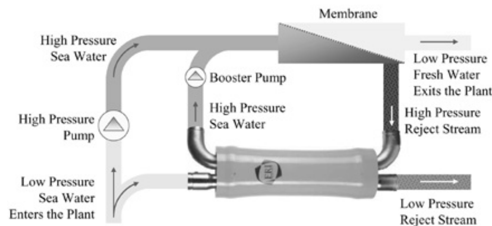
- ***Continue to broaden our product portfolio.*** We are developing new products that should continue to grow our market share and meet the increasing demands of our clients. As the SWRO market moves towards increasingly larger desalination plants, we are developing products designed to address these larger volume plants. Specifically, we have developed a product, the PX-1200 Titan, that is expected to provide a five-fold increase in water flow capacity from that of our largest current PX device. For customers who are more sensitive to up-front costs and who operate smaller plants, we are developing the Comp PX device. We also intend to expand our product portfolio to include additional circulation/booster pumps (internal or private label) and a bundled turnkey solution for customers that would include both a PX device and pump.
- ***Increase our aftermarket sales.*** Over time, components of our PX device will need to be repaired or replaced. Thus, as our installed base of PX devices ages and the number of installed units increases, we expect aftermarket sales of replacement PX parts and services to increase. We are also considering formulating a service contract model and strategic stocking centers to help drive additional aftermarket sales.
- ***Capitalize on growth opportunities in alternative power and other emerging sectors.*** We are diversifying our energy recovery offerings to capitalize on growth opportunities in emerging sectors. For example, osmotic power generation utilizes a process similar to that of SWRO and is a clean, alternate source of power currently under development. We are participating in an osmotic power pilot test facility being designed by a European utility company that may use PX technology. In addition, the PX device could potentially be applied in any process that has a high-pressure waste stream including chemical and petroleum processing. Also, participants in the growing brackish water reverse osmosis desalination market are increasingly interested in reducing energy consumption through the use of energy recovery devices such as our PX device.

Products and Services

Our core product, the PX, is an energy recovery device employed within SWRO desalination systems. The PX device utilizes the principle of positive displacement and isobaric chambers to achieve an extremely efficient transfer of energy from a high-pressure waste stream, the reject stream, to a low-pressure incoming feed stream, effectively recycling energy that otherwise would have been lost.

Our PX device uses a cylindrical rotor with longitudinal ducts parallel to its rotational axis to transfer the pressure energy from the reject stream directly to the feed stream. The rotor spins inside a sleeve between two end covers with port openings for low and high pressure. The low-pressure side of the rotor fills with sea water while the high-pressure side discharges sea water. The rotational action of the PX device is similar to that of a Gatling machine gun and is refilled with new sea water cartridges while rotating around a central axis. A liquid piston moves back and forth inside each duct, significantly minimizing mixing between the reject water and incoming sea water streams.

The flow diagram below depicts how our PX device takes pressure energy from the reject stream and recycles it back to the desalination process at up to 98% efficiency.



We produce a variety of PX models to suit the design and capacity needs of various SWRO plants. We also manufacture a line of booster pumps for use in conjunction with PX devices to service flows up to 300 gallons per minute, or gpm.

Current Products

65-Series PXs

The PX-220 has been our flagship product. However, we expect the recently introduced PX-260 to become our flagship product in late 2008. The 65-Series PX product line, named for the diameter of the rotor, includes the following models:

Model	Capacity
PX-260	220–260 gpm (48–58 m^3/hr)
PX-220	180–220 gpm (41–50 m^3/hr)
PX-180	140–180 gpm (32–41 m^3/hr)

The 65-Series is designed for SWRO plants with production capacities greater than 120 gpm (650 m^3/day). PX devices are manifolded together into trains to achieve unlimited capacity ranges.

4S-Series PXs

The 4S-Series devices are designed for plants with production capacities in the range of 25 to 300 gpm (140 to 1,600 m^3/day). The current product line includes the following models:

Model	Capacity
PX-140S	90–140 gpm (20–32 m^3/hr)
PX-90S	60–90 gpm (14–20 m^3/hr)
PX-70S	40–70 gpm (9–16 m^3/hr)
PX-45S	30–45 gpm (7–10 m^3/hr)
PX-30S	20–30 gpm (4–7 m^3/hr)

Booster Pumps

Our PX booster pumps are suitable for SWRO plants with production rates ranging from approximately 25 to 300 gpm (140 to 1,600 m^3/day). Each of the following series of booster pumps has two models to cover the pressure range and flow requirements of that series. Our current product line includes the following series:

Series	Capacity
HP-2400	150–300 gpm (34–68 m^3/hr)
HP-1250	80–170 gpm (18–39 m^3/hr)
HP-8500	30–110 gpm (7–25 m^3/hr)

New Products and Products in Development

We recently have developed and commercially released several new products. In addition, we are currently developing several new products for possible commercial release in 2009 and 2010.

PX-260

We launched the PX-260 in late 2007. The PX-260 utilizes the same vessel as the PX-220 but incorporates new ceramic designs and internal components. The PX-260 will provide higher capacity while achieving similar efficiency as the PX-220. We expect a number of customers who are currently using the PX-220 in their SWRO processes to purchase the PX-260 for their future projects. However, because of the six to 16 month sales cycle, we do not expect to ship the first large volume orders of the PX-260 until the fourth quarter of 2008.

PX-30S

We have recognized the need to supply units for pilot projects, typically mandated by large municipal water projects. The PX-30S was designed as a test unit and entry point to gain the approval and acceptance of large municipal projects. With only a 4-inch rotor, the PX-30S allows a municipal water operator to achieve the same efficiency as our larger

recovery devices, except on a smaller scale. The PX-30S, launched in October 2007, is also expected to serve as an attractive solution for smaller SWRO plants, particularly marine-based and solar-powered units.

Brackish PXs

We have developed and recently introduced a new line of brackish PX devices that takes advantage of the less stringent requirements of brackish water applications. Because less pressure is required to desalinate brackish water, brackish water reverse osmosis, or BWRO, requires less power than SWRO. Our new line of brackish PX devices should help us be competitive in the BWRO market.

Comp PX

We are developing a new PX device designed for customers who are more sensitive to up-front costs and who operate small plants or are in regions where energy costs are low. The device will not have the same durability as our current devices. The Comp PX is expected to be available in 2009.

PX-1200 Titan

We expect to commercially deploy the PX-1200 Titan, which is a 1,200 gpm (273 m^3/hr) PX device, in 2010 or later. The following highlights some of the PX-1200 Titan's primary features:

- five-fold increase in capacity compared to the PX-260;
- simple four-point hookup;
- scalability in cost and pricing; and
- simplicity of installation.

The PX-1200 Titan is intended to meet the requirements of the increasingly larger SWRO desalination facilities scheduled to be built in the near future.

Private Label Pump

We currently manufacture and sell a line of booster pumps for plants with production rates ranging from 25–300 gpm. We are evaluating a strategic expansion of our product portfolio by offering larger capacity private label booster pumps to our customers. We would outsource production of the pumps to one or more specialized pump manufacturers. This would provide our customers a one-stop shop solution for their energy recovery requirements.

Aftermarket Services and Sales

Due to the importance of the PX device in the operation of the plant, we have full-time employees and factory-trained contractors who perform engineering support and technical service functions on a global basis. As our installed base of PX devices ages and the number of installed units increases, we expect aftermarket sales of replacement PX parts and services to increase. We are also considering formulating a service contract model and strategic stocking centers to help drive additional aftermarket sales.

Future Market Opportunities

Leasing Model

While we have occasionally offered leasing options for PX products, we are evaluating a wide range of leasing models with potential strategic partners. A PX lease structure could comprise a lease of only the ceramics portion of an energy recovery solution or, alternatively, encompass an entire energy transfer center, which would include the manifold, booster pump and potentially, a high-pressure pump/motor.

SWRO Pump Bay

We currently build and market a line of booster pumps for plants with production rates up to 300 gpm. The addition of a full range of booster pumps to 1,200 gpm and above would complement the entire product suite of PX devices, providing an additional revenue opportunity. These booster pumps would enable us to offer our customers a fully integrated energy recovery solution, which would allow our customers to reduce implementation time. The addition of booster pumps to

complement larger rotor PX devices could be achieved through in-house production or, alternatively, through a strategic venture with an outside manufacturer.

Osmotic Power (Forward Osmosis)

A potential future technology, osmotic power, could also utilize PX devices. Osmotic power generates power by capturing the natural energy generated as fresh water is drawn into salt water, or forward osmosis. This occurs whenever there is a large source of fresh water in proximity to a large body of salt water, such as the Scandinavian fjords, the Salton Sea in California, the Great Salt Lake in Utah or the Dead Sea in Israel. We are currently in discussions with a European utility company that is designing an osmotic power pilot test facility that may use PX technology.

Sales and Marketing

As of December 31, 2007 our sales force consisted of seven employees. We have sales representatives located in Spain, China, the United States and the United Arab Emirates. They are compensated with both a base salary and a commission based on a percentage of the gross profit generated by their sales. We occasionally use outside sales agents who receive a commission when the purchase price is collected.

We sell the PX device through two main divisions which are aligned with our target markets. Our Agua Grande, or AG, division targets projects exceeding 50,000 cubic meters a day in overall capacity. Our OEM division targets projects with fewer than 50,000 cubic meters a day in overall capacity.

AG Target Customers

Sales to our AG customers is the fastest growing revenue source for our business. Each AG project typically represents a revenue opportunity ranging from $2 million to $7 million. These projects have an average sales cycle (time from initial project tender to the time the PX device is shipped to client) of six to 16 months. EPCs are the primary target market for our PX-220s and 260s and our forthcoming PX-1200 Titan device. With the current pipeline of new SWRO plants exceeding 50,000 cubic meters per day capacity, we expect these customers to continue to be our largest revenue generators. These large projects also provide the most significant revenue opportunities for aftermarket services through operating, maintenance and extended warranty sales.

Our AG customers primarily consist of large EPC firms primarily located in the United States and Europe. We recently established a sales and technical center in Madrid, Spain, in proximity to many of the large European EPCs. This new strategic location allows rapid response to the complex requirements of European EPC customers.

OEM Target Customers

This customer group is defined as small to medium sized SWRO projects (fewer than 50,000 cubic meters a day). Unlike the AG customers, this group is highly fragmented. OEM customers are further divided into small (5,000 cubic meters a day) and mid-tier (5,000–50,000 cubic meters a day) operators that purchase both standardized and custom-made SWRO packages used by hotel chains, large resorts, cruise ship terminals, island bottlers and industrial/power plants. Because OEM customers are located worldwide, we have placed our sales force and service support strategically to address customer needs.

This customer group represents an ideal retrofit opportunity for cost-conscious operators utilizing competing energy recovery devices with lower efficiency rates. Based on our experience, the OEM market has a much shorter sales cycle than the AG group, with a typical sales cycle of one to three months.

Marketing

Our marketing and promotional efforts are undertaken in a variety of channels:

- *Demonstration, Retrofit and Pilot Test Facilities.* Many high-profile retrofit projects and pilot test facilities have demonstrated the tangible benefits of the PX device, increasing industry acceptance of our product. Upon commissioning in 2001, the Cyprus Dhekelia SWRO plant utilized the PX device in the largest isobaric train in the world. Our successful retrofit of the Dhekelia plant demonstrated to large international EPCs the efficiency and reliability of the PX device. Similarly, the Huntington Beach and Carlsbad (Poseidon/Dow FILMTEC) pilot test facilities in California provide us with conveniently accessible demonstration facilities to promote the benefits of the PX device to potential customers.

- *Technical Papers/Trade Shows.* We have leveraged the technical talent of our chief technical officer, Dr. Richard Stover, to generate technical papers, which are presented at trade shows and published in international trade magazines and journals. These papers provide an efficient yet low cost vehicle for educating OEMs and other end users about positive displacement isobaric technology.
- *Seminars.* We hold joint technical seminars with various industry participants on desalination solutions pertaining to core SWRO processes in an effort to disseminate information about the PX device.
- *Industry Publications/Trade Association Membership.* We gain important exposure through advertising in well-known industry publications. Advertising of the PX device has consisted of advertisements in Desalination and Water Reuse Quarterly, Arab Water World, GWI, Everything About Water (India), Agua Latinoamerica, Filtration and Separation Technology, InfoEnviro (Spain) and the Technology of Water Treatment (China).
- *Interactive Website.* We have developed a website focused on facilitating an understanding of PX technology, its economic benefits and practical applications. The suite of PX technical tools (The Power Model, SWRO Cost Estimator, ERI SIMtm SWRO Process Simulator and PX Animation) allows a potential user to review power consumption, cost and operation of the PX technology. We utilize our website as a management tool to provide content about our products and we track activity on our website.

In addition, we are a founding member, promoter and participant in the Affordable Desalination Collaboration, or ADC, a consortium of industry leaders, federal and state government agencies and water districts. ADC seeks to promote SWRO as an affordable, reliable and environmentally sound source of fresh water.

Customers

Currently, most of our revenue is generated from sales to large EPCs. In addition, as of December 31, 2007, we are specified in plant designs by over 60 OEMs and EPCs worldwide and have sold PX devices to approximately 250 other customers, including small and mid-tier OEMs, hotel operators, power plants and municipalities.

A limited number of our EPC customers accounts for a substantial portion of our net revenue. Specifically, Acciona Water, Geida and its affiliated entities and Doosan Heavy Industries represented approximately 20%, 23% and 13% of our total sales in 2007, respectively, and GE Ionics and Geida and its affiliated entities accounted for approximately 18% and 11% of our total sales in 2006, respectively. In 2005, GE Ionics and Multiplex Degremont JV accounted for 19% and 17% of our total revenue, respectively. No other customer accounted for more than 10% of our total revenue during any of these periods.

In order to make customer support efficient, we maintain strategic satellite technical centers, located in Madrid, the United Arab Emirates, Shanghai, Perth and Fort Lauderdale. These technical centers support existing customers and aftermarket sales efforts for both EPCs who deal in large projects and small OEM customers across multiple continents and time zones. In addition, we support a troubleshooting hotline.

We offer customer service and support programs including PX technology education, design review, startup support and operator training. We regularly conduct “PX school” in California and many places around the world to upgrade the skills of designers and operators in the application of PX technology.

In addition, we provide a number of product support resources and services. These include operations and maintenance manuals, a maintenance training video and the “PX Simulator” factory and regional technical seminars. We also offer the “PX Power Model” SWRO energy consumption calculator, manifold, rack and instrumentation designs, project management, startup assistance and field service.

Manufacturing

All of our PX devices are assembled, packaged and shipped from our facility in San Leandro, California. We purchase ceramic components in an unfinished state from approved suppliers and perform the final finishing and assembly in-house to help protect the proprietary nature of our products.

Our manufacturing team collaborates with our technical team to execute production, wet testing and product delivery. Currently, we outsource production of all metal and composite components and initial processing of most of our ceramic components to outside vendors. Final finishing of all end covers, rotors and sleeves is performed in-house to help maintain the integrity of trade secrets and patents.

We presently run one shift per day to meet current and near-term expected demand. Increased work schedules, outsourcing and additional personnel could combine to increase manufacturing capacity significantly above current

production levels. Critical end functions such as final testing and assembly are expected to remain in-house for the foreseeable future.

To avoid unnecessary inventory build-up and provide timely order fulfillment, our manufacturing team coordinates with our sales divisions to review sales forecasts and schedule production runs. Our manufacturing department generally maintains a four-week safety stock to meet any unforeseen shortfalls. We utilize an enterprise resource planning system to model for various production constraints. As manufacturing activity increases, a more advanced modeling system may eventually be needed to queue production runs and minimize inventory levels.

We use several strategies to optimize manufacturing efficiency and avoid costly downtime of both personnel and equipment:

- *Cross-training.* Our manufacturing employees are cross-trained in different functionalities. This practice reduces downtime while creating a knowledge buffer to ensure a reliable production flow. As needed, additional personnel can be focused on specific time-sensitive tasks.
- *Collaboration.* We emphasize new product development to keep us on the cutting edge of pressure exchange technology while continuously improving existing products.
- *Outsourcing.* Outsourcing allows us to concentrate on the final in-house finishing and grinding of ceramic components. Key proprietary information is kept in-house, preventing technology from passing outside of our company. Our manufacturing capacity can increase throughput without requiring additional units of labor and equipment.
- *Multiple-vendor Strategy.* To prevent supply chain disruption, improve supplier pricing concessions and ensure timely customer order fulfillment, we have expanded the scope of our vendor relationships. We utilize three outside ceramic vendors and are currently qualifying a fourth to establish an additional supplier of unfinished, PX-220/PX-260 rotors and sleeves. Because the ceramic components of our products are vital to the operation of our business, our selection of ceramic vendors entails a rigorous qualification process.
- *Quality Control.* Purchased materials must conform to our design specifications, go through a thorough receiving inspection as specified in our quality procedures and be delivered with material certifications. A quality assurance inspection report is completed and accepted prior to any material being placed into inventory. Ceramic components are inspected for cracks and defects, as well as to ensure they meet exacting size and dimension specifications, following any in-house production operation. Critical components such as housings, ports and ceramic components are marked with serial numbers for traceability. Assembled PX and booster pump models and ceramic cartridges are subjected to specific performance testing to ensure they comply with our standards and customer requirements.

Research and Development

Continued investment in research and development is critical to our business. Over the past four years, our mechanical designs have been integrated into a single standardized design format aimed at facilitating knowledge redundancy. This redundancy benefits our technical team design tools, including finite element analysis and computational fluid dynamics modeling. Our technical team’s approach is targeted at establishing the necessary systems, procedures, tools and skills to foster new product innovation and accommodate a larger and more specialized staff, particularly as our technical needs grow.

The technical team serves as the knowledge base for dispersing technical information to other divisions and prospective customers. We also share our engineering drawings and designs with customers and vendors in an effort to promote industry knowledge and to continually improve our technology. As of December 31, 2007, our technical team consisted of seven employees.

We plan to continue to dedicate significant resources to these research and development efforts. Further, as we continue to expand internationally, we may incur additional costs to conform our products to comply with local laws and local product specifications.

Research and development expense totaled $1.7 million for 2007, $1.3 million for 2006 and $630,000 for 2005.

Competition

The market for energy recovery devices in desalination plants is competitive and continually evolving. The PX device competes with slow cycle isobarics, Pelton wheels and hydraulic turbochargers. Pelton wheels and hydraulic

turbochargers are used primarily in the OEM market in which we compete, and where customers are more sensitive to upfront prices. Slow cycle isobarics, and particularly the DWEER technology, are our main competition in the EPC market.

Our three primary competitors are Calder AG, Fluid Equipment Development Company and Pump Engineering Incorporated. Calder AG currently is the principal manufacturer of DWEER devices and Pelton wheels. Fluid Equipment Development Company and Pump Engineering manufacture hydraulic turbochargers. We expect competition to persist and intensify as the desalination market opportunity grows.

We believe that the principal factors of competition in our industry include device efficiency, price, innovation, customer service and durability. We believe that we compete favorably with respect to each of these factors. We differentiate our products from those of our competitors by having up to 98% energy recovery efficiency, a proprietary design employing only one moving part, a corrosion resistant, highly durable ceramic composition, smaller footprint, modular design and system redundancy, and lower life cycle cost. However, we cannot assure you that we will be able to compete successfully in the future against existing or new competitors, and increased competition may adversely affect our business.

Intellectual Property and Proprietary Rights

We rely on a combination of intellectual property rights, including patents, trade secrets and trademarks, as well as customary contractual protections.

We have five United States patents and nine international counterpart patents related to the PX device. The United States patents expire between 2011 and 2025, and the international patents expire at later dates. We have also applied for two additional United States patents and 14 international counterpart patents.

Our registered trademarks in the United States are “ERI,” the ERI logo, “Making Desalination Affordable,” “PX Pressure Exchanger” and “PX.” We also hold as trade secrets the specialized tooling, fixturing, instrumentation and processing techniques employed in the final production stages for ceramic components.

In addition, we generally control access to and use of our proprietary software and other confidential information through internal and external controls, including nondisclosure and assignment of intellectual property agreements with employees and contractors, and nondisclosure agreements with customers, and our online models and software are protected by United States and international copyright laws. We keep certain key proprietary manufacturing processes in-house to reduce the risk that they are not maintained as trade secrets. We have an array of security cameras in all manufacturing and office building to record and document access.

Employees

As of March 15, 2008, we had 67 employees consisting of 10 technicians, four employees in field service, eight employees in sales and marketing, two employees in customer services, 24 employees in management and administration and 19 employees in operations and production. A total of seven of these employees were located outside of the United States. In addition, we had three full-time independent contractors. We have not experienced any work stoppages. Our employees are non-union and we consider our employee relations to be good.

Facilities

We lease approximately 26,254 square feet of space in San Leandro, California pursuant to a lease that expires in April 2010, which house a ceramics manufacturing and research and development center, technical testing facilities and our executive headquarters. In February 2008 we entered into a two-year lease beginning in April 2008 for approximately 6,000 square feet for additional corporate office space, located approximately two miles away from our headquarters. We also maintain international sales offices in Madrid, the United Arab Emirates, Shanghai and Fort Lauderdale. We believe that our facilities are suitable and adequate to meet our current needs. We intend to add new facilities or expand existing facilities as we add employees to support existing customers and aftermarket sales, and we believe that suitable additional or substitute space will be available as needed to accommodate any such expansion of our operations.

Legal Proceedings

We are not party to any material litigation, and we are not aware of any pending or threatened litigation against us that we believe would adversely affect our business, operating results, financial condition or cash flows. In the future, we may be subject to legal proceedings in the ordinary course of our business.

MANAGEMENT

Executive Officers and Directors

Our executive officers and directors, and their ages and positions as of December 31, 2007, are set forth below:

Name	Age	Position
G.G. Pique	60	President, Chief Executive Officer and Director Nominee
Richard Stover, Ph.D.	45	Chief Technical Officer and Vice President of Sales
Thomas D. Willardson	57	Chief Financial Officer
Marilyn A. Lobel	55	Chief Accounting Officer and Corporate Controller
Terrill Sandlin	59	Vice President of Manufacturing
MariaElena Ross	58	Vice President of Administration and Human Resources
Hans Peter Michelet	48	Executive Chairman of the Board
Ole Peter Lorentzen	55	Director
Arve Hanstveit	52	Director
Peter Darby	59	Director
Marius Skaugen	49	Director
Fred Olav Johannessen	54	Director
James Medanich	69	Director
Dominique Trempont	53	Director Nominee
Paul Cook	84	Director Nominee

G.G. Pique has served as our president and chief executive officer since August 2002, and has been appointed to serve as a member of our board of directors upon the effectiveness of our initial public offering. From October 2001 until August 2002, Mr. Pique served as our executive vice president, and from February 2000 until October 2001 Mr. Pique was a consultant to our company. From 1993 to 1999, Mr. Pique was the group vice president Latin America of US Filter Corporation, a company focused on the acquisition, turnaround, integration and growth management of water treatment companies, before it was acquired by Vivendi in 1999, and served as group president of the integrated companies from 1999 to January 2000. Since October 2007, Mr. Pique has served as member of the board of directors of International Desal Association, a non-profit association committed to the development of desalination technology world-wide. Mr. Pique has also served as a member of the board of directors of P-K Direct Inc., a manufacturer of electronic coils and transformers since May 2000. Mr. Pique has over 30 years of experience in the water treatment industry. Mr. Pique holds a B.S. in Chemical Engineering from the University of Connecticut and an M.B.A. from Hartford University.

Richard Stover, Ph.D. has served as our vice president of sales since November 2007 and our chief technical officer since December 2004. From December 2004 to November 2007, Dr. Stover also served as our vice president of engineering and research. From April 2002 to December 2004 Dr. Stover was the engineering manager at our company. Dr. Stover has over 20 years of experience in research and development, manufacturing and consulting for 3M and IBM, among others. Dr. Stover earned his B.S. in Chemical Engineering from the University of Texas at Austin and his Ph.D. in Chemical Engineering at the University of California at Berkeley.

Thomas D. Willardson has served as our chief financial officer since November 2007. From January 2006 to August 2007, Mr. Willardson served as executive vice president and chief financial officer of Cost Plus, Inc. From April 2004 to February 2006, Mr. Willardson served as chief financial officer of WebSideStory, Inc., a provider of on-demand digital marketing applications. From August 2003 until April 2004 he served as chief financial officer of Archimedes Technology Group Holdings, LLC, a privately held technology development company. From April 2002 until July 2003, Mr. Willardson was an independent financial consultant. Mr. Willardson holds a B.A. in Finance from Brigham Young University and an M.B.A. from the University of Southern California.

Marilyn A. Lobel has served as our chief accounting officer and corporate controller since January 2008. From March 2007 to December 2007, Ms. Lobel served as corporate controller and corporate secretary of Red.Com, Inc., a privately held company that manufactures digital cinema photography equipment. From February 2006 to March 2007, Ms. Lobel served as the chief accounting officer and corporate controller of Pacific Energy Partners, L.P., a public partnership that engages principally in the business of gathering, transporting, storing and distributing crude oil and refined petroleum products. From June 2004 to December 2005, Ms. Lobel served as the vice president of finance and corporate controller of Biolase Technology, Inc., a public company that manufactures medical devices. From January 2004 to June

2004, Ms. Lobel was an independent financial consultant. From May 2002 to December 2003, Ms. Lobel served as director of finance at Xoma Ltd., a public company engaged in research and development of biopharmaceuticals. Ms. Lobel is a Certified Public Accountant currently licensed in the state of California and holds a B.S. in Business Administration from the University of Nevada.

Terrill Sandlin has served as our vice president of manufacturing since April 2002. From 1999 to 2001, he served as director of manufacturing for Novus Packaging Corporation, a packaging material company acquired by FP International in 2001. From 1978 to 1999, Mr. Sandlin served in various management positions, including as plant manager for Whitney Research, a valve manufacturer supplying exclusively for Swagelok Company. Mr. Sandlin holds a B.S. in Civil Engineering from the University of California at Berkeley.

MariaElena Ross has served as our vice president of administration and human resources since July 2006. From February 2005 to July 2006, Ms. Ross served as our executive director of human resources. From February 2002 to January 2005, Ms. Ross served as human resources manager for SPL World Group, a provider of revenue and operations management software for the utilities industry, before it was acquired by Oracle Corporation in 2006. Ms. Ross holds a B.A. in Anthropology from the University of California at Berkeley, a teaching credential from the University of San Francisco, and a J.D. from Hastings College of Law.

Hans Peter Michelet has served as the executive chairman of our board of directors since March 2008. As our executive chairman, he will play a role in investor relations and the determination of our strategic direction. Prior to being named the executive chairman of our board, Mr. Michelet had served as the chairman of our board since September 2004 and a member of our board of directors since August 1995. From January 2005 to November 2007, Mr. Michelet served as our interim chief financial officer. Mr. Michelet's other current directorships include serving as the chairman of the board of directors of SynchroNet Marine Inc., a maritime technology service provider, since June 2000 and as a member of the board of directors of Arvarius AS, a privately held Norwegian investment company, since June 1997. From September 1985 until February 2000, Mr. Michelet was a member of the Norwegian Society of Financial Analysts. Mr. Michelet holds a B.A. in Finance from the University of Oregon.

Ole Peter Lorentzen has served as a member of our board of directors since January 2007. Mr. Lorentzen has also served as the chairman of Caprice AS, an investment company, since October 1987, and as chief executive officer of Ludvig Lorentzen AS, an investment company, since December 1987. Mr. Lorentzen holds a B.A. in Business Administration from the University of Lund in Sweden.

Arve Hanstveit has served as a member of our board of directors since 1995. Since 1997, Mr. Hanstveit has served as partner and vice president of ABG Sundal Collier, a Scandinavian investment bank. Since February 2007, Mr. Hanstveit has also served on the board of directors of Kezzler AS, a privately held Norwegian company which delivers secure track and trace solutions to the pharmaceutical and consumer goods industry. Mr. Hanstveit holds a B.A. in Business from the Norwegian School of Management and an M.B.A. from the University of Wisconsin, Madison.

Peter Darby has served as a member of our board of directors since December 2001. Since September 2004, Mr. Darby has been a private investor. Mr. Darby was a managing member of Pema Properties, LLC, a company engaged in real estate development, from June 1995 to August 2004, after which Pema Properties was sold. Mr. Darby has over 30 years of experience in the water industry, which began with the founding of Advanced Structures, Inc. in 1976, which was a supplier for specialized pressure vessels used in reverse osmosis and other membrane-based water purification processes. Mr. Darby holds a B.S. in Mechanical Engineering from Michigan State University.

Marius Skaugen has served as a member of our board of directors since 1999. Mr. Skaugen has been a private investor since 1991. Mr. Skaugen has served as a member of the board of directors of Alf R. Bjercke & Co. AS, a private investment Norwegian company, since 2001, as a member of the boards of directors of Haut Brion AS, Morgenfuglen AS, Jampe AS, all of which are Norwegian private holding companies, since 2005. Mr. Skaugen received his B.B.A. in finance from the University of Oregon.

Fred Olav Johannessen has served as a member of our board of directors since June 1992. Since September 2001, Mr. Johannessen has served as president of the Nordiska Literary Agency in Denmark. Mr. Johannessen also has served as a member of the board of directors of Thalia Teater AS, a private theater production company in Norway, since June 1985, as a member of the board of directors of Lande & Co, a private media consulting company in Norway, since November 2005 and as a member of the board of directors of Folin, a private European company that invests in literary agencies, since March 1999. Mr. Johannessen earned his M.S. in Finance from Colorado State University.

James Medanich has served as a member of our board of directors since December 2001. Mr. Medanich has served as president and a member of the board of directors of the Piedmont Pacific Corporation, a private company engaged in the

manufacture and sale of pipe couplings, since July 2002. Mr. Medanich served as president of our company from February 2001 until July 2002. Mr. Medanich earned his B.A. in Geology from the University of California at Berkeley.

Dominique Trempont has been appointed to serve as a member of our board of directors upon the effectiveness of our initial public offering. Mr. Trempont is currently a member of the board of directors of 3Com Corporation, a position he has held since June 2006. Mr. Trempont also is currently a member of the board of directors of Finisar Corporation, a public company that develops and markets high speed data communication systems and software for networking and storage, a position he has held since September 2005. Since June 2006, Mr. Trempont has served on the board of directors of Cquay Technologies Corp., a private company that develops next generation search software. Mr. Trempont was CEO-in-Residence at Battery Ventures, a venture capital firm, from September 2003 to September 2005. From May 1999 to November 2002, Mr. Trempont was chairman, president and chief executive officer of Kanisa, Inc., a software company focused on customer self-service, contact center, and peer support applications. Mr. Trempont has served as chief executive officer of Gemplus Corporation, a smart card application company, and chief financial officer at NeXT Software. Mr. Trempont received a degree in Economics from College Saint Louis (Belgium), a bachelor's in Business Administration and Computer Sciences from IAG at the University of Louvain (Belgium) and a master's in Business Administration from INSEAD (France).

Paul M. Cook has been appointed to serve as a member of our board of directors upon the effectiveness of our initial public offering. Mr. Cook is the chairman and founder of Promptu Systems Corporation, a private company that develops a speech recognition system that enables the mobile phone user or the television viewer to control programming choices and services using voice commands, a position he has held since June 2000. Mr. Cook is also currently the chairman of Global Translation, Inc., a private company that provides automated translation services for television stations and networks, a position he has held since December 2006. In addition, since 1993, Mr. Cook has been a member of the board of directors of Sarnoff Corporation, which provides vision, video and semiconductor technology innovations and is a wholly owned subsidiary of SRI International. Mr. Cook is the founder of Raychem Corporation, where he served as its chief executive officer for 33 years. Mr. Cook received an undergraduate degree in engineering from Massachusetts Institute of Technology.

Board of Directors

Immediately prior to the completion of this offering, Messrs. Darby, Lorentzen and Skaugen will resign from our board of directors. Upon the completion of this offering, the board of directors will be divided into three classes, with each class serving for a staggered three-year term. The terms of the class I directors, class II directors and class III directors will expire upon the election and qualification of successor directors at the annual meeting of stockholders held during the calendar years 2009, 2010 and 2011, respectively.

Director Independence

In March 2008, our board of directors undertook a review of the independence of our directors and considered whether any director has a material relationship with us that could compromise his ability to exercise independent judgment in carrying out his responsibilities. As a result of this review, our board of directors determined that Messrs. Lorentzen, Johannessen, Medanich and Hanstveit, representing a majority of our directors, are "independent directors" as defined under the rules of the NASDAQ Global Market, or NASDAQ. Our board of directors expects that Messrs. Cook and Trempont, upon their appointment to the board, will be "independent directors" as defined under the NASDAQ rules.

Committees of the Board of Directors

Our board of directors has an audit committee, a compensation committee and a nominating and governance committee, each of which has the composition and responsibilities described below.

Audit Committee

Upon the effectiveness of our initial public offering, our audit committee will consist of Messrs. Hanstveit, Medanich and Trempont, each of whom is a non-employee member of our board of directors. Mr. Trempont will serve as the chairman of the committee. The NASDAQ corporate governance rules require that each issuer has an audit committee of at least three members, and that one independent director (as defined in those rules) be appointed to the audit committee at the time of listing, a majority within 90 days after listing and the entire committee within one year after listing. Messrs. Hanstveit, Medanich and Trempont are independent directors. Mr. Trempont will be our "audit committee financial

expert" as defined in SEC rules and will satisfy the financial sophistication requirements of NASDAQ for audit committee membership. The audit committee will be responsible for, among other things:

- overseeing the accounting and financial reporting processes and audits of our financial statements;
- selecting and hiring our independent registered public accounting firm, and approving the audit and non-audit services to be performed by our independent registered public accounting firm;
- assisting the board of directors in monitoring the integrity of our financial statements, our internal accounting and financial controls, our compliance with legal and regulatory requirements, the performance of our internal audit function and the qualifications, independence and performance of our independent registered public accounting firm;
- providing to the board of directors information and materials to make the board of directors aware of significant financial and audit-related matters that require the attention of the board of directors; and
- reviewing and discussing with management and our independent registered public accounting firm our annual and quarterly financial statements and annual and quarterly reports on Form 10-K and 10-Q.

Compensation Committee

Our compensation committee consists of Messrs. Hanstveit, Darby, Daniel Johnson, our vice president, information technology, and Ms. Ross. Immediately prior to the effectiveness of our initial public offering, Messrs. Darby and Johnson and Ms. Ross will resign from our compensation committee, and upon the effectiveness of our initial public offering, our compensation committee will consist of Messrs. Cook, Hanstveit, Johannessen and Trempont. Mr. Darby is currently the chairman of our compensation committee, and upon the effectiveness of this offering Mr. Hanstveit will be appointed as chairman of our compensation committee. Our board of directors has determined that upon effectiveness of this offering, each member of our compensation committee will meet the requirements for independence under the current NASDAQ rules, the non-employee director definition of Rule 16b-3 promulgated under the Securities Exchange Act of 1934 and the outside director definition of Section 162(m) of the Internal Revenue Code of 1986, as amended. The compensation committee will be responsible for, among other things:

- overseeing our compensation policies, plans and benefit programs and making recommendations to the board of directors with respect to improvements or changes to the plans and adoption of other plans;
- reviewing and approving with respect to our chief executive officer and other executive officers' annual base salaries, annual incentive bonuses, including the specific goals and amounts, equity compensation, employment agreements, severance arrangements and change of control agreements/provisions, and any other benefits, compensation or arrangements;
- evaluating and approving the corporate goals and objectives relevant to the compensation of our chief executive officer; and
- administering our equity compensation plans.

Corporate Governance and Nominating Committee

Upon the effectiveness of this offering, Messrs. Hanstveit, Medanich and Trempont, each of whom is a non-employee member of our board of directors, will comprise our nominating and governance committee. Mr. Trempont will be the chairman of our nominating and governance committee. Our board of directors has determined that each member of our nominating and governance committee will meet the requirements for independence under the current NASDAQ rules. The nominating and governance committee will be responsible for, among other things:

- assisting our board of directors in identifying prospective director nominees and recommending to our board of directors the director nominees for each annual meeting of stockholders;
- evaluating the performance of current members of our board of directors;
- developing principles of corporate governance and recommending them to our board of directors;
- recommending to our board of directors persons to be members of each board committee; and
- overseeing the evaluation of our board of directors and management.

Director Compensation

None of our directors currently receives any compensation for his services as a member of our board of directors or any committee of our board of directors.

Following the closing of this offering, each non-employee member of our board of directors will be entitled to receive an annual retainer of $50,000, paid in quarterly installments. New non-employee directors, upon joining our board of directors, will receive options to purchase 100,000 shares of our common stock which will vest over four years. Such options will be granted at the fair market value on the date of the award. In addition, each chairman of our audit committee, compensation committee and nominating and governance committee will be entitled to receive an additional annual retainer of $5,000, paid in quarterly installments.

Code of Business Conduct and Ethics

We have adopted a code of business conduct and ethics that is applicable to all of our employees, officers and directors, which will become effective upon the effectiveness of this offering.

Compensation Committee Interlocks and Insider Participation

Our compensation committee consists of Messrs. Hanstveit, Darby and Johnson and Ms. Ross. Mr. Johnson and Ms. Ross are employees of our company. Mr. Johnson and Ms. Ross, as well as Mr. Darby, will resign from the compensation committee immediately prior to the effectiveness of this offering.

Hans Peter Michelet, our executive chairman, currently serves as a member of the board of directors of Arvarius AS. Marius Skaugen, one of our directors, is an executive officer and a controlling stockholder of Arvarius AS. None of our other executive officers currently serves, or in the past year has served, as a member of the board of directors or compensation committee of any entity that has one or more executive officers serving on our board of directors or compensation committee.

COMPENSATION DISCUSSION AND ANALYSIS

Philosophy and Objectives of our Executive Compensation Program

The principal objectives of our compensation and benefits programs for executive officers are to:

- attract and retain exceptional executives;
- reward superior performance;
- motivate our executives' performance toward clearly defined corporate goals; and
- align the interests of our executives with those of our stockholders.

Our compensation committee believes that maintaining and improving the quality and skills of our management and appropriately incentivizing their performance are critical factors that will affect the long-term value realized by our stockholders.

At the beginning of each fiscal year, our compensation committee approves specific corporate goals and objectives for our senior management to address within the fiscal year. Through our annual goal-setting process, individual objectives are aligned with our corporate objectives. We also evaluate and reward our executive officers based on their willingness to take a leadership position in improving the operation of our business and their ability to identify and exploit opportunities to grow our business.

We believe our compensation decisions in 2007 achieved the principal objectives of our compensation and benefits programs for executive officers as follows: (i) we paid competitive salaries to senior management and offered competitive stock option awards in the hiring of Mr. Willardson, our chief financial officer, in an industry faced with a shortage of knowledgeable and experienced candidates; (ii) we rewarded our executive officers for their individual contributions to the growth of our company and our achievement of specific corporate goals such as the accomplishment of research and development projects, expansion of production facilities, development of internal infrastructure and expanding global market share; and (iii) our issuance of stock options to all employees continued to align their interests with those of our stockholders.

Principal Components of our Executive Compensation Program

Our executive compensation program consists of five components:

- base salary;
- annual cash bonuses;
- equity-based incentives;
- benefits; and
- severance/termination benefits.

We believe that a program containing each of these components, combining both short and long-term incentives, is necessary to achieve our compensation objectives and that collectively these components have been effective in properly incentivizing our Named Executive Officers and helping to achieve our corporate goals.

Annual Review Process

Our compensation committee reviews data and makes executive compensation decisions on an annual basis. In connection with that process, executive officers are responsible for establishing and submitting for review to the chief executive officer (and in the case of the chief executive officer, directly to the compensation committee) their departmental goals and financial objectives for the then current fiscal year. The chief executive officer then compiles the information submitted and provides it, along with information relating to his own personal goals and objectives, to the compensation committee for review. The compensation committee, including the chief executive officer with respect to all officers and excluding the chief executive officer with respect to discussions of his own compensation, reviews, considers, and may amend the terms and conditions proposed by management.

As part of the annual review process, the compensation committee makes determinations of changes in annual base compensation based on numerous factors, including individual performance over the prior fiscal year, established corporate and financial objectives for the next fiscal year, our operating budgets, and a review of survey data relating to base

compensation for the position at comparable companies. During the annual review process, the compensation committee also reviews our cash bonus plan for executive officers, with bonuses becoming payable under the plan based on management's achieving identified performance goals during the fiscal year, and considers each executive's equity incentive position, including the extent to which he or she was vested or unvested. Periodically, the compensation committee may provide refresher equity incentive grants, typically in the form of stock options, as an individual officer becomes substantially vested in his or her current equity position.

We hired a human resources consulting firm to assist us with the design of our employee compensation plan, including executive compensation. The employee compensation plan considered the following factors:

- a market analysis comparing total compensation of our employees and those of other companies of similar sizes and revenue;
- a salary structure with defined grades and ranges; and
- market data from three national benchmark salary survey firms.

We considered comparable market data with respect to industry, company size (both in terms of number of employees and revenue) and location in developing our employee compensation plan. In taking these components into consideration, we endeavored to offer competitive compensation packages that were in line with other similar companies in the San Francisco Bay Area and within our industry.

Weighting of Compensation Components

The compensation committee's determination of the appropriate use and weight of each component of executive compensation is subjective, based on the compensation committee's view of the relative importance of each component in meeting our overall objectives and factors relevant to the individual executive.

Base Salary

In general, base salaries for the Named Executive Officers are determined by evaluating the responsibilities of the executive's position, the executive's experience and knowledge and the competitive marketplace. In addition, each Named Executive Officer is assigned to a certain level and the corresponding salary rage for purposes of designing an equitable compensation package. Any future base salary adjustments are expected to take into account changes in the executive's responsibilities, the executive's performance, corporate objectives and changes in the competitive marketplace.

Cash Bonuses

Annual cash bonus incentives for our executive officers are designed principally to reward performance that furthers key corporate goals, particularly annual performance goals. For example, in 2007 our chief executive officer's bonus was tied to our achievement of a certain level of EBITDA for our company for that year, and the bonuses of our two top salespersons were tied to their management of their respective sales goals and budgeted expenses. These 2007 targets were in excess of the 2006 actual results and the revenue-related targets depended on sales of our devices. We believe that the disclosure of these non-public financial and other targets would cause competitive harm to our company. We believe these objectives will change from year to year as our business evolves and our priorities change. Under our current bonus plan, the Executive Financial Compensation Bonus Plan, our executive officers are eligible to earn an annual bonus as discussed below. In 2007, each executive officer, other than our chief executive officer and executive chairman, had written performance objectives (such as, for example, hiring designated personnel) for the year. The actual bonuses paid were based on a subjective consideration of the achievement of the various objectives by our compensation committee.

For 2007, our compensation committee set the maximum amount of the bonus for which our chief executive officer was eligible to 140% of his base salary. The committee set the maximum amount of the bonus for which our other Named Executive Officers, other than Mr. Michelet, were eligible to 30% of each executive officer's base salary. Based on subjective considerations of the individual's performance and achievement of objectives, our compensation committee approved bonuses for 2007 that were within the maximum amount, and that ranged from 26% to 100% of the maximum bonus amounts.

For 2008, our compensation committee set the following maximum bonus amounts for which each of our Named Executive Officers is eligible, based on a subjective consideration of each individual's performance:

Named Executive Officer	Maximum Bonus Allowable Under the Executive Financial Compensation Plan
Hans Peter Michelet	100% of base salary
G.G. Pique	140% of base salary
Thomas Willardson	140% of base salary
Richard Stover	10% of base salary
Terry Sandlin	30% of base salary
MariaElena Ross	30% of base salary

Dr. Stover is eligible to receive an additional commission bonus for the sale and installation of our equipment worldwide. For 2008, Dr. Stover's commission bonus rate is 0.5% of the net margin contribution of all sales and installations of our equipment. However, Dr. Stover's maximum annual commission bonus is set at $300,000 and any earned but unpaid bonus in excess of such $300,000 limit will be paid the following year.

In 2007, Mr. Michelet received a bonus in the amount of $125,000, which was paid outside the scope of the Executive Financial Compensation Bonus Plan. We awarded Mr. Michelet the bonus due to his expanded role in our company in 2007, including serving as our interim chief financial officer until November 2007, establishing new banking relationships that were necessary for large international projects and identifying strategic investors for our private placement in May 2007. Although performance bonuses typically are capped at 100% of an executive's base salary under our executive bonus plan, our board of directors awarded a $125,000 bonus to Mr. Michelet in 2007 due to his expanded role and performance, after taking into consideration the same market data that was used to create our employee compensation plan. In 2008, Mr. Michelet will be eligible to receive an annual bonus in an amount not to exceed 100% of his base salary.

Equity Based Incentives

We grant equity based incentives to employees, including our executive officers, in order to create a corporate culture that aligns employee interests with stockholder interests. We have not adopted any specific stock ownership guidelines, and other than the issuance of shares to our founders when we were established and the sale of shares of common stock to our executive officers, in addition to other third parties, in connection with common stock offerings, our equity incentive plans have provided the principal method for our executive officers to acquire an equity position in our company, whether in the form of shares or options.

Prior to this offering, we granted options and other equity incentives to our officers under our 2001 Stock Option Plan, 2002 Stock Option/Stock Issuance Plan, 2004 Stock Option/Stock Issuance Plan or 2006 Stock Option/Stock Issuance Plan, as the case may be. In connection with this offering, our board of directors has adopted the 2008 Equity Incentive Plan, which we will implement following this offering. The 2008 Equity Incentive Plan permits the grant of stock options, stock appreciation rights, restricted stock, restricted stock units, performance units, performance shares and other stock-based awards. Historically, our Stock Option/Stock Issuance Plans were administered by our board of directors. Going forward, all equity compensation plans and awards will be administered by our compensation committee under the delegated authority established in the compensation committee charter.

Our stock option grants are discretionary. Employees may be granted options for company stock upon approval by the board of directors. The plan is designed to give employees an opportunity to share in the company's success by allowing them to purchase shares of stock. After an initial grant in connection with the offer of employment, additional grants are based on the employee's performance which contributes towards meeting specific company performance milestones. However, the size and terms of any initial option grants to new employees, including executive officers, are based largely on competitive conditions applicable to the specific position and calibrated for the phase of the Company's development.

After the completion of this offering our practice will be to grant additional annual option grants to employees, including executive officers, when the individual becomes substantially vested and the board of directors or compensation committee believes additional unvested equity incentives are appropriate as a retention incentive. We expect this practice will be implemented in connection with the compensation committee's annual performance review at the beginning of each fiscal year. In making its determination concerning additional option grants, the compensation committee will also consider, among other factors, individual performance and the size and terms of the individual's outstanding equity grants in the then-current competitive environment.

To date, our equity incentives have been granted principally with time-based vesting. Most new hire option grants, including for executive officers, vest over a four-year period with 25% vesting at the end of the first year of employment and the remainder vesting in equal monthly installments over the subsequent three years. We expect that additional annual option grants to continuing employees will typically vest over a four-year period with 25% vesting on each annual anniversary of the date of grant. Although our practice in recent years has been to provide equity incentives principally in the form of stock option grants that vest over time, our compensation committee may consider alternative forms of equity in the future, such as performance shares, restricted stock units or restricted stock awards with alternative vesting strategies based on the achievement of performance milestones or financial metrics.

During 2007, our board of directors reviewed the aggregate equity position of each of our executive officers as well as the portion of the aggregate equity incentives that were vested versus unvested. After these reviews, because a large portion of the stock options previously granted to Messrs. Pique and Sandlin and Ms. Ross remained subject to vesting, our board of directors determined not to grant additional stock options to each of these Named Executive Officers in 2007. Our board of directors approved an option to purchase 100,000 shares of our common stock at an exercise price of $5.00 per share to Thomas Willardson, our chief financial officer, in connection with his employment offer in November 2007. During 2007 our board of directors also granted an option to purchase 2,800 shares of our common stock at an exercise price of $5.00 per share to Richard Stover, our chief technical officer and vice president of sales, in connection with his completion of specified research and development projects.

Benefits

We provide the following benefits to our Named Executive Officers, generally on the same basis provided to all of our employees with the exception of life insurance coverage:

- health, dental and vision insurance;
- life insurance, including accidental death and dismemberment;
- employee stock option plan;
- medical and dependant care flexible spending account;
- long-term disability; and
- a 401(k) plan.

We believe these benefits are consistent with companies with which we compete for employees.

Severance and Termination Compensation

In connection with certain terminations of employment, our executive officers may be entitled to receive certain severance payments and benefits pursuant to their respective employment agreements, offer letters and/or management retention agreements. In setting the terms of and determining whether to approve these arrangements, our board of directors recognized that executives often face challenges securing new employment following termination and that distractions created by uncertain job security surrounding potential beneficial transactions may have a detrimental impact on their performance.

Chief Executive Officer

Under the terms of the March 2006 employment agreement with our president and chief executive officer, G.G. Pique, as amended in January 2008, if Mr. Pique is involuntarily terminated (other than for cause, death or disability) he will be entitled to receive the following benefits:

- lump sum payment, immediately following termination, of any and all base salary due and owing to him through the date of termination, plus an amount equal to his earned but unused vacation through the date of termination, reimbursement for all reasonable expenses and any earned but unpaid and undeferred bonus attributable to the year that ends immediately before the year in which his termination occurs;
- lump sum payment, immediately following termination, of an amount equal to 70% of Mr. Pique's then current annual base salary, less deductions required by law; and
- immediate vesting of all unvested equity compensation held by Mr. Pique as of the date of termination;
- until the earlier of one year from the date of termination or such time as Mr. Pique has become covered under another employer's plans with comparable coverage, continued health, dental, vision and life insurance benefits at the same levels of coverage and with the same relative ratios of premium payments by us and Mr. Pique as existed prior to the termination.

In addition, if during the term of the agreement, Mr. Pique is involuntarily terminated (other than for cause, death or disability) within one year following a change in control of our company, Mr. Pique will be entitled to receive the severance benefits described above and an additional lump sum payment of an amount equal to 30% of Mr. Pique's current annual base salary to be paid immediately following such termination.

Payment of the benefits described above is subject to Mr. Pique's executing a general release of claims against us or persons affiliated with us and agreeing not to prosecute any legal action or other proceeding based on any such claims.

In the event of a termination of employment for cause, including death or disability, or a voluntary termination by Mr. Pique, Mr. Pique will be entitled to receive:

- a lump sum payment of any and all base salary due and owing through to the date of termination;
- an amount equal to earned but unused vacation through the date of termination and reimbursement of all reasonable expenses; and
- any earned but unpaid and undeferred bonus attributable to the year that ends immediately before the year in which Mr. Pique's termination occurs.

Other Named Executive Officers

We also entered management retention agreements with our other Named Executive Officers, with the exception of Hans Peter Michelet. Under the terms of these agreements, if the executive is involuntarily terminated (other than for cause, death, or disability) our executive officers will be entitled to receive the following benefits:

- lump sum payment, immediately following termination, of any and all base salary due and owing to the executive through the date of termination, plus an amount equal to his/her earned but unused vacation through the date of termination, reimbursement for all reasonable expenses and any earned but unpaid and undeferred bonus attributable to the year that ends immediately before the year in which the termination occurs;
- lump sum payment, immediately following termination, of an amount equal to 50% of the executive's current annual base salary, less deductions required by law, and an additional amount equal to 50% of the executive's current annual base salary if the executive is involuntarily terminated (other than for cause, death, or disability) within 12 months following a change of control; and
- immediate vesting of all unvested equity compensation held by the executive as of the date of termination;
- until the earlier of one year from the date of termination or such time as the executive has become covered under another employer's plans with comparable coverage, continued health, dental, vision and life insurance benefits at the same levels of coverage and with the same relative ratios of premium payments by us and the executive as existed prior to the termination.

Payment of the benefits described above under these management retention agreements is subject to the executive's executing and a general release of claims against us or persons affiliated with us and agreeing not to prosecute any legal action or other proceeding based on any such claims.

In the event of a termination of employment for cause, or upon death or disability, or a voluntary termination by the executive, the executive will be entitled to receive:

- a lump sum payment of any and all base salary due and owing through to the date of termination;
- an amount equal to earned but unused vacation through the date of termination and reimbursement of all reasonable expenses; and
- any earned but unpaid and undeferred bonus attributable to the year that ends immediately before the year in which the executive's termination occurs.

Tax Deductibility

Section 162(m) of the Internal Revenue Code generally disallows a tax deduction to public corporations for compensation greater than $1 million paid for any fiscal year to certain executive officers. However, performance-based compensation is not subject to the $1 million deduction limit if certain requirements are met. Our compensation committee may consider the impact of Section 162(m) when designing our cash and equity bonus programs, but may elect to provide compensation that is not fully deductible as a result of Section 162(m) if it determines this is in our best interests.

COMPENSATION OF EXECUTIVE OFFICERS

Summary Compensation Table

The table below summarizes the compensation information in respect of the Named Executive Officers for 2007.

Name and Principal Position	Salary ($)	Option Awards ($)(1)	Non-Equity Incentive Plan Compensation and Other Bonus ($)(2)	All Other Compensation ($)(3)	Total ($)
G.G. Pique President and Chief Executive Officer	250,000	68,877	90,000	1,401	410,278
Hans Peter Michelet(4) Former Chief Financial Officer	109,615	—	125,000	—	234,615
Thomas Willardson(5) Chief Financial Officer	35,577	8,451	25,250	159	69,437
Richard Stover(6) Chief Technical Officer and Vice President of Sales	216,461	12,420	70,300	278	299,459
Terrill Sandlin(7) Vice President of Manufacturing	138,700	9,999	42,900	391	191,990
MariaElena Ross(8) Vice President Administration and Human Resources	133,461	8,313	40,000	377	182,151

(1) The amounts shown represent the compensation costs for financial reporting purposes of previously granted stock awards and stock options recognized for the year ended December 31, 2007 under FAS 123R, rather than an amount paid to or realized by the Named Executive Officer. The FAS 123R value as of the grant date for stock awards and stock options is spread over the number of months of service required for the grant to become non-forfeitable. The amount disclosed disregards estimates of forfeitures of awards that are otherwise included in the financial statement reporting for such awards. Ratable amounts expensed for stock options that were granted in years prior to 2007 are also reflected in this column.

(2) In 2007, under our Executive Financial Compensation Plan, our chief executive officer was eligible to earn an annual bonus in an amount not to exceed 100% of his base salary, and the maximum bonus amount for which our other Named Executive Officers were eligible, other than Mr. Michelet, was 30% of such executive officer's base salary.

(3) Represents amounts paid for life insurance for the executive.

(4) Mr. Michelet served as our interim chief financial officer from January 2005 to November 2007, and received a year-end bonus outside of our executive compensation bonus plan in the amount of $125,000.

(5) Mr. Willardson was appointed as our chief financial officer in November 2007. Mr. Willardson received a performance-based bonus in the amount of $25,000 and a holiday bonus in the amount of $250.

(6) Dr. Stover received a performance-based bonus in the amount of $69,300 and a holiday bonus in the amount of $1,000.

(7) Mr. Sandlin received a performance-based bonus in the amount of $41,900 and a holiday bonus in the amount of $1,000.

(8) Ms. Ross received a performance-based bonus in the amount of $39,000 and a holiday bonus in the amount of $1,000.

Table of Contents

Grants of Plan-Based Awards in 2007

The following table sets forth information concerning non-equity incentive plan grants to the Named Executive Officers during 2007. The non-equity incentive plan consists of the Executive Financial Compensation Bonus Plan that is described in the Compensation Discussion and Analysis section above. The actual amounts realized in respect of the non-equity plan incentive awards are reported in the Summary Compensation Table under the Non-Equity Incentive Compensation Bonus Plan column. The table also sets forth information with respect to option awards granted by our company during 2007.

		Estimated Future Payouts Under Non-Equity Incentive Plan Awards ($)(1)					
Name	Grant Date	Threshold ($)	Target ($)	Maximum ($)	All Other Option Awards: Number of Securities Underlying Options (#)	Exercise or Base Price of Option Awards ($)(2)	Grant Date Fair Value of Option Awards ($)(3)
G.G. Pique	—	—	187,500	250,000	—	—	—
Hans Peter Michelet(4)	—	—	—	—	—	—	—
Thomas Willardson(5)	11/1/07	—	—	—	100,000	5.00	237,000
Richard Stover	6/28/07	—	52,000	69,300	2,800	5.00	6,900
Terrill Sandlin	—	—	29,300	41,900	—	—	—
MariaElena Ross	—	—	29,300	39,000	—	—	—

(1) In 2007, under our Executive Financial Compensation Plan, our chief executive officer was eligible to earn an annual bonus in an amount not to exceed 100% of his base salary, and the maximum bonus amount for which our other Named Executive Officers were eligible, other than Mr. Michelet, was 30% of such executive officer's base salary. Mr. Michelet's bonus was paid outside of our Executive Financial Compensation Bonus Plan.

(2) The fair value of the common stock for options granted was estimated either by our board of directors with input from management or by the stock prices in conjunction with private placements with third parties.

(3) Amounts reflect the aggregate grant date fair value of stock options granted in 2007, calculated in accordance with SFAS No. 123(R) without regard to estimated forfeitures. See Note 9 of Notes to Consolidated Financial Statements for a discussion of assumptions made in determining the grant date fair value of our stock options.

(4) Mr. Michelet served as our interim chief financial officer from January 2005 to November 2007.

(5) Mr. Willardson was appointed as our chief financial officer in November 2007.

Outstanding Equity Awards At December 31, 2007

The following table presents certain information concerning equity awards held by our Named Executive Officers at the end of 2007.

	Option Awards				
Name	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) Unexercisable	Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options (#)	Option Exercise Price ($)	Option Expiration Date
G.G. Pique	250,000(1)	—	187,500	2.65	12/08/16
Hans Peter Michelet	—	—	—	—	—
Thomas Willardson	47,083 (2)	—	47,083	5.00	10/31/17
	52,917 (3)	—	52,917	5.00	10/31/17
Richard Stover	59,000 (4)	—	29,500	1.00	12/14/15
	1,042 (5)	—	521	1.00	12/14/15
	30,000 (6)	—	22,500	2.65	12/08/16
	2,800 (7)	—	2,800	5.00	6/27/17
Terrill Sandlin	5,000 (8)	—	2,500	1.00	12/14/15
	30,000 (9)	—	22,500	2.65	12/08/16
MariaElena Ross	40,000 (10)	—	13,334	1.00	04/04/15
	45,000 (11)	—	22,500	1.00	12/14/15
	30,000 (12)	—	22,500	2.65	12/08/16

(1) This option was granted under the 2006 Stock Option/Stock Issuance Plan, or the 2006 Plan, on December 9, 2006 and vests for a period of four years beginning December 9, 2006. The options vest 25% on the first anniversary of the vesting commencement date and 1/36 of the remaining per month thereafter and will be fully vested on December 9, 2010.

(2) This option was granted under the 2006 Plan on November 1, 2007 and vests for a period of four years beginning November 1, 2007. The options vest 25% on the first anniversary of the vesting commencement date and 1/36 of the remaining per month thereafter and will be fully vested on November 1, 2011.

(3) This option was granted under the 2004 Stock Option/Stock Issuance Plan, or the 2004 Plan, on November 1, 2007 and vests for a period of four years beginning November 1, 2007. The options vest 25% on the first anniversary of the vesting commencement date and 1/36 of the remaining per month thereafter and will be fully vested on November 1, 2011.

(4) This option was granted under the 2004 Plan on December 15, 2005 and vests for a period of four years beginning December 15, 2005. The options vest 25% on the first anniversary of the vesting commencement date and 1/36 of the remaining per month thereafter and will be fully vested on December 15, 2009.

(5) This option was granted under the 2002 Stock Option/Stock Issuance Plan, or the 2002 Plan, on December 15, 2005 and vests for a period of four years beginning December 15, 2005. The options vest 25% on the first anniversary of the vesting commencement date and 1/36 of the remaining per month thereafter and will be fully vested on December 15, 2009.

(6) This option was granted under the 2006 Plan on December 9, 2006 and vests for a period of four years beginning December 9, 2006. The options vest 25% on the first anniversary of the vesting commencement date and 1/36 of the remaining per month thereafter and will be fully vested on December 9, 2010.

(7) This option was granted under the 2006 Plan on June 28, 2007 and vests for a period of four years beginning June 28, 2007. The options vest 25% on the first anniversary of the vesting commencement date and 1/36 of the remaining per month thereafter and will be fully vested on June 28, 2011.

(8) This option was granted under the 2004 Plan on December 15, 2005 and vests for a period of four years beginning December 15, 2005. The options vest 25 on the first anniversary of the vesting commencement date and 1/36 of the remaining per month thereafter and will be fully vested on December 15, 2009.

(9) This option was granted under the 2006 Plan on December 9, 2006 and vests for a period of four years beginning December 9, 2006. The options vest 25% on the first anniversary of the vesting commencement date and 1/36 of the remaining per month thereafter and will be fully vested on December 9, 2010.

(10) This option was granted under the 2002 Stock Option/Stock Issuance Plan on April 5, 2005 and vests for a period of four years beginning April 5, 2005. The options vest 25% on the first anniversary of the vesting commencement date and 1/36 of the remaining per month thereafter and will be fully vested on April 5, 2009.

(11) This option was granted under the 2002 Plan on December 15, 2005 and vests for a period of four years beginning December 15, 2005. The options vest 25 on the first anniversary of the vesting commencement date and 1/36 of the remaining per month thereafter and will be fully vested on December 15, 2009.

(12) This option was granted under the 2006 Plan on December 9, 2006 and vests for a period of four years beginning December 9, 2006. The options vest 25% on the first anniversary of the vesting commencement date and 1/36 of the remaining per month thereafter and will be fully vested on December 9, 2010.

Option Exercises and Stock Vested

None of our Named Executive Officers exercised any options and no shares vested for any of our Named Executive Officers during 2007.

Employment Arrangements with Named Executive Officers

G.G. Pique

In March 2006, we entered into an employment agreement with G.G. Pique, our president and chief executive officer. Under the employment agreement, we employ Mr. Pique for a period of two years from the date of the agreement, at the end of which Mr. Pique's agreement terminates and he will be employed with us on an at-will basis. Mr. Pique's initial base salary was set at $250,000, which the compensation committee reviews annually for potential adjustments. The employment agreement also provides Mr. Pique with an annual performance bonus opportunity in an amount not to exceed 100% of his base salary. In addition, Mr. Pique's employment agreement provides for the grant of options to purchase 250,000 shares of our common stock. Mr. Pique exercised options granted in 2002, 2003 and 2004 to purchase an aggregate of 750,000 shares of our common stock upon execution and delivery of promissory notes dated February 2005 in the aggregate amount of $195,000, all of which notes and accrued interest totaling $219,187 were repaid as of March 2008.

In January 2008, we amended Mr. Pique's employment agreement to provide for an increase of his annual base salary to $350,000. The amendment also extends Mr. Pique's term of employment with us for an additional 24 months from the date of the amendment, at the end of which term Mr. Pique's agreement terminates and he will be employed with us on an at-will basis. In addition, the amendment provides for the accelerated vesting of all stock options granted to Mr. Pique under his 2006 Equity Compensation Grant at the end of his employment term or if our initial public offering is not consummated by December 31, 2008 through no fault of Mr. Pique, as determined in good faith by the board.

Hans Peter Michelet

During 2007, we paid Hans Peter Michelet a base salary in the amount of $109,615 and a bonus in the amount of $125,000 for his services as our interim chief financial officer. We did not enter into a formal employment agreement with Mr. Michelet relating to his services in this role.

In March 2008, our board approved an employment arrangement with Mr. Michelet for his services as executive chairman of our board. As our executive chairman, he will play a role in investor relations and the determination of our strategic direction. Under this arrangement, Mr. Michelet serves as an at-will employee of our company and his initial base salary is set at $250,000. Additionally, the employment arrangement provides for the grant of options to purchase 100,000 shares of our common stock and an annual performance bonus opportunity in an amount not to exceed 100% of his base salary.

Thomas Willardson

We entered into an employment agreement in November 2007 with Thomas Willardson, our chief financial officer. Under the employment agreement, we employ Mr. Willardson for a period of eight months from the date of the agreement, at the end of which Mr. Willardson's agreement terminates and he will be employed with us on an at-will basis. Mr. Willardson's initial base salary was set at $250,000. The employment agreement also provides Mr. Willardson with an annual performance bonus opportunity in an amount not to exceed 100% of his base salary.

In February 2008, we amended Mr. Willardson's employment agreement, effective July 1, 2008. Pursuant to the amendment, Mr. Willardson's term of employment was extended from 24 months to 30 months, at the end of which Mr. Willardson's employment becomes at-will. The amendment also provides that in the event that the initial public offering is not consummated through no fault of Mr. Willardson, all stock options granted to Mr. Willardson in December 2007 will immediately and fully vest as of December 31, 2008.

Richard Stover

We entered into an employment agreement dated July 1, 2006 with Richard Stover, our chief technical officer. Under the employment agreement, we employ Dr. Stover for a period of 24 months from the date of the agreement, at the end of which Dr. Stover's agreement terminates and he will be employed with us on an at-will basis. Dr. Stover's initial base salary was set at $210,000. The employment agreement also provides Dr. Stover with an annual performance bonus opportunity in an amount not to exceed 100% of his base salary. Pursuant to the employment agreement, we granted Dr. Stover an option to purchase 30,000 shares of our common stock. Dr. Stover exercised options granted in 2002, 2003 and 2004 to purchase an aggregate of 175,000 shares of our common stock upon execution

and delivery of promissory notes dated February 2005 in the aggregate amount of $51,000, all of which notes and accrued interest totaling $56,173 were repaid as of March 2008.

In February 2008, we amended Dr. Stover's employment agreement, effective July 1, 2008. Pursuant to the amendment, Dr. Stover's term of employment was extended from 24 months to 30 months, at the end of which Dr. Stover's employment becomes at-will. In addition, under the amendment Dr. Stover's base salary is increased to $231,000 effective as of January 1, 2008. The amendment also provides that in the event that the initial public offering is not consummated as scheduled, through no fault of Dr. Stover, all stock options granted to Dr. Stover in December 2006 will immediately and fully vest as of December 31, 2008.

Terrill Sandlin

We entered into an employment agreement dated July 1, 2006 with Terrill Sandlin, our vice president of manufacturing. Under the employment agreement, we employ Mr. Sandlin for a period of 24 months from the date of the agreement, at the end of which Mr. Sandlin's agreement terminates and he will be employed with us on an at-will basis. Mr. Sandlin's initial base salary was set at $130,000. The employment agreement also provides Mr. Sandlin with an annual performance bonus opportunity in an amount not to exceed 100% of his base salary. Pursuant to the employment agreement, we granted Mr. Sandlin an initial option to purchase 30,000 shares of our common stock. Mr. Sandlin exercised options granted in 2001, 2002 and 2004 to purchase an aggregate of 120,000 shares of our common stock upon execution and delivery of promissory notes dated February 2005 in the aggregate amount of $36,000, all of which notes and accrued interest totaling $40,364 were repaid as of March 2008.

In February 2008, we amended Mr. Sandlin's employment agreement, effective July 1, 2008. Pursuant to the amendment, Mr. Sandlin's term of employment was extended from 24 months to 30 months, at the end of which Mr. Sandlin's employment becomes at-will. In addition, under the amendment Mr. Sandlin's base salary is increased to $143,000 effective as of January 1, 2008. The amendment also provides that in the event that the initial public offering is not consummated as scheduled, through no fault of Mr. Sandlin, all stock options granted to Mr. Sandlin in December 2006 will immediately and fully vest as of December 31, 2008.

MariaElena Ross

We entered into an employment agreement dated July 1, 2006 with MariaElena Ross, our vice president of administration and human resources. Under the employment agreement, we employ Ms. Ross for a period of 24 months from the date of the agreement, at the end of which Ms. Ross's agreement terminates and she will be employed with us on an at-will basis. Ms. Ross's initial base salary was set at $130,000. The employment agreement also provides Ms. Ross with an annual performance bonus opportunity in an amount not to exceed 100% of her base salary. Pursuant to the employment agreement, we granted Ms. Ross an initial option to purchase 30,000 shares of our common stock.

In February 2008, we amended Ms. Ross's employment agreement, effective July 1, 2008. Pursuant to the amendment, Ms. Ross's term of employment was extended from 24 months to 30 months, at the end of which Ms. Ross's employment becomes at-will. In addition, under the amendment Ms. Ross's base salary is increased to $145,000 effective as of January 1, 2008. The amendment also provides that in the event that the initial public offering is not consummated as scheduled, through no fault of Ms. Ross, all stock options granted to Ms. Ross in December 2006 will immediately and fully vest as of December 31, 2008.

The severance and termination terms of our Named Executive Officers' current employment agreements are further discussed under the caption "Compensation Discussion and Analysis—Severance and Termination" above. Additionally, each of our Named Executive Officers has entered into our standard employment agreement, which contains customary provisions relating to restrictions on competition during the period of employment as well as restrictions on solicitation during the term of employment and for two years after termination.

Potential Payments Upon Termination or Change of Control

The table below reflects the compensation and benefits due to each of the Named Executive Officers in the event of termination of employment: (i) upon a voluntary termination; (ii) an involuntary for cause termination (including death and disability); (iii) an involuntary termination without cause; and (iv) an involuntary termination following a change in control. The amounts shown assume that each termination of employment was effective as of December 31, 2007. The amounts shown in the table are estimates of the amounts which would be paid upon termination of employment. The actual amounts to be paid can only be determined at the time of the termination of employment.

Name	Voluntary Termination ($)(1)	Involuntary Termination For Cause ($)(1)	Involuntary Termination Without Cause ($)(2)(3)	Involuntary Termination Within 12 Months Following a Change in Control ($)(3)(4)
G.G. Pique	25,700	25,700		
Hans Peter Michelet(5)	8,061	8,061		
Thomas Willardson(6)	7,722	7,722		
Richard Stover	12,382	12,382		
Terrill Sandlin	23,287	23,287		
MariaElena Ross	12,038	12,038		

(1) This amount includes: (i) base salary due and owing at termination; (ii) earned but unused vacation through the date of termination; (iii) reimbursement of all reasonable expenses; and (iv) any earned but unpaid and undeferred bonus attributable to the year that ends immediately before the year in which the executive's termination occurs.

(2) This amount includes: (i) base salary due and owing at termination; (ii) earned but unused vacation through the date of termination; (iii) reimbursement of all reasonable expenses; (iv) any earned but unpaid and undeferred bonus attributable to the year that ends immediately before the year in which the executive's termination occurs; (v) payment in an amount equal to 70% of current annual base salary, in the case of Mr. Pique, and 50% of current annual base salary, in the case of other Named Executive Officers; (vi) equity acceleration; and (vii) our payments for continued health, dental, vision and life insurance benefits for a period of one year.

(3) Equity acceleration is calculated as the spread value of all unvested stock options and restricted stock held by the executive on December 31, 2007, assuming an initial public offering price of our common stock of $. The vesting of all then-unvested stock options, restricted stock or other unvested equity incentives held by the executive immediately accelerates upon termination of executive's employment without cause.

(4) This amount includes: (i) base salary due and owing at termination; (ii) earned but unused vacation through the date of termination; (iii) reimbursement of all reasonable expenses; (iv) any earned but unpaid and undeferred bonus attributable to the year that ends immediately before the year in which the executive's termination occurs; (v) payment in an amount equal to 100% of current annual base salary; (vi) equity acceleration; and (vii) our payments for continued health, dental, vision and life insurance benefits for a period of one year.

(5) Mr. Michelet served as our interim chief financial officer from January 2005 to November 2007.

(6) Mr. Willardson was appointed as our chief financial officer in November 2007.

In addition to the benefits described above, our 2002 Stock Option/Stock Issuance Plan, 2004 Stock Option/Stock Issuance Plan and 2006 Stock Option/Stock Issuance Plan provide for the acceleration of vesting of awards in certain circumstances in connection with or following a change of control of our company. See "Employee Benefit Plans" below.

Employee Benefit Plans

2008 Equity Incentive Plan

The following contains a summary of the material terms of our 2008 Equity Incentive Plan, or the 2008 Plan, which was approved by our board of directors in March 2008 and which we expect our stockholders will approve prior to the completion of this offering. The 2008 Plan, which will be effective immediately prior to the effectiveness of this offering, is the successor to our 2006 Stock Option/Stock Issuance Plan. No further awards will be granted under our 2006 Stock Option/Stock Issuance Plan after this offering. The awards outstanding after this offering under the 2006 Stock Option/Stock Issuance Plan will continue to be governed by their existing terms.

Purpose of the 2008 Plan. The 2008 Plan is intended to promote our long-term success and the creation of stockholder value by encouraging employees, directors and consultants to focus on critical long-range objectives, encouraging the attraction and retention of employees, directors and consultants with exceptional qualifications and linking employees, directors and consultants directly to stockholder interests through increased stock ownership.

Term of the 2008 Plan. The 2008 Plan will continue in effect for seven years from its adoption date, unless our board of directors decides to terminate the plan earlier.

Share Reserve. The maximum number of shares that we have authorized for issuance under the 2008 Plan is 1,000,000 shares.

Any award intended to comply with Section 162(m) of the Code shall be limited to an aggregate of 500,000 shares per individual in a single calendar year, except that a newly hired employee may receive one or more awards intended to comply with Section 162(m) of the Code up to 800,000 shares in the first calendar year of employment. All shares available under the 2008 Plan may be issued upon the exercise of incentive stock options.

As of the first day of each year, commencing in 2009, the aggregate number of shares that may be issued or transferred under the 2008 Plan shall automatically increase by a number equal to the lowest of (a) 5% of the total number of shares then outstanding, (b) 2,500,000 shares or (c) the number determined by the board of directors. Notwithstanding the foregoing, the maximum aggregate number of shares that may be issued or transferred under the 2008 Plan during the term of the Plan shall not exceed 10,000,000 shares.

In general, if options or other awards granted under the 2008 Plan are forfeited or terminate for any other reason before being exercised or settled, then the shares subject to such options or awards will again become available for awards under the 2008 Plan.

Administration of the 2008 Plan. The 2008 Plan is administered by a committee of our board of directors, which will have complete discretion to make all decisions relating to the interpretation and operation of the 2008 Plan. The committee will have the discretion to determine who will receive an award, the type of award, the number of shares that will be covered by the award, the vesting requirements of the award, if any, and all other features and conditions of the award. The committee may implement rules and procedures that differ from those described below in order to adapt the 2008 Plan to the requirements of countries other than the United States. Any action taken or determination made by the committee will be final, binding and conclusive on all affected persons. Within the limits set forth by the 2008 Plan, the committee may also reprice outstanding options and modify outstanding awards in other ways.

Eligibility. Any employee, consultant or non-employee director may be selected by the committee to participate in the 2008 Plan. Except as set forth below with respect to incentive options, all awards may be granted by the committee to any employee, consultant or non-employee director who performs services for us or our parent or subsidiary and who is determined by the committee to be eligible for an award.

Type of 2008 Plan Awards. Awards granted under the 2008 Plan may include any of the following:

- non-qualified options are options to purchase shares of our common stock at an exercise price of not less than 100% of the fair market value per share on the date of grant;
- incentive options are options designed to meet certain tax code provisions, which provide favorable tax treatment to optionees if certain conditions are met. Incentive options are issued at an exercise price not less than 100% of the fair market value per share (or 110% of fair market value per share if issued to 10% stockholders) on the date of grant and may only be granted to employees;
- stock units are rights to receive a specified number of shares of our common stock, the fair market value of such common stock in cash or a combination of cash and shares upon expiration of the vesting period specified for such stock units by the committee;

- restricted shares are shares of common stock which are issued to the participant subject to such forfeiture and other restrictions as the committee, in its sole discretion, shall determine. Restricted shares may not be transferred by the participant prior to the lapse of such restrictions; and
- stock appreciation rights are rights to receive shares of our common stock, cash or a combination of shares and cash, the value of which is equal to the spread or excess of (i) the fair market value per share on the date of exercise over (ii) the fair market value per share on the date of grant with respect to a specified number of shares of common stock.

Performance Awards. The committee may grant performance awards to employees, consultants or non-employee directors based on performance criteria measured over a specified period of one or more years. Such criteria may include operating profits (including EBITDA), net profits, earnings per share, profit returns and margins, revenue, stockholder return and/or value, stock price and working capital or, for awards not intended to comply with Section 162(m) of the Code, such other performance criteria determined by the board of directors.

Vesting of Awards and Exercise of Options and Stock Appreciation Rights. Options and stock appreciation rights vest at the time or times determined by the committee. In most cases, our options vest over the four-year period following the date of grant. Vesting may accelerate in the event of death or disability.

Restricted shares and stock units vest at the time or times determined by the committee and may be subject to service-based or performance-based vesting conditions. Vesting may accelerate in the event of death or disability.

Change in Control. If a change in control of our company occurs, the vesting of an award under the 2008 Plan will generally not accelerate unless the surviving corporation in a merger or consolidation does not assume the option or award or replace it with a comparable award. A change in control includes:

- a merger of our company after which our stockholders own 50% or less of the surviving corporation or its parent company;
- a sale of all or substantially all of our assets;
- a change in the composition of the board of directors, as a result of which less than 50% of the incumbent directors either had been directors two years before the change in composition of the board or were appointed or nominated by the board by a majority of the directors who had been directors two years before or had been selected in this manner; or
- an acquisition of 50% or more of our outstanding stock by any person or group, other than a person related to our company, such as a holding company owned by our stockholders.

In the event that we are a party to a merger or consolidation in which options or awards are not assumed or replaced with comparable awards by the surviving corporation, all outstanding options or awards shall be subject to the agreement of merger or consolidation, which shall provide for one or more of the following:

- the acceleration of vesting of 100% of the then unvested portion of the common stock subject to any outstanding options and stock appreciation rights;
- the cancellation of all outstanding options and stock appreciation rights in exchange for a payment to the holders thereof equal to the excess of (i) the fair market value of the common shares subject to such options and stock appreciation rights over (ii) their exercise price. Such payment shall be made in the form of cash, cash equivalents or securities of the surviving corporation or its parent, and such payment may be made in installments and deferred until the date or dates when such options and stock appreciation rights would have vested; and
- The cancellation of all outstanding stock units and a payment to the holders thereof equal to the fair market value of the common stock subject to such stock units. Such payment shall be made in the form of cash, cash equivalents or securities of the surviving corporation or its parent, and such payment may be made in installments and deferred until the date or dates when such stock units would have vested.

In addition, our committee shall have the discretion, in connection with a change in control or otherwise, to provide for the acceleration of vesting at any time of some or all of any options or awards granted under our 2008 Plan.

Amendment and Termination of 2008 Plan. The board of directors may amend or terminate the 2008 Plan at any time. No amendment can be effective prior to its approval by our stockholders, to the extent that such approval is required by applicable legal requirements or any exchange on which our common stock is listed.

2006 Stock Option/Stock Issuance Plan

Our 2006 Stock Option/Stock Issuance Plan, or the 2006 Plan, was adopted by our board of directors and approved by our stockholders in May 2006. The plan provides for the grant of stock issuances and stock options to our employees, non-employee directors, consultants and independent advisors. The 2006 Plan is divided into two separate equity programs, an option grant program and a stock issuance program, each of which is discussed in more detail below.

We have reserved a total of 860,000 shares of our common stock for issuance pursuant to the 2006 Plan. As of December 31, 2007, options to purchase 760,983 shares of our common stock were outstanding and 39,017 shares were available for future grant under this plan. Our board of directors has decided not to grant any additional options or other awards under this plan following the completion of this offering. However, this plan will continue to govern the terms and conditions of the outstanding awards previously granted under this plan.

The 2006 Plan calls for administration to be carried out by the board of directors or a committee delegated by the board of directors. Our 2006 Plan is administered by our compensation committee.

Under the 2006 Plan, the plan administrator has the full authority to determine: (i) with respect to grants under the option grant program, which eligible persons are to receive option grants, the times when those grants are to be made, the number of shares to be covered by each such grant, the status of the granted option as either an incentive option or a nonstatutory option, the times when each option is to become exercisable, the exercise price per share, the vesting schedule applicable to the option shares and the maximum term for which the option is to remain outstanding; and (ii) with respect to stock issuances under the stock issuance program, which eligible persons are to receive stock issuances, the times when those issuances are to be made, the number of shares to be issued to each participant, the vesting schedule applicable to the issued shares and the consideration to be paid by the participant for such shares. The plan administrator also has the absolute discretion either to grant or to effect stock issuances.

Option Grant Program

The exercise price of all options, except for incentive options (or options that satisfy the requirements of the Internal Revenue Code Section 422) granted under our option grant program must not be less than 85% of the fair market value of our common stock on the date of grant. However, with respect to any participant who is a 10% stockholder, the exercise price of such options must not be less than 110% of the fair market value on the grant date. The term of any options granted under our option grant program may not exceed 10 years. With respect to incentive options, the exercise price per share of an incentive option must not be less than 100% of the fair market value on the grant date. Also, the aggregate fair market value of the incentive options that become exercisable for the first time during any one calendar year must not exceed $100,000. Finally, the term of any incentive option granted to an employee who is a 10% stockholder may not exceed five years.

After termination of service by an employee, director or consultant, for any reason other than death, disability or misconduct, he or she has a period of one month following the date of termination during which to exercise his or her option. If termination is due to death or disability, the option will remain exercisable for 12 months. If the termination is due to misconduct, then all outstanding options held by the individual terminates immediately. While the plan administrator may, at its discretion, extend the period of time for which the option is to remain exercisable, no option may is exercisable after the expiration of its term.

Our option grant program provides that in the event of a change in control of our company, defined as a merger or consolidation where more than fifty percent of the total combined voting power of our outstanding securities are transferred to a person or persons different from those holding our securities immediately prior to such transaction, or the sale, transfer or other disposition of all or substantially all of our assets, the shares subject to each outstanding option shall automatically vest in full so that each such option becomes fully exercisable and may be exercised as fully vested shares prior to the effective date of the change in control. However, such shares may not vest on such an accelerated basis if:

- the option is assumed by the successor corporation and our repurchase rights with respect to the unvested option shares are assigned to such corporation;

- such option is to be replaced with the successor corporation's cash incentive program, which preserves the spread existing on the unvested option shares and provides for subsequent payout in accordance with the same vesting schedule applicable to those unvested option shares; or
- acceleration of the option is subject to other limitations imposed by the plan administrator at the time of the option grant.

In any case, our option grant program gives the plan administrator the discretion to provide for automatic acceleration of one or more outstanding options in the event of a change in control, whether or not those options are to be assumed in the change in control.

Our option grant program also gives the plan administrator the full power and authority to structure an option so that the shares subject to that option will automatically vest on an accelerated basis should the option holder's service terminate by reason of an involuntary termination within a period not to exceed 18 months following the effective date of a change in control. Any option so accelerated remains exercisable until the earlier of the expiration of the option term or the expiration of one year from the effective date of the involuntary termination.

Stock Issuance Program

Under our stock issuance program, the plan administrator has discretion to fix the purchase price of the shares. However, such price may not be less than 85% of the fair market value of our common stock on the issue date, and with respect to any shares issued to a 10% stockholder, the purchase price may not be less than 110% of the fair market value on the issue date.

Shares of our common stock issued under the stock issuance program may be fully and immediately vested upon issuance or may vest in installments over the participant's period of service or upon attainment of specific performance goals. While the plan administrator has discretion in determining the vesting schedule, no vesting schedule may be more restrictive than 20% per year vesting, with initial vesting to occur no later than one year after the issuance date. However, such limitation does not apply to common stock issuances made to our officers, non-employee board members or independent consultants.

Our stock issuance program gives the participant full stockholder rights with respect to any shares of common stock issued under such program, whether or not the participant's interest in those shares is vested. Our stock issuance program also calls for immediate surrender and cancellation of any unvested shares of common stock should the participant's service be terminated or his/her performance goals not be attained with respect to such unvested shares. However, the plan administrator may at its discretion waive such the surrender and cancellation of the unvested shares at any time.

Our stock issuance program further provides that in the event of a change in control, all repurchase rights under the program terminates immediately and shares subject to those rights immediately vest in full, except to the extent that: (i) our repurchase rights are assigned to such corporation; or (ii) acceleration is subject to other limitations imposed by the plan administrator at the time the repurchase right is issued.

The plan administrator has the discretionary authority to provide that our repurchase rights with respect to unvested shares automatically terminate and the shares subject to such rights immediately vest in the event that the participant's service terminates by reason of an involuntary termination within a period not to exceed 18 months following the effective date of a change in control.

2004 Stock Option/Stock Issuance Plan

Our 2004 Stock Option/Stock Issuance Plan, or 2004 Plan, was adopted by our board of directors and approved by our stockholders in January 2004. Our 2004 Plan provides for the grant of stock issuances and stock options to our employees, non-employee directors, consultants and other independent advisors. The administration and features of the 2004 Plan and the terms of the options granted thereunder are substantially similar to the corresponding features of the 2006 Plan.

We have reserved a total of 850,000 shares of our common stock for issuance pursuant to the 2004 Plan. As of December 31, 2007, options to purchase 339,208 shares of our common stock were outstanding and 8,709 shares were available for future grant under this plan. Our board of directors has decided not to grant any additional options or other awards under this plan following the completion of this offering. However, this plan will continue to govern the terms and conditions of the outstanding awards previously granted under this plan.

2002 Stock Option/Stock Issuance Plan

Our 2002 Stock Option/Stock Issuance Plan, or 2002 Plan, was adopted by our board of directors in March 2002 and approved by our stockholders in April 2002. Our 2002 Plan provides for the grant of stock issuances and stock options to our employees, non-employee directors, consultants and other independent advisors. The administration and features of the 2002 Plan and the terms of the options granted thereunder are substantially similar to the corresponding features of the 2006 Plan.

We have reserved a total of 1,509,375 shares of our common stock for issuance pursuant to the 2002 Plan. As of December 31, 2007, options to purchase 180,417 shares of our common stock were outstanding and 5,625 shares were available for future grant under this plan. Our board of directors has decided not to grant any additional options or other awards under this plan following the completion of this offering. However, this plan will continue to govern the terms and conditions of the outstanding awards previously granted under this plan.

2001 Stock Option Plan

Our 2001 Stock Option Plan was adopted by our board of directors in March 2001 and approved by our stockholders in April 2001. Our 2001 Stock Option Plan provides for the grant of stock options to our employees, consultants and directors as well as prospective employees, consultants and directors in connection with written offers of employment or other service relationship with our Company.

We have reserved a total of 2,500,000 shares of our common stock for issuance pursuant to the 2001 Stock Option Plan. As of December 31, 2007, no options to purchase shares of our common stock remained outstanding and no shares were available for future grant under this plan.

The 2001 Stock Option Plan calls for administration to be carried out by our board of directors. Under our 2001 Stock Option Plan, the board of directors have the full power and authority to determine: (i) which eligible persons are to receive option grants, the times when those grants are to be made, the number of shares to be covered by each such grant; (ii) the status of the granted option as either an incentive option or a nonstatutory option; (iii) the fair market value of shares of stock or other property; (iv) the terms, conditions and restrictions applicable to each option and any shares acquired upon their exercise, including without limitation: (a) the exercise price, (b) the method of payment for shares purchased upon exercise of the option, (c) the method for satisfaction of any tax withholding obligation arising in connection with the option or such shares, (d) the timing, terms and conditions of the exercisability of the option or the vesting of any shares acquired upon their exercise, (e) the time of expiration of the option, (f) the effect of the optionee’s termination of employment or service, and (g) all other terms, conditions and restrictions applicable to the option. Our board of directors also has the full authority to amend the exercisability of any option or the vesting of any shares acquired upon their exercise, including with respect to the period following any optionee’s termination of employment or service with our Company.

The 2001 Stock Option Plan provides for the grant of either incentive options or nonstatutory options. However, the board may only issue incentive options to those individuals who are deemed employees of our Company on the effective grant date of the option.

The exercise price of nonstatutory options must not be less than 85% of the fair market value of our common stock on the date of grant. However, with respect to any participant who is a 10% stockholder, the exercise price of such options must not be less than 110% of the fair market value on the grant date. The term of any options granted may not exceed 10 years. With respect to incentive options, the exercise price per share of an incentive option must not be less than the fair market value of a share of stock on the effective grant date. Also, the aggregate fair market value of the incentive options that become exercisable for the first time during any one calendar year must not exceed $100,000. Finally, the term of any incentive option granted to an employee who is a 10% stockholder may not exceed five years.

Our 2001 Stock Option Plan provides that in the event of a change of control of our Company, defined as a direct or indirect sale or exchange by our stockholders of more than 50% of the voting stock of our Company, a merger or consolidation in which our Company is a party, the sale exchange or transfer of all or substantially all of the assets of our company, or a liquidation or dissolution of our Company, the acquiring corporation must either assume our rights and obligations under outstanding options or substitute for outstanding options substantially equivalent options for the acquiring corporation’s stock.

Our 2001 Stock Option Plan also provides for indemnification of our board of directors and any officers or employees delegated to act on behalf of the board of directors against any action, suit or proceeding initiated against them by reason of any action taken by them or their failure to act under or in connection with the 2001 Stock Option Plan.

In January 2007, our board of directors amended our 2001, 2002, 2004 and 2006 Stock Option Plans to allow for accelerated vesting of all unvested options upon an optionee's death resulting while employed and engaged in the course and scope of company business.

Defined Contribution Plan

401(k) Plan. We maintain a tax-qualified retirement plan that provides eligible employees with an opportunity to save for retirement on a tax advantaged basis. Eligible employees are able to participate in the 401(k) plan as of the first day of the month. Employees must be 21 years of age to participate. Participants may contribute from 1% to 20% of their annual salary, subject to the annual maximum determined by the IRS. All participants' interests in their deferrals are 100% vested when contributed. The 401(k) plan permits us to make matching contributions to eligible participants, where we match 50% of the first 6% of each participant's contributions. Pre-tax contributions are allocated to each participant's individual account and are then invested in selected investment alternatives according to the participants' directions. The 401(k) plan is intended to qualify under Sections 401(a) and 501(a) of the Internal Revenue Code. As a tax-qualified retirement plan, contributions to the 401(k) plan and earnings on those contributions are not taxable to the employees until distributed from the 401(k) plan and all contributions are deductible by us when made. Participants are fully vested in our contribution account after four years of service. Participants may borrow money from the accumulated value of his/her vested accounts. However, the maximum loan amount must be either the lesser of $50,000 or 50% of the vested account balance. Such loans are to be repaid through payroll deductions over a five year period. Upon termination of employment any outstanding loan balance is due within 30 days. If such loan is not paid within 30 days, the loan is reported as a withdrawal and subject to an income tax.

Limitation on Liability and Indemnification Matters

Our amended and restated certificate of incorporation and amended and restated bylaws that will become effective upon the completion of this offering contain provisions that limit the personal liability of our directors for monetary damages to the fullest extent permitted by Delaware law. Consequently, our directors will not be personally liable to us or our stockholders for monetary damages for any breach of fiduciary duties as directors, except liability for:

- any breach of the director's duty of loyalty to us or our stockholders;
- any act or omission not in good faith or that involves intentional misconduct or a knowing violation of law;
- unlawful payments of dividends or unlawful stock repurchases or redemptions as provided in Section 174 of the Delaware General Corporation Law; or
- any transaction from which the director derived an improper personal benefit.

Our amended and restated certificate of incorporation that will become effective upon the completion of this offering provides that we indemnify our directors to the fullest extent permitted by Delaware law. In addition, our amended and restated bylaws that will become effective upon the completion of this offering provide that we indemnify our directors and officers to the fullest extent permitted by Delaware law. Our amended and restated bylaws, that will become effective upon the completion of this offering also provide that we will advance expenses incurred by a director or officer in advance of the final disposition of any action or proceeding, and permit us to secure insurance on behalf of any officer, director, employee or other agent for any liability arising out of his or her actions in that capacity, regardless of whether we would otherwise be permitted to indemnify him or her under the provisions of Delaware law. After the effectiveness of this offering, we expect to enter into agreements to indemnify our directors, executive officers and other employees as determined by the board of directors. With certain exceptions, these agreements provide for indemnification for related expenses including, among others, attorneys' fees, judgments, fines and settlement amounts incurred by any of these individuals in any action or proceeding. We believe that these bylaw provisions and indemnification agreements are necessary to attract and retain qualified persons as directors and officers. We also maintain directors' and officers' liability insurance.

The limitation of liability and indemnification provisions in our amended and restated certificate of incorporation and amended and restated bylaws that will become effective upon the completion of this offering, may discourage stockholders from bringing a lawsuit against our directors for breach of their fiduciary duty of care. They may also reduce the likelihood of derivative litigation against our directors and officers, even though an action, if successful, might benefit us and other stockholders. Further, a stockholder's investment may be adversely affected to the extent that we pay the costs of settlement and damage awards against directors and officers. At present, there is no pending litigation or proceeding involving any of our directors, officers or employees for which indemnification is sought, and we are not aware of any threatened litigation that may result in claims for indemnification.

CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS

We intend to adopt a policy to address the review, approval or ratification of related person transactions. An investor may obtain a written copy of this policy, once adopted, by sending a written request to Energy Recovery, Inc., 1908 Doolittle Drive, San Leandro, CA 94577, attention Chief Financial Officer.

Since January 1, 2007, there has not been, nor is there currently proposed, any transaction or series of transactions to which we were or are a party in which the amount involved exceeds $120,000 and in which any of our directors, executive officers, holders of more than 5% of any class of our voting securities, or any member of the immediate family of or any entities affiliated with any of the foregoing persons, had or has a direct or indirect material interest, other than arrangements which are described where required under the heading titled “Management” above, and the transactions described below.

Common Stock Purchases and Sales

In June 2007, Caprice AS, a Norwegian corporation, purchased 64,752 shares of our common stock at a price of $5.00 per share for an aggregate purchase price of $323,760. This purchase was part of a private placement of our common stock to various investors. Ole Peter Lorentzen, one of our directors, is a controlling stockholder of Caprice AS. Caprice AS is a holder of more than 5% of our outstanding common stock.

Stock Option Grants

Certain stock option grants to our directors and executive officers and related option grant policies are described above in this prospectus under the caption “Management.”

Employment Arrangements and Indemnification Agreements

We have entered into employment arrangements with certain of our executive officers. See “Employment Agreements” and “Potential Payments on Termination or Change of Control” under “Management” above.

Our amended and restated bylaws and amended and restated certificate of incorporation that will be effective upon the completion of this offering require us to indemnify our directors and executive officers in the event that they are named parties to certain actions, suits or proceedings. See “Management—Limitations on Liability and Indemnification Matters” above.

Promissory Notes

G.G. Pique

In February 2005, in connection with the exercise of incentive stock options issued pursuant to certain stock option agreements entered into between us and G.G. Pique, our president and chief executive officer, Mr. Pique purchased an aggregate of 750,000 shares of our common stock with three promissory notes totaling $195,000, payable to us. All three promissory notes bore interest at 3.76% per annum and were secured first by a pledge of the underlying shares purchased by Mr. Pique and then by Mr. Pique’s assets until payment in full of the promissory notes, including accrued interest. As of December 31, 2007, 2006 and 2005, $8,000, $8,000 and $7,000, respectively, of interest had accrued on the notes. The entire principal and accrued interest of all three promissory notes were repaid in full as of March 2008.

Hans Peter Michelet

In February 2005, Hans Peter Michelet, our executive chairman, purchased 100,000 shares of our common stock pursuant to the exercise of a warrant and 250,000 shares of our common stock pursuant to the exercise of a stock option with two promissory notes totaling $70,000. The promissory notes bore interest at 3.76% per annum and were secured first by a pledge of the underlying shares purchased by Mr. Michelet and then by Mr. Michelet’s assets until payment in full of the promissory notes, including accrued interest. As of December 31, 2007, 2006 and 2005, $3,000 of interest had accrued on the note for each such year. The entire principal and accrued interest were repaid in full as of March 2008.

Terrill Sandlin

In February 2005, in connection with the exercise of incentive stock options issued pursuant to certain stock option agreements entered into between us and Terrill Sandlin, our vice president of manufacturing, Mr. Sandlin purchased an aggregate of 120,000 shares of our common stock with three promissory notes payable to us totaling $36,000. All three

promissory notes bore interest at 3.76% per annum and were secured first by a pledge of the underlying shares purchased by Mr. Sandlin and then by Mr. Sandlin's assets until payment in full of the promissory notes, including accrued interest. As of December 31, 2007, 2006 and 2005, $2,000, $1,000 and $1,000, respectively, of interest had accrued on the notes. The entire principal and accrued interest of all three promissory notes were repaid in full as of March 2008.

Richard Stover

In February 2005, in connection with the exercise of incentive stock options issued pursuant to certain stock option agreements entered into between us and Richard Stover, our chief technical officer, Dr. Stover purchased an aggregate of 175,000 shares of our common stock with three promissory notes payable to us totaling $51,000. All three promissory notes bore interest at 3.76% per annum and were secured first by a pledge of the underlying shares purchased by Dr. Stover and then by Dr. Stover's assets until payment in full of the promissory notes, including accrued interest. As of December 31, 2007, 2006 and 2005, $2,000 of interest had accrued on the notes for each such year. The entire principal and accrued interest of all three promissory notes were repaid in full in January 2008.

C. Peter Darby

In February 2005, in connection with the exercise of a non-statutory stock option issued pursuant to a certain stock option agreement entered into between us and Peter Darby, one of our directors, Mr. Darby purchased 250,000 shares of our common stock for an aggregate price of $50,000 with a promissory note payable to us in the amount of $50,000. The promissory note bore interest at 3.76% per annum and was secured first by a pledge of the underlying shares purchased by Mr. Darby and then by Mr. Darby's assets until payment in full of the promissory note, including accrued interest. As of December 31, 2007, 2006 and 2005, $2,000 of interest had accrued on the note for each such year. The entire principal and accrued interest were repaid in full in March 2008.

James Medanich

In February 2005, in connection with the exercise of non-statutory stock options issued pursuant to certain stock option agreements entered into between us and James Medanich, one of our directors, Mr. Medanich purchased an aggregate of 350,000 shares of our common stock with two promissory notes payable to us in the amount of $70,000. The promissory notes bore interest at 3.76% per annum and was secured first by a pledge of the underlying shares purchased by Mr. Medanich and then by Mr. Medanich's assets until payment in full of the promissory notes, including accrued interest. As of December 31, 2007, 2006 and 2005, $3,000 of interest had accrued on the notes for each such year. The entire principal and accrued interest were repaid in full in March 2008.

Other Relationships

We entered into an independent contractor agreement with Darby Engineering, LLC in January 2008, pursuant to which Darby Engineering will provide engineering and management consulting services to us for a period of 12 months, after which the agreement will be on a month-to-month basis. Pursuant to the independent contractor agreement, Darby Engineering will be compensated for services rendered as follows: $1,000 for each day worked at Darby Engineering's offices and $1,200 for each day worked at any other location, provided that Darby Engineering will provide at least eight days of service per month. Peter Darby, one of our directors, is a managing member of Darby Engineering LLC.

PRINCIPAL AND SELLING STOCKHOLDERS

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information with respect to the beneficial ownership of our common stock at December 31, 2007, as adjusted to reflect the sale of common stock offered by us in this offering, for:

- each person who we know beneficially owns more than 5% of our common stock;
- each of our directors and director nominees;
- each of our Named Executive Officers;
- all of our directors, director nominees and executive officers as a group; and
- each selling stockholder.

We have determined beneficial ownership in accordance with SEC rules. Except as indicated by the footnotes below, we believe, based on the information furnished to us, that the persons and entities named in the table below have sole voting and investment power with respect to all shares of common stock that they beneficially own, subject to applicable community property laws.

Applicable percentage ownership is based on 39,777,446 shares of common stock outstanding at December 31, 2007. For purposes of the table below, we have assumed that shares of common stock will be outstanding upon completion of this offering. In computing the number of shares of common stock beneficially owned by a person and the percentage ownership of that person, we deemed to be outstanding all shares of common stock subject to options and warrants held by that person or entity that are currently exercisable or exercisable within 60 days of December 31, 2007. We did not deem these shares outstanding, however, for the purpose of computing the percentage ownership of any other person. Beneficial ownership representing less than one percent is denoted with an "*."

Unless otherwise indicated, the address of each beneficial owner listed in the table below is c/o Energy Recovery, Inc. 1908 Doolittle Drive, San Leandro, California, 94577.

	Shares Beneficially Owned		
		Percent	
Name of Beneficial Owner	**Number**	**Before Offering**	**After Offering**
5% Stockholders (other than directors, director nominees and Named Executive Officers)			
Arvarius AS(1) Parkv.57 c/o B. Skaugen AS 0256 Oslo, Norway	12,026,533	28.9%	
Caprice AS(2) Haakon Vi's Gate 1 0161 Oslo, Norway	4,480,638	11.3	
Directors, Director Nominees and Named Executive Officers:			
Hans Peter Michelet	1,781,613	4.5	
James Medanich(3)	3,606,534	9.1	
Fred Olav Johannessen(4)	2,829,497	7.1	
Ole Peter Lorentzen(5)	4,480,638	11.3	
Arve Hanstveit(6)	2,031,751	5.1	
Peter Darby(7)	856,375	2.1	
Marius Skaugen(1)(8)	12,641,103	31.8	
Dominique Trempont	–	*	
Paul Cook	–	*	
G.G. Pique(9)	1,130,000	2.8	
Richard Stover(10)	267,842	*	
Thomas D. Willardson(11)	100,000	*	
Terrill Sandlin(12)	155,000	*	
MariaElena Ross(13)	115,000	*	
All directors and executive officers as a group (14 persons)	30,045,353	72.1	
Selling Stockholders:			

* Less than one percent.

(1) Includes warrants to purchase 1,904,122 shares of common stock that are exercisable within 60 days of December 31, 2007. Mr. Skaugen, one of our directors, is a controlling stockholder of Arvarius AS.

(2) Mr. Lorentzen, one of our directors, is a controlling stockholder of Caprice AS.

(3) Consists of 3,047,485 shares held of record by Mr. Medanich, 275,551 shares held of record by Mr. Medanich and his wife and 283,498 shares held of record by his wife.

(4) Consists of 1,390,165 shares held of record by Mr. Johannessen, 80,000 shares held of record by Mr. Johannessen's wife, 355,500 shares held of record by Mr. Johannessen's children, 307,210 shares held of record by Logar AS, 375,792 shares held of record by Kalamaris Invest AS, 66,025 shares held of record by Osip ApS, and 254,805 shares held of record by Rolechoice Ltd. Mr. Johannessen has shared voting and investment power over the shares that are owned by his children. Mr. Johannessen is the sole shareholder of Osip ApS and Rolechoice Ltd. Mr. Johannessen is also a controlling stockholder of Logar AS.

(5) Includes 4,480,638 shares of common stock held by Caprice AS. Mr. Lorentzen, one of our directors, is a controlling stockholder of Caprice AS.

(6) Consists of 1,831,751 shares held of record by Mr. Hanstveit and 200,000 shares held of record by Mr. Hanstveit's daughters. Mr. Hanstveit has shared voting and investment power over the shares that are owned by his daughters.

(7) Consists of 250,000 shares held of record by Mr. Darby, 586,375 shares held of record by Mr. Darby and his wife as trustees of the Darby Revocable Trust dated February, 9, 1998, and a warrant held by Mr. Darby and his wife to purchase 20,000 shares of common stock that are exercisable within 60 days of December 31, 2007.

(8) Consists of 307,285 shares held of record by Lafite AS, 307,285 shares held of record by Mouton AS and 12,026,533 shares held of record by Arvarius AS or issuable to Arvarius AS pursuant to outstanding warrants. See footnote (1) above. Mr. Skaugen has shared voting and investment power over the shares owned by Lafite AS and Mouton AS. Mr. Skaugen is also a controlling stockholder of Arvarius AS.

(9) Consists of 730,000 shares held of record by Mr. Pique, a warrant held by Mr. Pique to purchase 150,000 shares of common stock that is exercisable within 60 days of December 31, 2007, and options to purchase 250,000 shares of common stock that are exercisable within 60 days of December 31, 2007, of which 177,084 shares are subject to a right of repurchase at cost within 60 days of December 31, 2007 in the event of termination of Mr. Pique's employment with us. The right of repurchase lapses at a rate of 5,208 shares of common stock per month.

(10) Includes options to purchase 92,842 shares of common stock that may be exercised within 60 days of December 31, 2007, of which 51,570 shares are subject to a right of repurchase at cost within 60 days of December 31, 2007 in the event of the termination of Dr. Stover's employment with us. The right of repurchase lapses at a rate of 1,876 shares per month until June 2008 and at a rate of 1,934 shares of common stock per month thereafter.

(11) Includes options to purchase 100,000 shares of common stock that may be exercised within 60 days of December 31, 2007, all of which are subject to a right of repurchase at cost within 60 days of December 31, 2007 in the event of the termination of Mr. Willardson's employment with us. The right of repurchase lapses at a rate of 25,000 shares as of November 2008 and at a rate of 2,083 shares of common stock per month thereafter.

(12) Includes options to purchase 35,000 shares of common stock that may be exercised within 60 days of December 31, 2007, of which 23,542 shares are subject to a right of repurchase at cost within 60 days of December 31, 2007 in the event of the termination of Mr. Sandlin's employment with us. The right of repurchase lapses at a rate of 729 shares of common stock per month.

(13) Includes options to purchase 115,000 shares of common stock that may be exercised within 60 days of December 31, 2007, of which 53,542 shares are subject to a right of repurchase at cost within 60 days of December 31, 2007 in the event of the termination of Ms. Ross's employment with us. The right of repurchase lapses at a rate of 2,396 shares of common stock per month.

DESCRIPTION OF CAPITAL STOCK

General

The following is a summary of the rights of our common stock and certain provisions of our amended and restated certificate of incorporation and amended and restated bylaws, as they will be in effect upon the completion of this offering. For more detailed information, please see our amended and restated certificate of incorporation and amended and restated bylaws, which are filed as exhibits to the registration statement of which this prospectus is a part.

Immediately following the completion of this offering, our authorized capital stock will consist of shares, with a par value of $0.001 per share, of which:

- 200,000,000 shares are designated as common stock; and
- 10,000,000 shares are designated as preferred stock.

At December 31, 2007, we had outstanding 39,777,446 shares of common stock, held of record by 135 stockholders. In addition, as of December 31, 2007, 1,280,608 shares of our common stock were subject to outstanding options, and 2,074,122 shares of our capital stock were subject to outstanding warrants that do not expire upon the completion of this offering. For more information on our capitalization, see “Capitalization” above.

Common Stock

The holders of our common stock are entitled to one vote per share on all matters to be voted on by our stockholders. Holders of common stock are entitled to receive such dividends as may be declared by the board of directors out of funds legally available therefor. In the event of our liquidation, dissolution or winding up, holders of common stock are entitled to share ratably in all assets remaining after payment of liabilities and distribution of the liquidation preferences of any then outstanding shares of preferred stock. There are no redemption or sinking fund provisions applicable to the common stock.

Preferred Stock

After the consummation of this offering and the filing of our amended and restated certificate of incorporation, our board of directors will have the authority, without further action by our stockholders, to designate and issue up to the total number of authorized shares of preferred stock in one or more series and to fix the rights, preferences, privileges and restrictions granted to or imposed upon each such series of preferred stock, including dividend rights, dividend rate, conversion rights, voting rights, rights and terms of redemption, redemption prices, liquidation preference and sinking fund terms, any or all of which may be greater than or senior to the rights of the common stock. The issuance of preferred stock could adversely affect the voting power of holders of common stock and reduce the likelihood that such holders will receive dividend payments or payments upon liquidation. Such issuance could have the effect of decreasing the market price of the common stock. The issuance of preferred stock or even the ability to issue preferred stock could also have the effect of delaying, deterring or preventing a change of control or other corporate action. Immediately after the completion of this offering, no shares of preferred stock will be outstanding, and we currently have no plans to issue any shares of preferred stock.

Warrants

At December 31, 2007, we had warrants outstanding to purchase 2,074,122 shares of our common stock at exercise prices ranging from $0.20 to $1.00 per share. These warrants will expire at various times between May 21, 2011 and November 1, 2015. Each warrant contains provisions for the adjustment of the exercise price and the number of shares issuable upon exercise in the event of stock dividends, stock splits, reorganizations, reclassifications, consolidations and the like.

Anti-Takeover Effects of Delaware Law and Our Amended and Restated Certificate of Incorporation and Amended and Restated Bylaws That Will Become Effective Upon Completion of This Offering

Certain provisions of Delaware law, our amended and restated certificate of incorporation and our amended and restated bylaws to become effective upon completion of this offering contain provisions that could have the effect of delaying, deferring or discouraging another party from acquiring control of us. These provisions, which are summarized below, are expected to discourage certain types of coercive takeover practices and inadequate takeover bids. These provisions are also designed, in part, to encourage persons seeking to acquire control of us to first negotiate with our board of directors. We believe that the benefits of increased protection of our potential ability to negotiate with an unfriendly or unsolicited

acquirer outweigh the disadvantages of discouraging such proposals, including proposals that are priced above the then-current market value of our common stock, because, among other reasons, the negotiation of such proposals could result in an improvement of their terms.

Amended and Restated Certificate of Incorporation and Amended and Restated Bylaws

Our amended and restated certificate of incorporation and amended and restated bylaws to become effective upon completion of this offering include provisions that:

- authorize the board of directors to issue, without further action by the stockholders, up to 10,000,000 shares of undesignated preferred stock;
- require that any action to be taken by our stockholders be effected at a duly called annual or special meeting and not by written consent;
- specify that special meetings of our stockholders can be called only by the board of directors, the chairman of the board of directors, the chief executive officer or the president;
- establish an advance notice procedure for stockholder approvals to be brought before an annual meeting of our stockholders, including proposed nominations of persons for election to the board of directors;
- provide that directors may be removed only for cause;
- provide that vacancies on our board of directors may be filled only by a majority of directors then in office, even though less than a quorum;
- establish that our board of directors is divided into three classes, Class I, Class II and Class III with each class serving staggered terms;
- specify that no stockholder is permitted to cumulate votes at any election of directors; and
- require a super-majority of votes to amend certain of the above-mentioned provisions.

Delaware Anti-Takeover Statute

We will be subject to the provisions of Section 203 of the Delaware General Corporation Law regulating corporate takeovers. In general, Section 203 prohibits a publicly-held Delaware corporation from engaging, under certain circumstances, in a business combination with an interested stockholder for a period of three years following the date the person became an interested stockholder unless:

- prior to such date, the board of directors of the corporation approved either the business combination or the transaction which resulted in the stockholder becoming an interested stockholder;
- upon completion of the transaction that resulted in the stockholder becoming an interested stockholder, the interested stockholder owned at least 85% of the voting stock of the corporation outstanding at the time the transaction commenced, excluding for purposes of determining the voting stock outstanding (but not the outstanding voting stock owned by the interested stockholder), (1) shares owned by persons who are directors and also officers and (2) shares owned by employee stock plans in which employee participants do not have the right to determine confidentially whether shares held subject to the plan will be tendered in a tender or exchange offer; or
- at or subsequent to the date of the transaction that resulted in a stockholder becoming an interested stockholder, the business combination is approved by the board of directors of the corporation and authorized at an annual or special meeting of stockholders, and not by written consent, by the affirmative vote of at least 66 2/3% of the outstanding voting stock which is not owned by the interested stockholder.

Generally, a business combination includes a merger, asset or stock sale, or other transaction resulting in a financial benefit to the interested stockholder. An interested stockholder is a person who, together with affiliates and associates, owns or, within three years prior to the determination of interested stockholder status, did own 15% or more of a corporation's outstanding voting stock. We expect the existence of this provision to have an anti-takeover effect with respect to transactions our board of directors does not approve in advance. We also anticipate that Section 203 may discourage business combinations or other attempts that might result in a premium over the market price for the shares of common stock held by our stockholders.

The provisions of Delaware law, our amended and restated certificate of incorporation and our amended and restated bylaws to become effective upon completion of this offering could have the effect of discouraging others from attempting hostile takeovers and, as a consequence, they may also inhibit temporary fluctuations in the market price of our common stock that often result from actual or rumored hostile takeover attempts. These provisions may also have the effect of preventing changes in our management. It is possible that these provisions could make it more difficult to accomplish transactions that stockholders may otherwise deem to be in their best interests.

Transfer Agent and Registrar

The transfer agent and registrar for our common stock is American Stock Transfer & Trust Company. The transfer agent's address is 59 Maiden Lane, Plaza Level, New York, New York 10038, and its telephone number is (800) 937-5449.

Listing

We expect to apply to list our common stock on the NASDAQ Global Market.

SHARES ELIGIBLE FOR FUTURE SALE

Before this offering, there has not been a public market for shares of our common stock. Future sales of substantial amounts of shares of our common stock, including shares issued upon the exercise of outstanding options, in the public market after this offering, or the possibility of these sales occurring, could cause the prevailing market price for our common stock to fall or impair our ability to raise equity capital in the future.

Upon the completion of this offering, a total of shares of common stock will be outstanding, assuming that there are no exercises of options or warrants to purchase common stock that were outstanding as of , 2008. Of these shares, all shares of common stock sold in this offering by us, plus any shares sold upon exercise of the underwriters' option to purchase additional shares, will be freely tradable in the public market without restriction or further registration under the Securities Act, unless these shares are held by "affiliates," as that term is defined in Rule 144 under the Securities Act.

The remaining shares of common stock will be "restricted securities," as that term is defined in Rule 144 under the Securities Act. These restricted securities are eligible for public sale only if they are registered under the Securities Act or if they qualify for an exemption from registration under Rules 144 or 701 under the Securities Act, which are summarized below.

Subject to the lock-up agreements described below and the provisions of Rules 144 and 701 under the Securities Act, these restricted securities will be available for sale in the public market as follows:

Date	Number of Shares
On the date of this prospectus	
Between 90 and 180 days after the date of this prospectus	
At various times beginning more than 180 days after the date of this prospectus	

In addition, of the shares of our common stock that were subject to stock options outstanding as of , 2008, options to purchase shares of common stock were vested as of , 2008 and will be eligible for sale 180 days following the effective date of this offering.

Rule 144

In general, under Rule 144 an affiliate who has beneficially owned shares of our common stock that are deemed restricted securities for at least six months would be entitled to sell, within any three-month period a number of shares that does not exceed the greater of:

- 1% of the number of shares of our common stock then outstanding, which will equal approximately shares immediately after this offering; or
- the average weekly trading volume of our common stock on the NASDAQ Global Market during the four calendar weeks preceding the filing of a notice on Form 144 with respect to that sale.

These sales may commence beginning 90 days after the date of this prospectus, subject to continued availability of current public information about us. Such sales under Rule 144 are also subject to certain manner of sale provisions and notice requirements.

A person who is not one of our affiliates and who is not deemed to have been one of our affiliates at any time during the three months preceding a sale may sell the shares proposed to be sold according to the following conditions:

- If the person has beneficially owned the shares for at least six months, including the holding period of any prior owner other than an affiliate, the shares may be sold, subject to continued availability of current public information about us.
- If the person has beneficially owned the shares for at least one year, including the holding period of any prior owner other than an affiliate, the shares may be sold without any Rule 144 limitations.

Rule 701

In general, under Rule 701 as currently in effect, any of our employees, consultants or advisors who purchase shares from us in connection with a compensatory stock or option plan or other written agreement in a transaction before the effective date of this offering that was completed in reliance on Rule 701 and complied with the requirements of Rule 701 will, subject to the lock-up restrictions described below, be eligible to resell such shares 90 days after the effective date of

this offering in reliance on Rule 144, but without compliance with certain restrictions, including the holding period, contained in Rule 144.

Lock-Up Agreements

We, all of our directors and officers and all holders of our common stock or securities convertible into common stock outstanding immediately prior to this offering have agreed that, without the prior written consent of Citi and Credit Suisse Securities (USA) LLC on behalf of the underwriters, we and they will not, during the period ending 180 days after the date of this prospectus offer, sell, contract to sell, pledge, grant any option to purchase, make any short sale or otherwise dispose of any shares of our common stock, or any options or warrants to purchase any shares of our common stock, or any securities convertible into, exchangeable for or that represent the right to receive shares of our common stock, whether now owned or hereinafter acquired, owned directly by us or them (including holding as a custodian) or with respect to which we or they have beneficial ownership within the rules and regulations of the SEC, whether any transaction described above is to be settled by delivery of shares of our common stock or such other securities, in cash or otherwise. These agreements are subject to certain exceptions, and are also subject to extension for up to an additional 18 days, as set forth in “Underwriting” below.

Registration Statements

We intend to file a registration statement on Form S-8 under the Securities Act covering all of the shares of common stock subject to options outstanding or reserved for issuance under our stock plans. We expect to file this registration statement as soon as practicable after this offering. However, none of the shares registered on Form S-8 will be eligible for resale until the expiration of the lock-up agreements to which they are subject.

MATERIAL UNITED STATES TAX CONSIDERATIONS FOR NON-U.S. HOLDERS

The following is a general discussion of material United States federal income and estate tax considerations with respect to the acquisition, ownership and disposition of shares of our common stock applicable to non-U.S. holders. In general, a "non-U.S. holder" is any holder other than:

- a citizen or resident of the United States;
- a corporation created or organized in or under the laws of the United States or any political subdivision thereof;
- an estate, the income of which is includible in gross income for United States federal income tax purposes regardless of its source; or
- a trust if (a) a court within the United States is able to exercise primary supervision over the administration of the trust and one or more United States persons have the authority to control all substantial decisions of the trust or (b) it has a valid election in effect under applicable Treasury regulations to be treated as a United States person.

Generally, an individual may be treated as a resident of the United States in any calendar year for United States federal income tax purposes by, among other ways, being present in the United States for at least 31 days in that calendar year and for an aggregate of at least 183 days during a three-year period ending in the current calendar year. For purposes of this calculation, such individual would count all of the days in which he or she was present in the current year, one-third of the days present in the immediately preceding year, and one-sixth of the days present in the second preceding year. Residents are taxed for United States federal income tax purposes as if they were citizens of the United States.

This discussion is based on current provisions of the Internal Revenue Code, final, temporary or proposed Treasury regulations promulgated thereunder, judicial opinions, published positions of the Internal Revenue Service and all other applicable authorities, all of which are subject to change (possibly with retroactive effect). We assume in this discussion that a non-U.S. holder holds shares of our common stock as a capital asset (generally property held for investment).

This discussion does not address all aspects of United States federal income and estate taxation that may be important to a particular non-U.S. holder in light of that non-U.S. holder's individual circumstances, nor does it address any aspects of United States state, local or non-U.S. taxes. This discussion also does not consider any specific facts or circumstances that may apply to a non-U.S. holder subject to special treatment under the United States federal income tax laws, including without limitation:

- banks, insurance companies or other financial institutions;
- partnerships or other entities classified as partnerships for United States federal income tax purposes;
- tax-exempt organizations;
- tax-qualified retirement plans;
- dealers in securities or currencies;
- traders in securities that elect to use a mark-to-market method of accounting for their securities holdings;
- certain United States expatriates; and
- persons that will hold common stock as a position in a hedging transaction, "straddle" or "conversion transaction" for tax purposes.

Accordingly, we urge prospective investors to consult with their own tax advisors regarding the United States federal, state, local and non-U.S. income and other tax considerations of acquiring, holding and disposing of shares of our common stock.

If a partnership holds shares of our common stock, the tax treatment of a partner will generally depend upon the status of the partner and the activities of the partnership. Any partner in a partnership holding shares of our common stock should consult its own tax advisors.

Dividends

In general, dividends we pay, if any, to a non-U.S. holder will be subject to United States withholding tax at a rate of 30% of the gross amount. The withholding tax might not apply or might apply at a reduced rate under the terms of an applicable income tax treaty between the United States and the non-U.S. holder's country of residence. A non-U.S. holder must demonstrate its entitlement to treaty benefits by certifying, among other things, its nonresident status. A non-U.S. holder generally can meet this certification requirement by providing an Internal Revenue Service Form W-8BEN or appropriate substitute form to us or our paying agent. Also, special rules apply if the dividends are effectively connected with a trade or business carried on by the non-U.S. holder within the United States and, if a treaty applies, are attributable to a permanent establishment of the non-U.S. holder within the United States. Dividends effectively connected with this United States trade or business, and, if a treaty applies, attributable to such a permanent establishment of a non-U.S. holder, generally will not be subject to United States withholding tax if the non-U.S. holder files certain forms, including Internal Revenue Service Form W-8ECI (or any successor form), with the payor of the dividend, and generally will be subject to United States federal income tax on a net income basis, in the same manner as if the non-U.S. holder were a resident of the United States. A non-U.S. holder that is a corporation may be subject to an additional "branch profits tax" at a rate of 30% (or a reduced rate as may be specified by an applicable income tax treaty) on the repatriation from the United States of its "effectively connected earnings and profits," subject to certain adjustments. A non-U.S. holder of shares of our common stock eligible for a reduced rate of United States withholding tax pursuant to an income tax treaty may obtain a refund of any excess amounts withheld by filing an appropriate claim for refund with the Internal Revenue Service.

Gain on Sale or Other Disposition of Common Stock

In general, a non-U.S. holder will not be subject to United States federal income tax on any gain realized upon the sale or other disposition of the holder's shares of our common stock unless:

- the gain is effectively connected with a trade or business carried on by the non-U.S. holder within the United States and, if required by an applicable income tax treaty as a condition to subjecting a non-U.S. holder to United States income tax on a net basis, the gain is attributable to a permanent establishment of the non-U.S. holder maintained in the United States, in which case a non-U.S. holder will be subject to United States federal income tax on any gain realized upon the sale or other disposition on a net income basis, in the same manner as if the non-U.S. holder were a resident of the United States. Furthermore, the branch profits tax discussed above may also apply if the non-U.S. holder is a corporation;
- the non-U.S. holder is an individual and is present in the United States for 183 days or more in the taxable year of disposition and certain other tests are met, in which case a non-U.S. holder will be subject to a flat 30% tax on any gain realized upon the sale or other disposition, which tax may be offset by United States source capital losses (even though the individual is not considered a resident of the United States); or
- we are or have been a United States real property holding corporation (a USRPHC) for United States federal income tax purposes at any time within the shorter of the five-year period preceding the disposition and the non-U.S. holder's holding period. We do not believe that we are a USRPHC, and we do not anticipate becoming a USRPHC. If we are or were to become a USRPHC at any time during this period, generally gains realized upon a disposition of shares of our common stock by a non-U.S. holder that did not directly or indirectly own more than 5% of our common stock during this period would not be subject to United States federal income tax, provided that our common stock is "regularly traded on an established securities market" (within the meaning of Section 897(c)(3) of the Internal Revenue Code). Our common stock will be treated as regularly traded on an established securities market during any period in which it is listed on a registered national securities exchange or any over-the-counter market.

United States Federal Estate Tax

Shares of our common stock that are owned or treated as owned by an individual who is not a citizen or resident (as defined for United States federal estate tax purposes) of the United States at the time of death will be includible in the individual's gross estate for United States federal estate tax purposes, unless an applicable estate tax treaty provides otherwise, and therefore may be subject to United States federal estate tax.

Backup Withholding, Information Reporting and Other Reporting Requirements

Generally, we must report annually to the Internal Revenue Service and to each non-U.S. holder the amount of dividends paid to, and the tax withheld with respect to, each non-U.S. holder. These reporting requirements apply regardless of whether withholding was reduced or eliminated by an applicable tax treaty. Copies of this information also may be made

available under the provisions of a specific treaty or agreement with the tax authorities in the country in which the non-U.S. holder resides or is established.

United States backup withholding tax is imposed (at a current rate of 28%) on certain payments to persons that fail to furnish the information required under the United States information reporting requirements. A non-U.S. holder of shares of our common stock will be subject to this backup withholding tax on dividends we pay unless the holder certifies, under penalties of perjury, among other things, its status as a non-U.S. holder (and we or our paying agent do not have actual knowledge or reason to know the holder is a United States person) or otherwise establishes an exemption.

Under the Treasury regulations, the payment of proceeds from the disposition of shares of our common stock by a non-U.S. holder made to or through a United States office of a broker generally will be subject to information reporting and backup withholding unless the beneficial owner certifies, under penalties of perjury, among other things, its status as a non-U.S. holder (and the broker does not have actual knowledge or reason to know the holder is a United States person) or otherwise establishes an exemption. The payment of proceeds from the disposition of shares of our common stock by a non-U.S. holder made to or through a non-U.S. office of a broker generally will not be subject to backup withholding and information reporting, except as noted below. In the case of proceeds from a disposition of shares of our common stock by a non-U.S. holder made to or through a non-U.S. office of a broker that is:

- a United States person;
- a "controlled foreign corporation" for United States federal income tax purposes;
- a foreign person 50% or more of whose gross income from certain periods is effectively connected with a United States trade or business; or
- a foreign partnership if at any time during its tax year (a) one or more of its partners are United States persons who, in the aggregate, hold more than 50% of the income or capital interests of the partnership or (b) the foreign partnership is engaged in a United States trade or business;

information reporting (but not backup withholding) will apply unless the broker has documentary evidence in its files that the owner is a non-U.S. holder and certain other conditions are satisfied, or the beneficial owner otherwise establishes an exemption (and the broker has no actual knowledge or reason to know to the contrary).

Backup withholding is not an additional tax. Any amounts withheld under the backup withholding rules from a payment to a non-U.S. holder can be refunded or credited against the non-U.S. holder's United States federal income tax liability, if any, provided that the required information is furnished to the Internal Revenue Service in a timely manner.

THE FOREGOING DISCUSSION OF CERTAIN UNITED STATES FEDERAL INCOME TAX CONSIDERATIONS IS FOR GENERAL INFORMATION ONLY AND IS NOT TAX ADVICE. ACCORDINGLY, EACH PROSPECTIVE HOLDER OF SHARES OF OUR COMMON STOCK SHOULD CONSULT HIS, HER OR ITS OWN TAX ADVISOR WITH RESPECT TO THE FEDERAL, STATE, LOCAL AND FOREIGN TAX CONSEQUENCES OF THE ACQUISITION, OWNERSHIP AND DISPOSITION OF OUR COMMON STOCK.

UNDERWRITING

Under the terms and subject to the conditions contained in an underwriting agreement dated , 2008, we and the selling stockholders have agreed to sell to the underwriters named below, for whom Citigroup Global Markets Inc. and Credit Suisse Securities (USA) LLC are acting as joint bookrunning managers and representatives, the following respective numbers of shares of common stock:

Underwriter	Number of Shares
Citigroup Global Markets Inc.	
Credit Suisse Securities (USA) LLC	
Total	

The underwriting agreement provides that the underwriters are obligated to purchase all the shares of common stock in the offering if any are purchased, other than those shares covered by the over-allotment option described below. The underwriting agreement also provides that if an underwriter defaults, the purchase commitments of non-defaulting underwriters may be increased or the offering may be terminated.

All sales of the common stock in the United States will be made by U.S. registered broker/dealers.

We and the selling stockholders have granted to the underwriters a 30-day option to purchase on a pro rata basis up to additional shares from us and an aggregate of additional outstanding shares from the selling stockholders at the initial public offering price less the underwriting discounts and commissions. The option may be exercised only to cover any over-allotments of common stock.

The underwriters propose to offer the shares of common stock initially at the public offering price on the cover page of this prospectus and to selling group members at that price less a selling concession of $ per share. After the initial public offering the representatives may change the public offering price and concession and discount to broker/dealers.

The following table summarizes the compensation and estimated expenses we and the selling stockholders will pay:

	Per Share		Total	
	Without Over-allotment	With Over-allotment	Without Over-allotment	With Over-allotment
Underwriting discounts and commissions paid by us	$	$	$	$
Expenses payable by us	$	$	$	$
Underwriting discounts and commissions paid by selling stockholders	$	$	$	$

The representatives have informed us that they do not expect sales to accounts over which the underwriters have discretionary authority to exceed 5% of the shares of common stock being offered.

We, our officers and directors, and all holders of our common shares, including the selling stockholders, have agreed that, for a period of 180 days from the date of this prospectus, we and they will not, without the prior written consent of each of Citi and Credit Suisse Securities (USA) LLC, dispose of or hedge any shares of our common stock or any securities convertible into or exchangeable for our common stock. Citi and Credit Suisse Securities (USA) LLC in their sole discretion may release any of the securities subject to these lock-up agreements at any time without notice. The 180-day lock-up period will be automatically extended if: (1) during the last 17 days of the 180-day period we issue an earnings release or announce material news or a material event; or (2) prior to the expiration of the 180-day period, we announce that we will release earnings results during the 16-day period following the last day of the 180-day period, in which case the restrictions will continue to apply until the expiration of the 18-day period beginning on the issuance of the earnings release or the announcement of the material news or event, unless Citi and Credit Suisse Securities (USA) LLC waive, in writing, such an extension.

We and the selling stockholders have agreed to indemnify the underwriters against liabilities under the Securities Act, or contribute to payments that the underwriters may be required to make in that respect.

We intend to apply to list the shares of common stock on the NASDAQ Global Market.

Prior to this offering, there has been no public market for our common stock. The initial public offering price will be determined by negotiations between us and the representatives of the underwriters. In determining the initial public offering price, we and the representatives of the underwriters will consider a number of factors including:

- the information set forth in this prospectus and otherwise available to the representatives;
- our prospects and the history and prospects for the industry in which we compete;
- an assessment of our management;
- our prospects for future earnings;
- the general condition of the securities markets at the time of this offering;
- the recent market prices of, and demand for, publicly traded common stock of generally comparable companies; and
- other factors deemed relevant by the underwriters and us.

Neither we nor the underwriters can assure investors that an active trading market will develop for our common stock, or that the shares will trade in the public market at or above the initial public offering price.

In connection with the offering the underwriters may engage in stabilizing transactions, over-allotment transactions, syndicate covering transactions, penalty bids and passive market making in accordance with Regulation M under the Securities Exchange Act of 1934, or the Exchange Act.

- Stabilizing transactions permit bids to purchase the underlying security so long as the stabilizing bids do not exceed a specified maximum.
- Over-allotment involves sales by the underwriters of shares in excess of the number of shares the underwriters are obligated to purchase, which creates a syndicate short position. The short position may be either a covered short position or a naked short position. In a covered short position, the number of shares over-allotted by the underwriters is not greater than the number of shares that they may purchase in the over-allotment option. In a naked short position, the number of shares involved is greater than the number of shares in the over-allotment option. The underwriters may close out any covered short position by either exercising their over-allotment option and/or purchasing shares in the open market.
- Syndicate covering transactions involve purchases of the common stock in the open market after the distribution has been completed in order to cover syndicate short positions. In determining the source of shares to close out the short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase shares through the over-allotment option. If the underwriters sell more shares than could be covered by the over-allotment option, a naked short position, the position can only be closed out by buying shares in the open market. A naked short position is more likely to be created if the underwriters are concerned that there could be downward pressure on the price of the shares in the open market after pricing that could adversely affect investors who purchase in the offering.
- Penalty bids permit the representatives to reclaim a selling concession from a syndicate member when the common stock originally sold by the syndicate member is purchased in a stabilizing or syndicate covering transaction to cover syndicate short positions.
- In passive market making, market makers in the common stock who are underwriters or prospective underwriters may, subject to limitations, make bids for or purchases of our common stock until the time, if any, at which a stabilizing bid is made.

These stabilizing transactions, syndicate covering transactions and penalty bids may have the effect of raising or maintaining the market price of our common stock or preventing or retarding a decline in the market price of the common stock. As a result the price of our common stock may be higher than the price that might otherwise exist in the open market. These transactions may be effected on the NASDAQ Global Market or otherwise and, if commenced, may be discontinued at any time.

A prospectus in electronic format may be made available on the web sites maintained by one or more of the underwriters, or selling group members, if any, participating in this offering and one or more of the underwriters participating in this offering may distribute prospectuses electronically. The representatives may agree to allocate a number of shares to underwriters and selling group members for sale to their online brokerage account holders. Internet distributions

will be allocated by the underwriters and selling group members that will make internet distributions on the same basis as other allocations.

In the ordinary course, the underwriters and their affiliates have provided, and may in the future provide, investment banking, commercial banking, investment management, or other financial services to us and our affiliates for which they have received compensation and may receive compensation in the future.

Each underwriter has represented, warranted and agreed that:

- it has not offered and will not make an offer of the common stock to the public in the United Kingdom prior to the publication of a prospectus in relation to the common stock and the approval of the offer by the Financial Services Authority, or, FSA or, where appropriate, approval in another Member State and notification to the FSA, all in accordance with the Prospectus Directive, except that it may make an offer of the stock to persons who fall within the definition of “qualified investor” as that term is defined in Section 86(1) of the Financial Services and Markets Act 2000, or FSMA, or otherwise in circumstances which do not result in an offer of transferable securities to the public in the United Kingdom within the meaning of the FSMA;
- it has only communicated or caused to be communicated and will only communicate or cause to be communicated any invitation or inducement to engage in investment activity (within the meaning of Section 21 of the FSMA) received by it in connection with the issue or sale of any stock in circumstances in which Section 21(1) of the FSMA does not apply to us or to persons who have professional experience in matters relating to investments falling within Article 19(5) of the FSMA; and
- it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the stock in, from or otherwise involving the United Kingdom.

We will not offer to sell any common stock to any member of the public in the Cayman Islands.

The common stock may not be offered or sold in Hong Kong, by means of any document, other than to persons whose ordinary business is to buy or sell stock or debentures, whether as principal or agent, or in circumstances which do not constitute an offer to the public within the meaning of the Companies Ordinance (Cap. 32) of Hong Kong. No advertisement, invitation or document relating to the common stock, whether in Hong Kong or elsewhere, may be issued, which is directed at, or the contents of which are likely to be accessed or read by, the public of Hong Kong (except if permitted to do so under the securities laws of Hong Kong) other than with respect to common stock which are or are intended to be disposed of only to persons outside Hong Kong or only to “professional investors” within the meaning of the Securities and Futures Ordinance (Cap. 571) of Hong Kong and any rules made thereunder.

The common stock has not been and will not be registered under the Securities and Exchange Law of Japan (Law No. 235 of 1948 as amended), or the Securities Exchange Law, and disclosure under the Securities Exchange Law has not been and will not be made with respect to the common stock. Accordingly, the common stock may not be, directly or indirectly, offered or sold in Japan or to, or for the benefit of, any resident of Japan or to others for re-offering or re-sale, directly or indirectly in Japan or to, or for the benefit of, any resident of Japan except pursuant to an exemption from the registration requirements of, and otherwise in compliance with, the Securities Exchange Law and other relevant laws, regulations and ministerial guidelines of Japan. As used in this paragraph, “resident of Japan” means any person residing in Japan, including any corporation or other entity organized under the laws of Japan.

This prospectus has not been and will not be registered as a prospectus with the Monetary Authority of Singapore under the Securities and Futures Act (Cap. 289) of Singapore, or the Securities and Futures Act. Accordingly, the common stock may not be offered or sold or made the subject of an invitation for subscription or purchase nor may this prospectus or any other document or material in connection with the offer or sale, or invitation for subscription or purchase of such common stock be circulated or distributed, whether directly or indirectly, to the public or any members of the public in Singapore other than: (1) to an institutional investor or other person falling within Section 274 of the Securities and Futures Act, (2) to a sophisticated investor, and in accordance with the conditions specified in Section 275 of the Securities and Futures Act or (3) pursuant to, and in accordance with the conditions of any other applicable provision of the Securities and Futures Act.

In relation to each Member State of the European Economic Area which has implemented the Prospectus Directive (each, a Relevant Member State), and effective as of the date on which the Prospectus Directive is implemented in that Relevant Member State (the Relevant Implementation Date), no common stock have been offered to the public in that Relevant Member State prior to the publication of a prospectus in relation to the common stock which has been approved by the competent authority in that Relevant Member State or, where appropriate, approved in another Relevant Member State and brought to the attention of the competent authority in that Relevant Member State, all in accordance with the Prospectus

Directive. Notwithstanding the foregoing, an offer of common stock may be made effective as of the Relevant Implementation Date to the public in that Relevant Member State at any time:

(1) to legal entities which are authorized or regulated to operate in the financial markets or, if not so authorized or regulated, whose corporate purpose is solely to invest in securities;

(2) to any legal entity which has two or more of (a) an average of at least 250 employees during the last financial year; (b) a total balance sheet of more than €43,000,000 and (c) an annual net turnover of more than €50,000,000, as shown in its last annual or consolidated accounts; or

(3) in any other circumstances which do not require the publication by the issuer of a prospectus pursuant to Article 3 of the Prospectus Directive. For the purposes of this paragraph, the expression an "offer of common stock to the public" in relation to any common stock in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and the common stock to be offered so as to enable an investor to decide to purchase or subscribe the common stock, as the same may be varied in that Member State by any measure implementing the Prospectus Directive in that Member State and the expression Prospectus Directive means Directive 2003/71/EC and includes any relevant implementing measure in each Relevant Member State.

The common stock has not been registered under the Korean Securities and Exchange Law. Each of the underwriters has represented and agreed that it has not offered, sold or delivered and will not offer, sell or deliver, directly or indirectly, any common stock in Korea or to, or for the account or benefit of, any resident of Korea, except as otherwise permitted by applicable Korean laws and regulations; and any securities dealer to whom it sells common stock will agree that it will not offer any common stock, directly or indirectly, in Korea or to any resident of Korea, except as permitted by applicable Korean laws and regulations, or to any other dealer who does not so represent and agree.

This prospectus has not been reviewed by or registered with the Oslo Stock Exchange or the Norwegian Register of Business Enterprises. The shares are being offered in Norway solely in reliance upon the exemption provided by Section 5-2, second paragraph of the Norwegian Securities Trading Act of June 19, 1997 no. 79.

NOTICE TO CANADIAN RESIDENTS

Resale Restrictions

The distribution of the shares in Canada is being made only on a private placement basis exempt from the requirement that we and the selling shareholders prepare and file a prospectus with the securities regulatory authorities in each province where trades of shares are made. Any resale of the shares in Canada must be made under applicable securities laws which will vary depending on the relevant jurisdiction, and which may require resales to be made under available statutory exemptions or under a discretionary exemption granted by the applicable Canadian securities regulatory authority. Purchasers are advised to seek legal advice prior to any resale of the shares.

Representations of Purchasers

By purchasing shares in Canada and accepting a purchase confirmation a purchaser is representing to us, the selling shareholders and the dealer from whom the purchase confirmation is received that:

- the purchaser is entitled under applicable provincial securities laws to purchase the shares without the benefit of a prospectus qualified under those securities laws;
- where required by law, that the purchaser is purchasing as principal and not as agent;
- the purchaser has reviewed the text above under Resale Restrictions; and
- the purchaser acknowledges and consents to the provision of specified information concerning its purchase of the shares to the regulatory authority that by law is entitled to collect the information.

Further details concerning the legal authority for this information is available on request.

Rights of Action – Ontario Purchasers Only

Under Ontario securities legislation, certain purchasers who purchase a security offered by this prospectus during the period of distribution will have a statutory right of action for damages, or while still the owner of the shares, for rescission against us and the selling stockholders in the event that this prospectus contains a misrepresentation without regard to whether the purchaser relied on the misrepresentation. The right of action for damages is exercisable not later than the earlier of 180 days from the date the purchaser first had knowledge of the facts giving rise to the cause of action and three years from the date on which payment is made for the shares. The right of action for rescission is exercisable not later than 180 days from the date on which payment is made for the shares. If a purchaser elects to exercise the right of action for rescission, the purchaser will have no right of action for damages against us or the selling stockholders. In no case will the amount recoverable in any action exceed the price at which the shares were offered to the purchaser and if the purchaser is shown to have purchased the securities with knowledge of the misrepresentation, we and the selling stockholders will have no liability. In the case of an action for damages, we and the selling stockholders will not be liable for all or any portion of the damages that are proven to not represent the depreciation in value of the shares as a result of the misrepresentation relied upon. These rights are in addition to, and without derogation from, any other rights or remedies available at law to an Ontario purchaser. The foregoing is a summary of the rights available to an Ontario purchaser. Ontario purchasers should refer to the complete text of the relevant statutory provisions.

Enforcement of Legal Rights

All of our directors and officers as well as the experts named herein and the selling stockholders may be located outside of Canada and, as a result, it may not be possible for Canadian purchasers to effect service of process within Canada upon us or those persons. All or a substantial portion of our assets and the assets of those persons may be located outside of Canada and, as a result, it may not be possible to satisfy a judgment against us or those persons in Canada or to enforce a judgment obtained in Canadian courts against us or those persons outside of Canada.

Taxation and Eligibility for Investment

Canadian purchasers of shares should consult their own legal and tax advisors with respect to the tax consequences of an investment in the shares in their particular circumstances and about the eligibility of the shares for investment by the purchaser under relevant Canadian legislation.

LEGAL MATTERS

The validity of the shares of common stock offered hereby will be passed upon for us by Baker & McKenzie LLP, San Francisco, California. Certain legal matters in connection with this offering will be passed upon for the underwriters by Davis Polk & Wardwell, Menlo Park, California.

EXPERTS

The financial statements and schedule included in this prospectus have been audited by BDO Seidman, LLP, an independent registered public accounting firm, to the extent and for the periods set forth in their report appearing elsewhere herein, and are included in reliance upon such report given upon the authority of said firm as experts in auditing and accounting.

WHERE YOU CAN FIND ADDITIONAL INFORMATION

We have filed with the SEC a registration statement on Form S-1 under the Securities Act with respect to the shares of our common stock offered hereby. This prospectus, which constitutes a part of the registration statement, does not contain all of the information set forth in the registration statement or the exhibits and schedules filed therewith. For further information about us and the common stock offered hereby, we refer you to the registration statement and the exhibits and schedules filed thereto. Statements contained in this prospectus regarding the contents of any contract or any other document that is filed as an exhibit to the registration statement are not necessarily complete and each such statement is qualified in all respects by reference to the full text of such contract or other document filed as an exhibit to the registration statement. A copy of the registration statement, and the exhibits and schedules thereto, may be inspected without charge at the public reference facilities maintained by the SEC in Room 1580, 100 F Street, N.E. Washington, D.C. 20549. Upon completion of this offering, we will be required to file periodic reports, proxy statements and other information with the SEC pursuant to the Securities Exchange Act of 1934. We intend to provide our stockholders with annual reports containing financial statements that have been audited by an independent registered public accounting firm and to file with the SEC quarterly reports containing unaudited financial data for the first three quarters of each year. You may read and copy this information at the Public Reference Room of the SEC, 100 F Street, N.E., Room 1580, Washington, D.C. 20549. You may obtain information on the operation of the public reference rooms by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet website that contains reports, proxy statements and other information about issuers, like us, that file electronically with the SEC. The address of that site is www.sec.gov.

ENERGY RECOVERY, INC.
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	Page
Report of Independent Registered Public Accounting Firm	F-2
Financial Statements	
Consolidated Balance Sheets	F-3
Consolidated Statements of Operations	F-4
Consolidated Statements of Stockholders' Equity and Comprehensive Income	F-5
Consolidated Statements of Cash Flows	F-6
Notes to Consolidated Financial Statements	F-7

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders of
Energy Recovery, Inc.

We have audited the accompanying consolidated balance sheets of Energy Recovery, Inc. as of December 31, 2007 and 2006 and the related consolidated statements of operations, stockholders' equity and comprehensive income, and cash flows for each of the three years in the period ended December 31, 2007. In connection with our audits of the financial statements, we have also audited the financial statement schedule listed in Item 16(b). These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements and schedule, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements and schedule. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Energy Recovery, Inc. at December 31, 2007 and 2006, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America.

Also, in our opinion, the financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 9 to the consolidated financial statements, effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123 (Revised), *Share-Based Payment*.

/s/ BDO Seidman LLP
San Jose, California
March 28, 2008

ENERGY RECOVERY, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	Years Ended December 31,	
	2007	2006
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 240	$ 42
Restricted cash	366	475
Accounts receivable, net of allowance for doubtful accounts of $121 and $230 in 2007 and 2006, respectively	13,131	5,646
Unbilled receivables, current	1,653	1,007
Notes receivable from stockholders	20	111
Inventories	4,791	2,888
Deferred tax assets, net	1,052	676
Prepaid expenses and other current assets	369	289
Total current assets	21,622	11,134
Unbilled receivables, non-current	2,255	712
Restricted cash, non-current	1,221	69
Property and equipment, net	1,671	1,056
Intangible assets, net	345	312
Deferred tax assets, non-current, net	148	183
Other assets, non-current	42	73
Total Assets	$27,304	$13,539
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 1,697	$ 1,114
Accrued expenses and other current liabilities	1,868	1,716
Liability for early exercise of stock options	20	111
Income taxes payable	1,154	1,397
Accrued warranty reserve	868	85
Deferred revenue	488	145
Customer deposits	318	79
Current portion of long-term debt	172	493
Current portion of capital lease obligations	38	38
Total current liabilities	6,623	5,178
Long-term debt	557	133
Capital lease obligations, non-current	63	101
Total Liabilities	7,243	5,412
Commitments and Contingencies (Note 7)		
Stockholders' Equity:		
Preferred stock, $0.001 par value; 10,000,000 shares authorized; zero shares issued and outstanding	—	—
Common stock, $0.001 par value; 45,000,000 shares authorized; 39,777,446 and 38,222,493 shares issued and outstanding in 2007 and 2006, respectively	40	38
Additional paid-in capital	20,762	14,519
Notes receivable from stockholders	(835)	(736)
Accumulated other comprehensive loss	(5)	—
Retained earnings (accumulated deficit)	99	(5,694)
Total Stockholders' Equity	20,061	8,127
Total Liabilities and Stockholders' Equity	$27,304	$13,539

See accompanying notes to consolidated financial statements.

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

	Years Ended December 31,		
	2007	2006	2005
Net revenue	$35,414	$20,058	$10,689
Cost of revenue(1)	14,852	8,131	4,685
Gross profit	20,562	11,927	6,004
Operating expenses:			
Sales and marketing(1)	5,230	3,648	1,779
General and administrative(1)	4,299	3,372	2,458
Research and development(1)	1,705	1,267	630
Total operating expenses	11,234	8,287	4,867
Income from operations	9,328	3,640	1,137
Other income (expense):			
Interest expense	(105)	(77)	(216)
Interest and other income	517	58	35
Income before provision for income taxes	9,740	3,621	956
Provision for income taxes	3,947	1,239	62
Net Income	$ 5,793	$ 2,382	$ 894
Earnings per share:			
Basic	$ 0.15	$ 0.06	$ 0.02
Diluted	$ 0.14	$ 0.06	$ 0.02
Number of shares used in per share calculations:			
Basic	39,060	38,018	36,790
Diluted	41,433	40,244	38,454

(1) Includes stock-based compensation expense.

See accompanying notes to consolidated financial statements.

ENERGY RECOVERY, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME
Years Ended December 31, 2007, 2006 and 2005
(in thousands)

	Common Stock		Additional Paid-in Capital	Note Receivable from Stockholders	Accumulated Other Comprehensive Income	Retained Earnings (Accumulated Deficit)	Total Stockholders' Equity
	Shares	Amount					
Balance at December 31, 2004	32,425	$ 32	$ 9,932	$ —	$ —	$ (8,970)	$ 994
Net income	—	—	—	—	—	894	894
Comprehensive income	—	—	—	—	—	—	894
Issuance of common stock	5,344	6	2,246	(763)	—	—	1,489
Interest on notes receivable from stockholders	—	—	—	(32)	—	—	(32)
Repayment of notes receivable from stockholders	—	—	—	222	—	—	222
Issuance of warrants to purchase common stock	—	—	132	—	—	—	132
Employee stock-based compensation	—	—	1,003	—	—	—	1,003
Balance at December 31, 2005	37,769	38	13,313	(573)	—	(8,076)	4,702
Net income	—	—	—	—	—	2,382	2,382
Comprehensive income	—	—	—	—	—	—	2,382
Issuance of common stock	453	—	142	(137)	—	—	5
Interest on notes receivable from stockholders	—	—	—	(31)	—	—	(31)
Repayment of notes receivable from stockholders	—	—	—	5	—	—	5
Employee stock-based compensation	—	—	1,061	—	—	—	1,061
Non-employee stock-based compensation	—	—	3	—	—	—	3
Balance at December 31, 2006	38,222	38	14,519	(736)	—	(5,694)	8,127
Net income	—	—	—	—	—	5,793	5,793
Foreign currency translation adjustments	—	—	—	—	(5)	—	(5)
Comprehensive income							5,788
Issuance of common stock	1,555	2	5,207	(91)	—	—	5,118
Interest on notes receivable from stockholders	—	—	—	(31)	—	—	(31)
Repayment of notes receivable from stockholders	—	—	—	23	—		23
Employee stock-based compensation			1,008	—	—	—	1,008
Non-employee stock-based compensation	—	—	28	—	—	—	28
Balance at December 31, 2007	39,777	$ 40	$ 20,762	$ (835)	$ (5)	$ 99	$ 20,061

See accompanying notes to consolidated financial statements.

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

	Years Ended December 31,		
	2007	2006	2005
Cash Flows From Operating Activities			
Net income	$ 5,793	$ 2,382	$ 894
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation and amortization	323	231	126
Impairment of intangible assets	31	—	—
Interest accrued on notes receivables from stockholders	(31)	(31)	(32)
Stock-based compensation	1,036	1,064	1,003
Issuance of warrants in exchange for debt guarantee	—	—	132
(Gain) loss on foreign currency transactions	(351)	4	—
Provision for doubtful accounts	(105)	80	104
Provision for warranty claims	850	61	161
Provision for excess or obsolete inventory	47	30	77
Changes in operating assets and liabilities:			
Accounts receivable	(7,029)	(1,513)	(3,132)
Unbilled receivables	(2,189)	(1,719)	—
Inventories	(1,950)	(960)	(901)
Deferred tax assets, net	(341)	(859)	0
Prepaid and other assets	(49)	(135)	(156)
Accounts payable	583	270	346
Accrued expenses and other liabilities	214	1,002	(23)
Income taxes payable	(243)	1,334	64
Deferred revenue	343	115	30
Customer deposits	239	(534)	613
Net cash (used in) provided by operating activities	(2,829)	822	(694)
Cash Flows From Investing Activities			
Capital expenditures	(918)	(328)	(566)
Restricted cash	(1,043)	(109)	(436)
Other	(84)	(74)	(35)
Net cash (used in) investing activities	(2,045)	(511)	(1,037)
Cash Flows From Financing Activities			
Proceeds from long-term debt	639	118	313
Repayment of long-term debt	(98)	(164)	(492)
Repayment of revolving note, net	(438)	(563)	545
Repayment of capital lease obligation	(38)	(60)	(25)
Net proceeds from issuance of common stock	5,118	5	1,389
Repayment of notes receivables from a stockholder	23	5	222
Repayment of notes payable to a stockholder	—	—	(100)
Other short term financing activities	(129)	129	—
Net cash provided by (used in) financing activities	5,077	(530)	1,852
Effect of exchange rate differences on cash and cash equivalents	(5)	—	—
Net change in cash and cash equivalents	198	(219)	121
Cash and cash equivalents, beginning of year	42	261	140
Cash and cash equivalents, end of year	$ 240	$ 42	$ 261
Supplemental disclosure of cash flow information			
Cash paid for interest	$ 97	$ 78	$ 70
Cash paid for income taxes	$ 4,555	$ 764	$ 1
Supplemental disclosure of non-cash transactions			
Issuance of common stock in exchange for notes receivable from stockholders	$ 91	$ 137	$ 763
Issuance of common stock in exchange for reduction in note payable from stockholders	$ —	$ —	$ 100
Equipment purchased under capital leases	$ —	$ 42	$ 161

See accompanying notes to consolidated financial statements.

ENERGY RECOVERY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Description of Business

Energy Recovery, Inc. ("the Company" or "ERI") was established in 1992, and is a leading global developer and manufacturer of highly efficient energy recovery devices utilized in the water desalination industry. The Company operates primarily in the sea water reverse osmosis ("SWRO") segment of the industry, which uses pressure to drive sea water through filtering membranes to produce fresh water. The Company's primary energy recovery device is the PX Pressure Exchanger® (PX®), which helps optimize the energy intensive SWRO process by reducing energy consumption by up to 60% as compared to the same process without any energy recovery devices. Products are manufactured in the United States of America ("U.S.") at ERI's headquarters located in San Leandro, California, and shipped from this location to specified customer locations worldwide. The Company has direct sales offices and technical support centers in Madrid, Dubai, Shanghai and Fort Lauderdale and the research and development center is located in San Leandro, California.

The Company was incorporated in Virginia in April 1992 and reincorporated in Delaware in March 2001. The Company incorporated its wholly owned subsidiaries, Osmotic Power, Inc. Energy Recovery, Inc. International and Energy Recovery Iberia, S.L., in September 2005, July 2006 and September 2006, respectively.

2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its foreign wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the Unites States of America ("U.S. GAAP") requires management to make judgments, estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results may materially differ from those estimates. The Company's most significant estimates and judgments involve the determination of revenue recognition, allowance for doubtful accounts, allowance for product warranty, valuation of the Company's stock and stock-based compensation, reserve for excess and obsolete inventory, deferred taxes and valuation allowances on deferred tax assets.

Cash and Cash Equivalents

The Company considers all highly liquid investments with a remaining maturity of three months or less at the time of purchase to be cash equivalents. The Company invests primarily in money market funds as these investments are subject to minimal credit and market risks.

Allowances of Doubtful Accounts

The Company records a provision for doubtful accounts based on its historical experience and a detailed assessment of the collectability of its accounts receivable. In estimating the allowance for doubtful accounts, the Company's management considers, among other factors, (1) the aging of the accounts receivable, (2) the Company's historical write-offs, (3) the credit worthiness of each customer and (4) general economic conditions.

Restricted Cash

The Company has irrevocable letters of credit with a bank securing performance under contracts with customers. At December 31, 2007 and 2006, the outstanding amounts with the bank were $1.6 million and $475,000, respectively. The Company has deposited a corresponding amount into a certificate of deposit that secures the letters of credit.

At December 31, 2006, the Company also had $69,000 deposited with another bank in an escrow account securing the Company's facility lease. During 2007, the lessor authorized an early closure of the escrow account and the restriction was released.

Inventories

Inventories are stated at the lower of cost (using the weighted average cost method) or market. The Company calculates inventory reserve for excess and obsolete inventories based on current inventory levels, expected useful life and estimated future demand of the products and spare parts. Cost of inventory is determined in accordance with Statement of Financial Accounting Standards ("SFAS") No. 151, *Inventory Costs*, an amendment of ARB No. 43, Chapter 4.

Property and Equipment

Property and equipment are stated at cost and depreciated over the estimated useful lives of the assets (generally three to seven years) using the straight-line method. A significant portion of equipment for the Company's manufacturing facility is acquired under capital lease obligations. These assets are amortized over periods consistent with depreciation of owned assets of similar types, generally five years. Lease improvements represent the remodeling expenses for the leased office space and are depreciated over the shorter of either the estimated useful lives or the term of the lease using the straight-line method. Software purchased for internal use consists primarily of amounts paid for perpetual licenses to third party software providers and are depreciated over the estimated useful lives, generally three to five years.

SFAS No. 143, *Accounting for Asset Retirement Obligations* and Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, an interpretation of SFAS 143, requires the recognition of a liability for the fair value of a legally required conditional asset retirement obligation when incurred, if the liability's fair value can be reasonably estimated. Management reviewed the Company's facility lease and concluded that the cost, if any of potential physical reinstatement obligations is not reasonably determinable, and as such, no asset retirement obligation was recorded in the financial statements for the years presented.

Maintenance and repairs are charged directly to expense as incurred, whereas improvements and renewals are generally capitalized in their respective property accounts. When an item is retired or otherwise disposed of, the cost and applicable accumulated depreciation are removed and the resulting gain or loss is recognized in the results of operations.

Intangible Assets

Intangible assets represent patents owned by the Company and are recorded at cost and are amortized on a straight-line basis over their expected useful life of 17 to 20 years.

Impairment of Long-Lived Assets

The Company accounts for its long-lived assets, including property and equipment and intangibles, in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. The Company evaluates its long-lived assets for indicators of possible impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable. An impairment loss would be recognized when estimated undiscounted future cash flows expected to result from the use of an asset and its eventual disposition are less than its carrying amount. During 2007, the Company determined that a patent was impaired as a result of the development of a new patent which effectively superseded and replaced an existing patent; accordingly, the Company recorded an impairment reserve of $31,000 for the year ended December 31, 2007, and this amount was included in research and development expense in the consolidated statement of operations. No impairment expense was recorded for the years ended December 31, 2006 and 2005.

Revenue Recognition

The Company recognizes revenue in accordance with SEC Staff Accounting Bulletin ("SAB") No. 104, *Revenue Recognition* ("SAB 104"). The Company recognizes revenue when the earnings process is complete, as evidenced by an agreement with the customer, transfer of title occurs, fixed pricing is determinable and collection is probable. Transfer of title typically occurs upon shipment of the equipment pursuant to a written purchase order or contract. The portion of the sales agreement related to the field services and training for commissioning of a desalination plant is deferred per guidance of Emerging Issues Task Force ("EITF") No. 00-21, *Revenue Arrangements with Multiple Deliverables*, by applying the residual value method. Under this method, revenue allocated to undelivered elements is based on vendor-specific objective evidence of fair value of such undelivered elements, and the residual revenue is allocated to the delivered elements. Vendor specific objective evidence of fair value for such undelivered elements is based upon the price we charge for such product or

service when it is sold separately. The Company may modify its pricing in the future, which could result in changes to our vendor specific objective evidence of fair value for such undelivered elements. The services element of our contracts represents an incidental portion of the total contract price.

Under the Company's revenue recognition policy, evidence of an arrangement has been met when it has an executed purchase order or a stand-alone contract. Typically, our smaller projects utilize purchase orders that conform to our standard terms and conditions that require the customer to remit payment generally within 30 to 90 days from product delivery. In some cases, if credit worthiness cannot be determined, prepayment is required from the smaller customers.

For our large projects, stand-alone contracts are utilized. For these contracts, consistent with industry practice, the customers typically require their suppliers, including the Company, to accept contractual holdback provisions whereby the final amounts due under the sales contract are remitted over extended periods of time. These retention payments typically range between 10% and 20%, and in some instances up to 30%, of the total contract amount and are due and payable when the customer is satisfied that certain specified product performance criteria have been met upon commissioning of the desalinization plant, which in the case of the Company's PX device may be 12 months to 24 months from the date of product delivery as described further below.

The specified product performance criteria for the Company's PX device generally pertains to the ability of the Company's product to meet its published performance specifications and warranty provisions, which the Company's products have demonstrated on a consistent basis. This factor, combined with the Company's historical performance metrics measured over the past 10 years, provides management with a reasonable basis to conclude that its PX device will perform satisfactorily upon commissioning of the plant. To ensure this successful product performance, the Company provides service, consisting principally of supervision of customer personnel, and training to the customers during the commissioning of the plant. The installation of the PX device is relatively simple, requires no customization and is performed by the customer under the supervision of Company personnel. The Company defers the fair value of the service and training component of the contract and recognizes such revenue as services are rendered. Based on these factors, management has concluded that delivery and performance have been completed when the product has been delivered (title transfers) to the customer.

The Company performs an evaluation of credit worthiness on an individual contract basis, to assess whether collectibility is reasonably assured. As part of this evaluation, management considers many factors about the individual customer, including the underlying financial strength of the customer and/or partnership consortium and management's prior history or industry specific knowledge about the customer and its supplier relationships. To date, the Company has been able to conclude that collectibility was reasonably assured on its sales contracts at the time the product was delivered and title has transferred; however, to the extent that management concludes that it is unable to determine that collectibility is reasonably assured at the time of product delivery, the Company will defer all or a portion of the contract amount based on the specific facts and circumstances of the contract and the customer.

Under the stand-alone contracts, the usual payment arrangements are summarized as follows:

- an advance payment, typically 10% to 20% of the total contract amount, is due upon execution of the contract;
- a payment upon delivery of the product, typically in the range of 50% to 70% of the total contract amount, is due on average between 120 and 150 days from product delivery, and in some cases up to 180 days; and
- a retention payment, typically in the range of 10% to 20%, and in some cases up to 30%, of the total contract amount is due subsequent to product delivery as described further below.

Under the terms of the retention payment component, the Company is generally required to issue to the customer a product performance guarantee that takes the form of a collateralized letter of credit, which is issued to the customer approximately 12 to 24 months after the product delivery date. The letter of credit is collateralized by restricted cash on deposit with the Company's financial institution (See Restricted Cash under Summary of Significant Accounting Policies). The letter of credit remains in place for the performance period as specified in the contract, which is generally 24 months and which runs concurrent with the Company's standard product warranty period. Once the letter of credit has been put in place, the Company invoices the customer for this final retention payment under the sales contract. During the time between the product delivery and the issuance of the letter of credit, the amount of the final retention payment is classified on the balance sheet as unbilled receivable, of which a portion may be classified as long term to the extent that the billable period extends beyond one year. Once the letter of credit is issued, the Company invoices the customer and reclassifies the retention

amount from unbilled receivable to accounts receivable where it remains until payment, typically 120 to 150 days after invoicing. (See Note 3 — Balance Sheet Information: Unbilled Receivables).

The Company does not provide its customers with a right of product return. However, the Company will accept returns of products that are deemed to be damaged or defective when delivered that are covered by the terms and conditions of the product warranty. Product returns have not been significant. Reserves are established for possible product returns related to the advance replacement of products pending the determination of a warranty claim.

Shipping and handling charges billed to customers are included in sales. The cost of shipping to customers is included in cost of revenue.

The Company sells its product to resellers and engineering, procurement and construction ("EPC") companies which are not subject to sales tax. Accordingly, the adoption of EITF Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation)*, does not have an impact on the Company's consolidated financial statements.

Warranty Costs

The Company sells products with a limited warranty for a period of one to two years. In August 2007, the Company modified the warranty to offer a five-year term on the ceramic components for new sales agreements executed after August 7, 2007. The Company accrues for warranty costs based on estimated product failure rates, historical activity and expectations of future costs. The Company periodically evaluates and adjusts the warranty costs to the extent actual warranty costs vary from the original estimates.

The Company may offer extended warranties on an exception basis and these are accounted for in accordance with Financial Accounting Standards Board ("FASB") Technical Bulletin 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts for Sales of Extended Warranties*.

Income Taxes

The Company accounts for income taxes in accordance with SFAS No. 109, "*Accounting for Income Taxes*" ("SFAS 109"), issued by FASB. SFAS 109 requires an entity to recognize deferred tax liabilities and assets. Deferred tax assets and liabilities are recognized for the future tax consequence attributable to the difference between the tax bases of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are measured using the enacted tax rate expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that included the enactment date. Valuation allowances are provided if, based upon the available evidence, management believes it is more likely than not that some or all of the deferred assets will not be realized or the use of prior years' net operating losses may be limited.

On July 13, 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in any entity's financial statements in accordance with SFAS 109 and prescribes a recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Under FIN 48, the impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more likely than not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Additionally, FIN 48 provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company adopted the provisions of FIN 48 on January 1, 2007. Measurement under FIN 48 is based on judgment regarding the largest amount that is greater than 50% likely of being realized upon ultimate settlement with a taxing authority. The total amount of unrecognized tax benefits as of the date of adoption was immaterial. As a result of the implementation of FIN 48, the Company recognized no increase in the liability for unrecognized tax benefits.

The Company adopted the accounting policy that interest recognized in accordance with Paragraph 15 of FIN 48 and penalty recognized in accordance with Paragraph 16 of FIN 48 are classified as part of its income taxes. The amounts of interest and penalty recognized in the statement of operations and statement of financial position for the year ended December 31, 2007 were insignificant.

The Company's operations are subject to income and transaction taxes in the U.S. and in foreign jurisdictions. Significant estimates and judgments are required in determining the Company's worldwide provision for income taxes. Some of these estimates are based on interpretations of existing tax laws or regulations. The ultimate amount of tax liability may be uncertain as a result.

The Company is subject to taxation in the U.S. and various states and foreign jurisdictions. There are no ongoing examinations by taxing authorities at this time. The Company's various tax years from 1997 to 2007 remain open in various taxing jurisdictions.

Stock-Based Compensation—Employees

Prior to January 1, 2006, the Company accounted for stock-based compensation to employees and members of the Company's board of directors under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB 25"), and related interpretations. Under APB 25, compensation expense for stock-based payment awards is based on the difference, if any, on the date of the grant, between the value of the Company's stock and the exercise price and is recognized over the vesting period of the awards. Accordingly, prior to January 1, 2006, no stock-based compensation expense was recognized in the Company's statements of operations for stock options granted to employees and directors that had an exercise price equal to the value of the Company's stock on the date of grant. The Company also followed the disclosure requirements of SFAS No. 123, *Accounting for Stock-Based Compensation*, amended by SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure* and used the minimum value method for pro-forma disclosures based on the disclosure provisions that was available for non–public companies.

On January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment* ("SFAS 123R"), which requires the measurement and recognition of compensation expense in the statement of operations for all awards made to employees and members of the Company's Board of Directors on estimated fair values. SFAS 123R supersedes the Company's previous accounting under APB 25.

Under the provisions of SFAS 123R, share-based compensation expense is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the employee's requisite service period, generally the vesting period of the awards. Under SFAS 123R, non-public companies that used the minimum value method under disclosure provisions of SFAS 148 shall apply the provisions of SFAS 123R prospectively to new and/or modified awards at the adoption date, and shall continue to account for any portion of awards outstanding at the adoption date, using the accounting principles originally applied to those awards. Accordingly, for awards granted prior to January 1, 2006 for which the requisite service period had not been performed as of December 31, 2005, the Company continued to recognize compensation expense on the remaining unvested awards under the intrinsic-value method of APB 25. In accordance with the requirements of SFAS 123R for non-public companies, the Company has not provided pro-forma disclosures for the year ended December 31, 2005 since the Company used the minimum value method for pro-forma disclosures for awards granted prior to January 1, 2006. For all awards granted or modified after December 31, 2005, the Company began recognizing compensation expense of the fair value, less expected forfeitures, on a straight-line basis over the vesting period.

To determine the inputs for the Black-Scholes options pricing model, the Company is required to develop several assumptions, which are highly subjective. These assumptions include:

- the length of its options' lives, which is based on anticipated future exercises;
- its common stock's volatility;
- the number of shares of common stock pursuant to which options which will ultimately be forfeited;
- the risk-free rate of return; and
- future dividends.

The Company uses the Black-Scholes options pricing model to determine the fair value of stock options. The determination of the fair value of stock-based payment awards on the date of grant is affected by stock price as well as assumptions regarding a number of complex and subjective variables. These variables include expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rates and

ENERGY RECOVERY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

expected dividends. The estimated grant date fair values of the employee stock options were calculated using the Black-Scholes options pricing model, based on the following assumptions:

	Years Ended December 31,	
	2007	2006
Expected term	5 years	5 years
Expected volatility	50%	50%
Risk-free interest rate	3.45%	4.70%
Dividend yield	0%	0%

Expected Term. Under the Company's option plans, the expected term of options granted is determined using the weighted average period during which the stock options are expected to remain outstanding and is based on the options vesting term, contractual terms and disclosure information from similar publicly traded companies to develop reasonable expectations about future exercise patterns and post-vesting employment termination behavior.

Expected Volatility. Since the Company has been a private entity through 2007 with no historical data regarding the volatility of its common stock price, the expected volatility used is based on volatility of a representative industry peer group. In evaluating similarity, the Company considered factors such as industry, stage of life cycle and size.

Risk-Free Interest Rate. The risk-free rate is based on U.S. Treasury issues with remaining terms similar to the expected term on the options.

Dividend Yield. The Company has never declared or paid any cash dividends and does not plan to pay cash dividends in the foreseeable future, and, therefore, used an expected dividend yield of zero in the valuation model.

Forfeitures. SFAS No. 123R also requires the Company to estimate forfeitures at the time of grant, and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. The Company uses historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. All stock-based payment awards are amortized on a straight-line basis over the requisite service periods of the awards, which are generally the vesting periods. If the Company's actual forfeiture rate is materially different from its estimate, the stock-based compensation expense could be significantly different from what the Company has recorded in the current period.

The absence of an active market for its common stock also requires management and board of directors to estimate the fair value of its common stock for purposes of granting options and for determining stock-based compensation expense. In response to these requirements, management and the board of directors estimate the fair market value common stock based on factors such as the price of the most recent common stock sales to investors, the valuations of comparable companies, the status of its development and sales efforts, our cash and working capital amounts, revenue growth, and additional objective and subjective factors relating to its business on an annual basis.

Stock-based compensation expense related to awards granted and or modified to employees was allocated as follows (in thousands):

	Years Ended December 31,		
	2007	2006	2005
Cost of revenue	$ 117	$ 143	$ 88
Sales and marketing	349	310	86
General and administrative	383	425	731
Research and development	159	183	98
	$ 1,008	$ 1,061	$ 1,003

To calculate the excess tax benefits available as of the date of adoption for use in offsetting future tax shortfalls, the Company elected the "short-form" method in accordance with FASB Staff Position FAS No. 123R-3, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards.*

Stock-Based Compensation—Non-Employees

The Company accounts for awards granted to non-employees other than members of the Company's board of directors in accordance with SFAS 123 and the EITF Abstract No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services,* which require such awards to be recorded at their fair value on the measurement date. The measurement of stock-based compensation is subject to periodic adjustment as the underlying awards vest. The Company amortizes compensation expense related to non-employee awards in accordance with FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans.*

Stock-based compensation expense related to awards granted and/or modified to non-employees was allocated as follows (in thousands):

	Years Ended December 31,		
	2007	2006	2005
Sales and marketing	$ 23	$ —	$ —
General and administrative	5	3	—
	$ 28	$ 3	$ —

See Note 9—Stockholders' Equity for additional information.

Foreign Currency

The Company's reporting currency is the U.S. dollar, while the functional currencies of the Company's foreign subsidiaries are their respective local currencies. The asset and liability accounts of the Company's foreign subsidiaries are translated from their local currencies at the rates in effect at the balance sheet date. Revenue and expenses are translated at average rates of exchange prevailing during the period. Translation adjustments are accumulated and reported as a component of stockholders' equity. Foreign currency transaction gains and losses which result from transactions with customers that are denominated in a currency other than the entity's functional currency are recorded in other income and expense in the consolidated statements of operations.

Advertising Expense

Advertising expense is charged to operations in the year in which it is incurred. Total advertising expense amounted to $118,000, $68,000 and $35,000 for the years ended December 31, 2007, 2006 and 2005, respectively.

Comprehensive Income

In accordance with SFAS No. 130, *Reporting Comprehensive Income*, the Company is required to display comprehensive income and its components as part of the Company's full set of consolidated financial statements. Comprehensive income is composed of net income and other comprehensive income, including currency translation adjustments.

Fair Value of Financial Instruments

The carrying amount of cash and cash equivalents, restricted cash, accounts receivable, accounts payable and accrued liabilities are reasonable estimates of their fair value because of the short maturity of these items.

The carrying amount of long-term debt reasonably approximates its fair value as the majority of the borrowings are at interest rates that fluctuate with current market conditions.

The Company has determined that it is not practicable to estimate the fair value of its non-current unbilled receivables as there is no ready market for such instruments. See Note 3 — Balance Sheet Information: Unbilled Receivables for additional information.

Earnings Per Share

In accordance with SFAS No. 128, *Earnings per Share*, the following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share data):

	Years Ended December 31,		
	2007	2006	2005
Numerator:			
Net income	$ 5,793	$ 2,382	$ 894
Denominator:			
Weighted average common shares outstanding	39,060	38,018	36,790
Effect of dilutive securities:			
Nonvested shares	4	—	155
Stock options	438	318	245
Warrants	1,931	1,908	1,264
Total shares for purpose of calculating diluted net income per share	41,433	40,244	38,454
Earnings per share:			
Basic	$ 0.15	$ 0.06	$ 0.02
Diluted	$ 0.14	$ 0.06	$ 0.02

The following potential common shares were excluded from the computation of diluted net income per share because their effect would have been anti-dilutive:

	Years Ended December 31,		
	2007	2006	2005
Nonvested shares	78	481	—
Stock options	283	38	—

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (“SFAS 157”). SFAS 157 defines fair value, establishes a framework for measuring fair value, and enhances fair value measurement disclosure. In February 2008, the FASB issued FASB Staff Position 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13 (“FSP 157-1”) and FSP 157-2, Effective Date of FASB Statement No. 157. FSP 157-1 amends SFAS 157 to remove certain leasing transactions from its scope. FSP 157-2 delays the effective date of SFAS 157 for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the first quarter of 2009. The measurement and disclosure requirements related to financial assets and financial liabilities are effective for the Company beginning in the first quarter of 2008. The adoption of SFAS 157 for financial assets and financial liabilities will not have a significant impact on the Company’s consolidated financial statements. However, the resulting fair values calculated under SFAS 157 after adoption may be different from the fair values that would have been calculated under previous guidance. The Company is currently evaluating the impact that SFAS 157 will have on its consolidated financial statements when it is applied to non-financial assets and non-financial liabilities beginning in the first quarter of 2009.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (“SFAS 159”). SFAS 159 permits companies to choose to measure certain financial instruments and other items at fair value. The standard requires that unrealized gains and losses are reported in earnings for items measured using the fair

value option. SFAS 159 is effective for the Company beginning in the first quarter of 2008. The adoption of SFAS 159 is not expected to have a significant impact on the Company's consolidated financial statements.

In June 2007, the FASB ratified EITF Issue No. 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities* ("EITF 07-3"). EITF 07-3 requires non-refundable advance payments for goods and services to be used in future research and development ("R&D") activities to be recorded as assets and the payments to be expensed when the R&D activities are performed. EITF 07-3 applies prospectively to new contractual arrangements entered into beginning in the first quarter of 2008. Prior to adoption, the Company recognized these non-refundable advance payments as an expense upon payment. The adoption of EITF 07-3 is not expected to have a significant impact on the Company's consolidated financial statements.

In December 2007, the U.S. Securities and Exchange Commission ("SEC") issued SAB 110 to amend the SEC's views discussed in SAB 107 regarding the use of the simplified method in developing an estimate of expected life of share options in accordance with SFAS 123R. SAB 110 is effective for the Company beginning in the first quarter of 2008. As of December 31, 2007, the Company did not use the simplified method and the adoption of SAB 107, as amended by SAB 110, is not expected to have a significant impact on the Company's consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* ("FAS 141(R)"). FAS 141(R) will change how business acquisitions are accounted for. FAS 141(R) is effective for fiscal years beginning on or after December 15, 2008. The adoption of FAS 141(R) is not expected to have a material impact on the Company's consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of Accounting Research Bulletin No. 51*. SFAS No. 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest, and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS No. 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008. The adoption of FAS 141(R) is not expected to have a material impact on the Company's consolidated financial statements.

3. Balance Sheet Information

Accounts Receivable:

Accounts receivable consisted of the following (in thousands):

	Years Ended December 31,	
	2007	2006
Accounts receivable	$ 13,252	$ 5,876
Less: allowance for doubtful accounts	(121)	(230)
	$ 13,131	$ 5,646

Unbilled Receivables

The Company has unbilled receivables pertaining to customer contractual holdback provisions, whereby the Company invoices the final retention payment(s) due under its sales contracts in periods generally ranging from 12 to 24 months after the product has been shipped to the customer and revenue has been recognized.

Long-term unbilled receivables as of December 31, 2007 and 2006 consisted of unbilled receivables from customers due more than one year subsequent to period end. The customer holdbacks represent amounts intended to provide a form of

security for the customer rather than a form of long-term financing; accordingly, these receivables have not been discounted to present value. At December 31, 2007, the expected payment schedule for these accounts was as follows (in thousands):

Years Ending December 31,	
2009	$ 2,023
2010	232
	$ 2,255

Inventories

Inventories consisted of the following (in thousands):

	Years Ended December 31, 2007	2006
Raw materials	$ 2,974	$ 1,051
Work in process	75	59
Finished goods	1,742	1,778
	$ 4,791	$ 2,888

Excess and obsolete reserves included in inventory at December 31, 2007 and 2006 were $102,000 and $55,000, respectively.

Property and Equipment

Property and equipment consisted of the following:

	Years Ended December 31, 2007	2006
Machinery and equipment	$ 2,209	$ 1,485
Office equipment, furniture, and fixtures	368	287
Automobiles	22	—
ERP software	166	158
Leasehold improvements	301	172
Construction in progress	169	215
	3,235	2,317
Less: accumulated depreciation and amortization	(1,564)	(1,261)
	$ 1,671	$ 1,056

Depreciation and amortization expense was approximately $304,000, $212,000 and $142,000 for the years ended December 31, 2007, 2006 and 2005, respectively. Included in these amounts was amortization expense related to equipment under capital leases of approximately $37,000, $39,000 and $18,000 for the years ended December 31, 2007, 2006 and 2005, respectively. The Company estimates the costs to complete construction in progress to be approximately 10% of the total costs incurred of $169,000 as of December 31, 2007.

Intangible Assets

Intangible assets consisted of the following (in thousands):

	Years Ended December 31,	
	2007	2006
Patents at cost	$ 573	$ 489
Less: accumulated amortization	(197)	(177)
Less: impairment reserve	(31)	—
Net carrying amount	$ 345	$ 312

Amortization of intangibles was approximately $19,000 for each of the years ended December 31, 2007, 2006 and 2005.

Future estimated amortization expense on intangible assets is as follows (in thousands):

Years Ending December 31,	
2008	$ 26
2009	25
2010	25
2011	25
2012	25
Thereafter	219
	$ 345

The weighted average remaining life at December 31, 2007 is 14.6 years.

Accrued Expenses and Other Current Liabilities

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

	Years Ended December 31,	
	2007	2006
Accrued payroll and commission expenses	$ 1,014	$ 1,359
Checks issued against future deposits	—	129
Inventory in transit	393	—
Professional fees	180	40
Other accrued expenses and current liabilities	281	188
	$ 1,868	$ 1,716

4. Long-Term Debt

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

	Years Ended December 31,	
	2007	2006
Revolving note payable	$ —	$ 438
Promissory notes payable	729	177
Other notes payable	—	11
	729	626
Less: current portion	(172)	(493)
Long-term debt	$ 557	$ 133

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

Years Ending December 31,	
2008	$ 172
2009	172
2010	172
2011	128
2012	85
	$ 729

Revolving Notes Payable and Promissory Note Payable

On December 1, 2005, the Company entered into an agreement with a financial institution for a $2.0 million revolving note ("revolving note") and a $222,000 fixed rate-installment note ("fixed promissory note") with maturity dates of December 1, 2006, subsequently extended to March 1, 2007 and December 15, 2010, respectively. The revolving note bears interest of base rate or LIBOR-based rate as elected by the Company. The interest rate was amended on April 26, 2006 to modify the definition of base rate and increase the rate to base rate plus 1% or LIBOR plus 2.5%. The fixed promissory note bears an annual interest rate of 10%. These notes are secured by the Company's accounts receivable, inventories, property, equipment and other general intangibles except for intellectual property.

On April 26, 2006, the Company entered into a loan and security agreement ("loan and security agreement") with the financial institution for an additional $2.0 million credit facility ("credit facility") with a maturity date of December 1, 2006, subsequently extended to March 1, 2007. The credit facility advances bear interest rates of base rate plus 1% or LIBOR plus 2.5%. The credit facility is secured by the Company's cash and cash equivalents, accounts receivable, inventory, property and other general intangibles except for intellectual property.

On December 7, 2006, the revolving note was amended to increase the face amount of the note to $3.5 million.

On March 1, 2007, the Company renewed the revolving note and the loan and security agreement ("the first modification") to a maturity date of March 31, 2008. Additional amended terms under the first modification were an interest rate change to base rate or LIBOR plus 2.5%, limitation of advances to a borrowing base, and various reporting requirements and satisfaction of certain financial ratios and covenants by the Company.

On March 28, 2007, the Company modified the loan and security agreement ("the second modification") to add a $1.0 million equipment promissory note ("equipment promissory note"). The equipment promissory note bears an interest rate of cost of funds plus 3% and matures September 30, 2012. Additional amended terms under the second modification were changes to the financial ratios and covenants that were to be maintained by the Company.

As of December 31, 2006, borrowings outstanding on the revolving note and the fixed promissory note were $438,000 and $177,000, respectively. There were no borrowings under the credit facility. The interest rate for the revolving note elected by the Company was the base rate at 9.25%. The Company was in compliance with all covenants under the loan and security agreement.

As of December 31, 2007 there were no borrowings under the revolving note and the credit facility. The amounts outstanding on the fixed promissory note and the equipment promissory note were $133,000 and $596,000, respectively at December 31, 2007. The interest rate for the equipment promissory note at December 31, 2007 was 7.81%. The Company was in compliance with all covenants under the loan and security agreement.

On March 27, 2008 the Company entered into a new credit agreement with its existing financial institution that replaces the $2.0 million credit facility and the $3.5 million revolving note. The new credit facility allows borrowings of up to $9.0 million on a revolving basis at LIBOR plus 2.75%. This new credit facility expires on September 30, 2008 and is secured by the Company's accounts receivable, inventories, property, equipment and other intangibles except intellectual property.

During the years presented, the Company provided certain customers with irrevocable standby letters of credit to secure its obligations for the delivery of products in accordance with sales arrangements. These letters of credit were issued under the Company's revolving note credit facility and generally terminate within eight months from issuance. At December 31, 2007 the amounts outstanding on the letters of credit totaled approximately $2.2 million.

Other Note Payable

The other note payable as of December 31, 2006 consisted of one obligation with an insurance corporation for financing of property and casualty insurance and bears a fixed interest rate of 9.19%.

5. Capital Leases

The Company leases certain equipment under agreements classified as capital leases. The terms of the lease agreements generally range up to five years. As of December 31, 2007, costs and accumulated amortization of equipment under capital leases were $193,000 and $92,000, respectively. As of December 31, 2006 costs and accumulated amortization of equipment under capital leases were $215,000, and $76,000, respectively.

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

Years Ending December 31,	
2008	$ 50
2009	43
2010	27
Total future minimum lease payments	120
Less: amount representing interest	(19)
Present value of net minimum capital lease payments	101
Less: current portion	(38)
Long-term portion	$ 63

ENERGY RECOVERY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

6. Income Taxes

The components of the provision for income taxes consist of the following (in thousands):

	Years Ended December 31,		
	2007	2006	2005
Current tax expense:			
Federal	$ 3,466	$ 1,654	$ —
State	806	442	62
Foreign	16	2	—
	$ 4,288	$ 2,098	$ 62
Deferred tax (benefit) expense:			
Federal	(327)	(775)	—
State	(14)	(84)	—
	$ (341)	$ (859)	$ —
Total provision for income taxes	$ 3,947	$ 1,239	$ 62

A reconciliation of income taxes computed at the statutory federal income tax rate to the provision for income taxes included in the accompanying statements of operations is as follows (in thousands, except percentages):

	Years Ended December 31,		
	2007	2006	2005
U.S. federal taxes at statutory rate	35%	34%	34%
State income taxes, net of federal benefit	5	5	4
Stock-based compensation	3	11	36
Valuation allowance	—	(13)	(73)
Disallowed interest	—	—	5
Extraterritorial income exclusion	—	(3)	—
Other	(1)	(1)	1
Effective tax rate	42%	33%	7%

ENERGY RECOVERY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Total deferred tax assets and liabilities consist of the following (in thousands):

	Years Ended December 31, 2007	2006
Deferred tax assets:		
Net operating loss carry forwards	$ 220	$ 232
Accruals and reserves	1,210	664
Tax credit carry forwards	–	9
Net deferred tax assets	$ 1,430	$ 905
Deferred tax liabilities:		
Depreciation on property and equipment	$ (90)	$ (46)
Unrecognized gain on translation of foreign currency receivables	(140)	–
Total deferred tax liabilities	$ (230)	$ (46)
Net deferred tax assets (liabilities)	$ 1,200	$ 859
As reported on the balance sheet:		
Current assets, net	$ 1,052	$ 676
Non-current assets, net	148	183
Net deferred tax assets	$ 1,200	$ 859

The Company had net deferred tax assets of approximately $1.2 million and $859,000 at December 31, 2007 and 2006, respectively, relating principally to accrued expenses and tax effects of net operating loss carry-forwards. In assessing the recoverability of deferred tax assets, management considers whether it is more likely than not that the assets will be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible.

Management considers, among other things, projected future taxable income in making this assessment. Based upon the projections for future taxable income over the periods in which the deferred tax items are recognizable for tax reporting purposes, management has determined it is more likely than not that the Company will realize the benefits of these differences at December 31, 2007 and 2006.

At December 31, 2007 and 2006, the Company had net operating loss carry-forwards of approximately $588,000 and $630,000, respectively, for federal and $252,000 and $294,000, respectively, for California. The net operating loss carry-forwards, if not utilized, will expire in 2021 for federal and 2013 for California purposes. Utilization of the net operating loss carry-forwards is subject to a substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code and similar state provisions. The annual limitation will result in the expiration of the net operating loss carry-forwards before utilization. Management has estimated the amount which may ultimately be realized and recorded deferred tax assets accordingly.

The Company adopted the provisions of FIN 48 on January 1, 2007. Measurement under FIN 48 is based on judgment regarding the largest amount that is greater than 50% likely of being realized upon ultimate settlement with a taxing authority. The total amount of unrecognized tax benefits as of the date of adoption was immaterial. As a result of the implementation of FIN 48, the Company recognized no increase in the liability for unrecognized tax benefits.

The Company adopted the accounting policy that interest recognized in accordance with Paragraph 15 of FIN 48 and penalty recognized in accordance with Paragraph 16 of FIN 48 are classified as part of its income taxes. The amounts of

interest and penalty recognized in the statement of operations and statement of financial position for the year ended December 31, 2007 were insignificant.

7. Commitments and Contingencies

Lease Obligations

The Company leases facilities under fixed non-cancelable operating leases that expire on various dates through June 2010. Future minimum lease payments consist of the following (in thousands):

Years Ending December 31,		
2008	$	411
2009		316
2010		135
	$	862

Total rent and lease expense was $462,000, $287,000 and $155,000 for the years ended December 31, 2007, 2006 and 2005, respectively.

Warranty

Changes in the Company's accrued warranty reserve and the expenses incurred under its warranties were as follows (in thousands):

	Years Ended December 31,	
	2007	2006
Balance, beginning of period	$ 85	$ 110
Warranty costs charged to cost of revenue, including extended warranty costs	850	61
Utilization of warranty	(67)	(86)
Balance, end of period	$ 868	$ 85

Warranty costs during 2007 included costs attributable to extended service contracts, for which the Company had recognized in 2007 estimated service costs to the extent that such costs were expected to exceed the related service revenue.

Purchase Obligations

The Company did not have any non-cancelable contractual purchase obligations with its vendors at December 31, 2007.

The Company had purchase order arrangements with its vendors for which it had not received the related goods or services at December 31, 2007. These arrangements are subject to change based on the Company's sales demand forecasts and the Company has the right to cancel the arrangements prior to the date of delivery. The majority of these purchase order arrangements were related to various key raw materials and components parts. As of December 31, 2007, the Company had approximately $8.1 million of open purchase order arrangements.

Guarantees

The Company enters into indemnification provisions under its agreements with other companies in the ordinary course of business, typically with customers. Under these provisions the Company generally indemnifies and holds harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of the Company's activities, generally limited to personal injury and property damage caused by 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 the Company's general liability insurance to the extent provided by the policy limitations. The Company has not

incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the estimated fair value of these agreements is not material. Accordingly, the Company has no liabilities recorded for these agreements as of December 31, 2007 and 2006.

In certain cases, the Company issues product performance guarantees to its customers for amounts ranging from 10% to 30% of the total sales agreement to endorse the warranty of design work, fabrication and operating performance of the PX device. These guarantees are issued under the Company's credit facility and collateralized by restricted cash (see Note 2). These guarantees typically remain in place for periods ranging from 24 to 36 months, which relates to the underlying product warranty period.

Employee Agreements

The Company has employment agreements with certain executives covering terms of up to 30 months which provide for, among other things, annual base salary.

Litigation

The Company is not party to any material litigation, and the Company is not aware of any pending or threatened litigation against it that the Company believes would adversely affect its business, operating results, financial condition or cash flows. However, in the future, the Company may be subject to legal proceedings in the ordinary course of business.

8. Defined Contribution Plan

The Company has a 401(k) defined contribution plan for all employees over age 18. Generally, employees can defer up to 20% of their compensation through payroll withholdings into the plan. The Company can make discretionary matching contributions. The Company made contributions of $100,000, $68,000 and $45,000 during the years ended December 31, 2007, 2006 and 2005, respectively.

9. Stockholders' Equity

Preferred Stock

The Company has the authority to issue 10,000,000 shares of $0.001 par value preferred stock. The Company's board of directors has the authority, without action by the Company's stockholders, to designate and issue shares of preferred stock in one or more series. The board of directors is also authorized to designate the rights, preferences, and voting powers of each series of preferred stock, any or all of which may be greater than the rights of the common stock including restrictions of dividends on the common stock, dilution of the voting power of the common stock, reduction of the liquidation rights of the common stock, and delaying or preventing a change in control of the Company without further action by the stockholders. To date, the board of directors has not designated any rights, preference or powers of any preferred stock and as of December 31, 2007 and 2006, none was issued or outstanding.

Common Stock

The Company has the authority to issue 45,000,000 shares of $0.001 par value common stock. Subject to the preferred rights of the holders of shares of any class or series of preferred stock as provided by the board of directors with respect to any such class or series of preferred stock, the holders of the common stock shall be entitled to receive dividends, as and when declared by the board of directors. In the event of any liquidation, dissolution or winding up of the Company, whether voluntary or involuntary, after the distribution or payment to the holders of shares of any class or series of preferred stock as provided by the Board of Directors with respect to any such class or series of preferred stock, the remaining assets of the Company available for distribution to stockholder shall be distributed among and paid to the holders of common stock ratably in proportion to the number of shares of common stock held by them respectively. As of December 31, 2007 and 2006, 39,777,446 and 38,222,493 shares were issued and outstanding, respectively.

Private Placement

In June 2007, the Company issued 1,000,000 shares of common stock with an issuance price of $5.00 per share. Net proceeds from the issuance were $5.0 million, less $41,000 in fees.

Stock Option Plans

In April 2001, the Company adopted the 2001 Stock Option Plan under which 2,500,000 shares of the Company's common stock were reserved for issuance to employees, directors and consultants. In April 2002, the Company adopted the 2002 Stock Option/Stock Issuance Plan under which 1,509,375 shares of the Company's common stock were reserved for issuance to employees, directors and consultants. In January 2004, the Company adopted the 2004 Stock Option/Stock Issuance Plan under which 850,000 shares of the Company's common stock were reserved for issuance to employees, directors and consultants. In May 2006, the Company adopted the 2006 Stock Option/Stock Issuance Plan under which 800,000 shares of the Company's common stock were reserved for issuance to employees, directors and consultants.

The option plans provide for the issuance of common stock and the granting of incentive stock options to employees, officers and directors and the granting of non-statutory stock options to employees, officers and directors or consultants of the Company. The Company may grant incentive stock options with exercise prices of not less than the estimated fair value of the stock on the date of grant (85% of the estimated fair value for non-statutory stock options). If, at the time the Company grants an option, the optionee directly owns stock possessing more than 10% of the total combined voting power of all classes of stock of the Company, the option price must be at least 110% of the estimated fair value and are not exercisable more than five years after the date of grant. Options granted under the plans vest at varying rates determined on an individual basis by the Board of Directors, generally over four years. Options generally expire no more than ten years after the date of grant or earlier if employment is terminated.

Options may be exercised prior to vesting, with the underlying shares subject to the Company's right of repurchase, which lapses over the vesting term. At December 31, 2007, 2006 and 2005, 56,879 shares, 279,799 shares and 728,134 shares, respectively, of common stock were outstanding subject to the Company's right of repurchase at prices ranging from $0.20 to $1.00 per share. As of December 31, 2007, 2006 and 2005, the outstanding balances of the full recourse promissory notes were $20,000, $111,000 and $243,000, respectively, as described below. As a result, the promissory notes related to the exercise of the unvested shares and the corresponding aggregate exercise price for these shares have been recorded as notes receivable from stockholders and liability for early exercise of stock options in the accompanying consolidated balance sheet, and are transferred into common stock and additional paid-in capital as the shares vest.

Early Exercise of Employee Options

In accordance with EITF Issue No. 23, Issues Related to the Accounting for Stock Compensation under APB 25 and FIN 44, shares purchased by employees pursuant to the early exercise of stock options are not deemed to be issued until all restrictions on such shares lapse (i.e., the employee is vested in the award). Therefore, consideration received in exchange for exercised and restricted shares related to the early exercise of stock options is recorded as a liability for early exercise of stock options in the accompanying consolidated balance sheets and will be transferred into common stock and additional paid-in capital as the restrictions on such shares lapse.

In February 2005, options to purchase 4,293,958 shares of common stock were exercised by the signing of full recourse promissory notes totaling $948,000. The notes bear interest at 3.76% and are due in February 2010. The interest rate on the notes was deemed to be a below market rate of interest resulting in a deemed modification in exercise price of the options. As a result, the Company is accounting for these options as variable option awards until the employee is vested in the award. Of the $948,000 of promissory notes, notes in an aggregate amount of $552,000 were issued by executive officers and directors. Subsequent to December 31, 2007, these notes were paid in full, including principal and interest, for a total of $606,000. As of December 31, 2006, there were 279,799 shares outstanding as a result of the early exercise of options that were classified as $111,000 in current liabilities. As of December 31, 2007, there were 56,879 shares outstanding as a result of the early exercise of options that were classified as $20,000 in current liabilities. For the years ended December 31, 2007, 2006 and 2005, the Company recorded $783,000, $1.1 million and $1.0 million, respectively, of stock-based compensation related to the options exercised with promissory notes.

As of December 31, 2005, the Company had outstanding 556,042 options that were accounted for using the intrinsic method consistent with APB 25 (FIN 44) whereby there was no stock compensation expense recognized as all of the options were issued at fair market value. For the years ended December 31, 2007 and 2006, the Company adopted SFAS 123R and recognized stock-based compensation of $251,000 and $13,000, respectively.

ENERGY RECOVERY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following table summarizes the stock option activity for the years ended December 31, 2007, 2006 and 2005 under the Company's stock option plans:

	Options Outstanding			
	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in thousands)(3)
Balance 12/31/04	**4,300,000**	**$ 0.25**	—	—
Granted	726,042	$ 0.82	—	—
Exercised(1)	(4,293,958)	$ 0.25	—	—
Forfeited	(176,042)	$ 0.34	—	—
Balance 12/31/05	**556,042**	**$ 1.00**	**9.8**	—
Granted	642,000	$ 2.65	—	—
Exercised	(5,000)	$ 1.00	—	—
Forfeited	(25,730)	$ 1.00	—	—
Balance 12/31/06	**1,167,312**	**$ 1.91**	**9.4**	—
Granted	181,900	$ 5.00	—	—
Exercised	(17,083)	$ 1.00	—	—
Forfeited	(51,521)	$ 1.32	—	—
Balance 12/31/07	**1,280,608**	**$ 2.38**	**8.6**	**$ 3,355**
Vested and exercisable as of December 31, 2007	**416,140**	**$ 1.63**	**8.2**	**$ 1,404**
Vested and exercisable as of December 31, 2007 and expected to vest thereafter(2)	**305,000**	**$ 1.71**	**8.3**	**$ 1,005**

(1) These include 1,330,943 options with an average exercise price of $0.31 that were unvested as of the exercise date.
(2) Options that are expected to vest are net of estimated future options forfeitures in accordance with the provisions of SFAS 123R.
(3) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying options and the estimated fair value of the Company's stock as of December 31, 2007.

Shares available for grant under the option plans at December 31, 2007 and 2006 were 53,351 and 133,730, respectively.

The per option fair value of options granted to employees during the years ended December 31, 2007 and 2006 was $2.41 and $1.30, respectively. The aggregate intrinsic value of options exercised during the years ended December 31, 2007, 2006 and 2005 was $62,000, $8,000 and $1.1 million, respectively. As of December 31, 2007, total unrecognized compensation cost, net of forfeitures, related to non-vested options was $902,000, which is expected to be recognized as expense over a weighted-average period of approximately 2.9 years.

The following table summarizes options outstanding after exercises and cancellations:

Range of Exercise Prices	Outstanding and Exercisable	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Vested and Exercisable	Weighted Average Exercise Price
$1.00	466,708	7.8	$ 1.00	258,140	$ 1.00
$2.65	632,000	8.9	$ 2.65	158,000	$ 2.65
$5.00	181,900	9.7	$ 5.00	—	$ 5.00
	1,280,608	8.6	$ 2.38	416,140	$ 1.63

The employee option plans allows for the immediate exercise of granted options, subject to the Company's right of repurchase which lapses over the vesting term.

Stock Based Compensation Before Adoption of SFAS 123R

The fair value of the common stock for options granted was estimated either by the Company's board of directors with input from management or by the stock prices in conjunction with private placements with third parties. The pro forma disclosures under SFAS 123 for the year ended December 31, 2005 have been omitted as the pro forma amounts do not differ materially from actual operating results reported.

Stock-Based Compensation After Adoption of SFAS 123R

On January 1, 2006, the Company adopted the fair value recognition provisions of SFAS 123R, using the prospective transition method. Under this transition method, beginning January 1, 2006, compensation cost recognized includes: (a) compensation cost for all stock-based awards granted prior to, but not yet vested as of December 31, 2005, based on the intrinsic value method and variable method in accordance with the provisions of APB 25, and (b) compensation cost for all stock-based payments granted or modified subsequent to December 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R.

Under SFAS 123R, compensation cost for employee stock-based awards is based on the estimated grant-date fair value and is recognized over the vesting period of the applicable award on a straight-line basis. In 2006, the Company issued employee stock-based awards in the form of stock options. See Note 2—Summary of Significant Accounting Policies.

Warrants

In July 2005, the Company issued warrants to purchase 400,000 shares (200,000 shares of which were forfeited subsequently) of the Company's common stock at $1.00 per share to a board member/stockholder of the Company. The warrant has a term of 10 years and was immediately exercisable. The warrant was issued in exchange for an irrevocable letter of credit issued by the warrant holder in July 2005 as collateral against the Company's line of credit with a bank. The Company valued the warrant at its estimated fair value upon issuance using the Black-Scholes options pricing model after taking into consideration the fact that the issuance of this warrant was directly related to the Company's debt borrowings for the second half of 2005. Since the fair value of services (issuance of irrevocable letter of credit) was difficult to assess, management determined that the more reliable measurement for this issuance was to use the fair value method to value the equity instrument issued with the following assumptions: expected volatility of 50%, an expected term of 10 years, a risk-free interest rate of 4.32% and no dividend yield. The resulting estimated fair value of the warrant of $132,000 was amortized to interest expense over the expected term of the credit facility, which expired in December 2005.

In November 2005, the Company issued warrants to purchase 150,000 shares of the Company's common stock at $1.00 per share to an executive of the Company. The warrant has a term of 10 years and was immediately exercisable. Because the warrant was issued in exchange for future services to the Company, the Company measured compensation using the intrinsic value method under ABP 25 and no stock-based compensation expense was recorded during the year since the exercise price of the warrant was equal to the estimated fair value of the Company's common stock at the time of issuance.

ENERGY RECOVERY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

During the year ended December 31, 2007, warrants to purchase 314,950 shares of common stock were exercised for cash and the proceeds received by the Company from these exercises were $143,000.

There were no warrant exercises during the year ended December 31, 2006.

During the year ended December 31, 2005, warrants to purchase 100,000 shares of common stock were exercised for cash and proceeds received by the Company from these exercises were $20,000.

In February 2005, warrants to purchase 315,974 shares of common stock were exercised by the signing of full recourse promissory notes totaling $63,000. The notes bear interest at 3.76% and are due February 2010. As of December 31, 2007, $43,000 of the notes had been repaid and the balance was repaid in March 2008.

A summary of the Company's warrant activity for the years ended (in thousands, except exercise prices and contractual life data):

	Years Ended December 31,		
	2007	2006	2005
Outstanding, beginning of year	2,389	2,589	2,455
Exercised during the year	(315)	—	(416)
Cancelled during the year	—	(200)	—
Issued during the year	—	—	550
Outstanding, end of year	2,074	2,389	2,589
Weighted average exercise price of warrants outstanding at end of year	$ 0.52	$ 0.52	$ 0.56
Weighted average remaining contractual life, in years, of warrants outstanding at end of year	5.7	6.7	8.1

10. Business Segment and Geographic Information

The Company manufactures and sells high efficiency energy recovery products and related services and operates under one segment. The Company's chief operating decision maker is the chief executive officer ("CEO"). The CEO reviews financial information presented on a consolidated basis, accompanied by desegregated information about revenue by geographic region for purposes of making operating decisions and assessing financial performance. Accordingly, the Company has concluded that it has one reportable segment.

The following geographic information includes net revenue to the Company's domestic and international customers based on the customers' requested delivery locations, except for certain cases in which the customer directed us to deliver the

ENERGY RECOVERY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Company's products to a location that differs from the known ultimate location of use. In such cases, the ultimate location of use is reflected in the table below instead of the delivery location.

	Years Ended December 31, (in thousands)		
	2007	2006	2005
Domestic revenue	$ 2,125	$ 1,003	$ 1,710
International revenue	33,289	19,055	8,979
Total revenue	$ 35,414	$ 20,058	$ 10,689
Revenue by country:			
Spain	35%	9%	5%
Saudi Arabia	13	*	*
Algeria	12	30	18
United States	6	5	16
United Arab Emirates	2	10	9
China	8	5	14
Australia	*	9	17
Others	24	32	21
Total	100%	100%	100%

* Less than 1%.

Approximately 90% of the Company's long-lived assets were located in the United States at December 31, 2007, 2006 and 2005.

11. Concentrations

Concentration of Credit Risk

Cash is placed on deposit in major financial institutions in the U.S. Such deposits may be in excess of insured limits. Management believes that the financial institutions that hold the Company's cash are financially sound and, accordingly, minimal credit risk exists with respect to these balances.

The Company's accounts receivable are derived from sales to customers in the water desalination industry located around the world. The Company generally does not require collateral to support customer receivables, but frequently requires letters of credit securing payment. The Company performs ongoing evaluations of its customers' financial condition and periodically reviews credit risk associated with receivables. For sales with customers outside the U.S. (see Note 10—Business Segment and Geographic Information), the Company also obtains credit risk insurance to minimize credit risk exposure. An allowance for doubtful accounts is determined with respect to receivable amounts that the Company has determined to be doubtful of collection using specific identification of doubtful accounts and an aging of receivables analysis based on invoice due dates. Actual collection losses may differ from management's estimates, and such differences could be material to the financial position, results of operations and cash flows. Uncollectible receivables are written off against the allowance for doubtful accounts when all efforts to collect them have been exhausted while recoveries are recognized when they are received.

Accounts receivable concentrations for the years ended December 31, 2007 and 2006 were represented by three different customers totaling approximately 74% and 77%, respectively.

Revenue from customers representing 10% or more of total revenue varies from year to year. For the year ended December 31, 2007, three customers accounted for approximately 56% of the Company's net revenue. Specifically, Acciona Water, Geida and its affiliated entities and Doosan Heavy Industries represented approximately 20%, 23% and 13% of the Company's net revenue in 2007, respectively, and GE Ionics and Geida and its affiliated entities accounted for approximately 18% and 11% of the Company's net revenue in 2006, respectively. In 2005, GE Ionics and Multiplex Degremont JV accounted for 19% and 17% of the Company's net revenue, respectively. No other customer accounted for more than 10% of the Company's net revenue during any of these periods.

Supplier Concentration

Certain of the raw materials and components used by the Company in the manufacture of its products are available from a limited number of suppliers. Shortages could occur in these essential materials and components due to an interruption of supply or increased demand in the industry. If the Company were unable to procure certain of such materials or components, it would be required to reduce its manufacturing operations, which could have a material adverse effect on its results of operations.

For the years ended December 31, 2007, 2006 and 2005, three suppliers represented approximately 66%, 71% and 62%, respectively, of the total purchases of the Company. As of December 31, 2007 and 2006, approximately 60% and 77%, respectively, of the Company's accounts payable were due to these suppliers.

12. Subsequent Events

Facility Lease

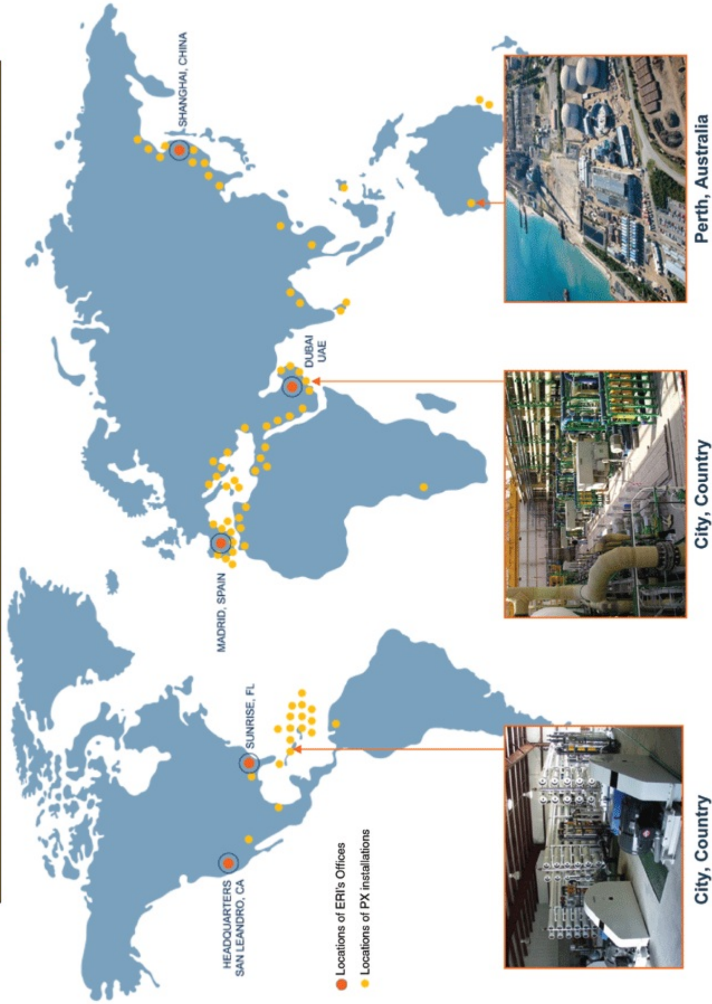
In February 2008, the Company entered into a facility lease agreement for additional office space located in Oakland, California. The lease agreement has an original term of two years commencing on April 1, 2008.

Consulting Agreement

In January 2008, the Company executed a consulting agreement with a member of its board of directors for services related to research and development of new technology. The board member receives compensation of $8,000 per month.

Equity Incentive Plan

In March 2008, the board of directors approved a 2008 Equity Incentive Plan which will become effective immediately preceding the effectiveness of this offering. There are 1,000,000 shares of common stock reserved for future issuance under this plan.


ERI's PX Technology Has A Presence Throughout the World.
HEADQUARTERS
SAN LEANDRO, CA
SUNRISE, FL
MADRID, SPAIN
DUBAI
UAE
SHANGHAI, CHINA
Locations of ERI's Offices
Locations of PX installations
City, Country
City, Country
Perth, Australia

PART II
INFORMATION NOT REQUIRED IN PROSPECTUS

ITEM 13. OTHER EXPENSES OF ISSUANCE AND DISTRIBUTION.

The following table sets forth all expenses to be paid by the registrant, other than estimated underwriting discounts and commissions, in connection with this offering. All amounts shown are estimates except for the SEC registration fee, the FINRA, as applicable, filing fee and NASDAQ, as applicable, listing fee.

SEC registration fee	$ 6,878
FINRA filing fee	18,000
NASDAQ, as applicable, listing fee	5,000
Printing and engraving	*
Legal fees and expenses	*
Accounting fees and expenses	*
Blue sky fees and expenses	*
Transfer agent and registrar fees	2,500
Miscellaneous	*
Total	$ *

* To be provided by amendment.

ITEM 14. INDEMNIFICATION OF DIRECTORS AND OFFICERS.

Section 145 of the Delaware General Corporation Law authorizes a corporation’s board of directors to grant, and authorizes a court to award, indemnity to officers, directors and other corporate agents.

As permitted by Section 102(b)(7) of the Delaware General Corporation Law, the registrant’s amended and restated certificate of incorporation that will become effective upon the completion of this offering includes provisions that eliminate the personal liability of its directors and officers for monetary damages for breach of their fiduciary duty as directors and officers.

In addition, as permitted by Section 145 of the Delaware General Corporation Law, the amended and restated bylaws of the registrant that will become effective upon the completion of this offering provide that:

- The registrant shall indemnify its directors and officers for serving the registrant in those capacities or for serving other business enterprises at the registrant’s request, to the fullest extent permitted by Delaware law. Delaware law provides that a corporation may indemnify such person if such person acted in good faith and in a manner such person reasonably believed to be in or not opposed to the best interests of the registrant and, with respect to any criminal proceeding, had no reasonable cause to believe such person’s conduct was unlawful.
- The registrant may, in its discretion, indemnify employees and agents in those circumstances where indemnification is not required by law.
- The registrant is required to advance expenses, as incurred, to its directors and officers in connection with defending a proceeding, except that such director or officer shall undertake to repay such advances if it is ultimately determined that such person is not entitled to indemnification.
- The registrant will not be obligated pursuant to the bylaws to indemnify a person with respect to proceedings initiated by that person, except with respect to proceedings authorized by the registrant’s board of directors or brought to enforce a right to indemnification.
- The rights conferred in the bylaws are not exclusive, and the registrant is authorized to enter into indemnification agreements with its directors, officers, employees and agents and to obtain insurance to indemnify such persons.
- The registrant may not retroactively amend the bylaw provisions to reduce its indemnification obligations to directors, officers, employees and agents.

The registrant intends to enter into separate indemnification agreements with each of its directors and officers upon the effectiveness of this offering that will provide the maximum indemnity allowed to directors and executive officers by

Section 145 of the Delaware General Corporation Law and will also provide for certain additional procedural protections. The registrant also maintains directors and officers insurance to insure such persons against certain liabilities.

These indemnification provisions and the indemnification agreements to be entered into between the registrant and its officers and directors upon the effectiveness of this offering may be sufficiently broad to permit indemnification of the registrant's officers and directors for liabilities (including reimbursement of expenses incurred) arising under the Securities Act.

The underwriting agreement filed as Exhibit 1.1 to this registration statement provides for indemnification by the underwriters of the registrant and its officers and directors for certain liabilities arising under the Securities Act and otherwise.

ITEM 15. RECENT SALES OF UNREGISTERED SECURITIES.

(a) Since January 1, 2005, the registrant has issued unregistered securities to a limited number of persons as described below:

1. Common Stock:

On June 15, 2007, the registrant issued and sold 1,000,000 shares of common stock to one accredited investor at $5.00 per share, for aggregate proceeds of $5,000,000.

2. Warrants:

On July 31, 2005, the registrant issued warrants to purchase 400,000 shares of its common stock to an accredited investor at an exercise price of $1.00 per share. 200,000 shares subject to this warrant were forfeited prior to December 31, 2005.

3. Warrants:

On November 1, 2005, the registrant issued warrants to purchase 150,000 shares of its common stock to an accredited investor at an exercise price of $1.00 per share.

4. Options:

On February 1, 2005, the registrant issued and sold an aggregate of 2,500,000 shares of common stock upon the exercise of options issued to certain employees, directors and consultants under the registrant's 2001 Stock Option Plan at exercise prices ranging from $0.20 to $0.50 per share, for an aggregate consideration of $522,500.

5. Options:

On February 1, 2005, the registrant issued and sold an aggregate of 1,313,958 shares of common stock upon the exercise of options issued to certain employees, directors and consultants under the registrant's 2002 Stock Option/Stock Issuance Plan at exercise prices from $0.20 to $0.50 per share, for an aggregate consideration of $334,728.90.

6. Options:

From February 1, 2005 through July 12, 2007, the registrant issued and sold an aggregate of 502,083 shares of common stock upon the exercise of options issued to certain employees, directors and consultants under the registrant's 2004 Stock Option/Stock Issuance Plan at exercise prices ranging from $0.25 to $1.00 per share, for an aggregate consideration of $219,583.

None of the foregoing transactions involved any underwriters, underwriting discounts or commissions, or any public offering, and the registrant believes each transaction was exempt from the registration requirements of the Securities Act in reliance on Section 4(2) thereof and Regulation D promulgated thereunder, with respect to items (1) and (2) above, as transactions by an issuer not involving a public offering, and Rule 701 promulgated thereunder, with respect to item (3), (4) and (5) above, as transactions pursuant to compensatory benefit plans and contracts relating to compensation as provided under such Rule 701. The recipients of securities in such transactions represented their intention to acquire the securities for investment only and not with a view to or for sale in connection with any distribution thereof, and appropriate legends were affixed to the share certificates and instruments issued in such transactions.

(b) Since January 1, 2005, the registrant has granted the following options to purchase common stock to its employees, directors and consultants:

1. On January 16, 2005, the registrant granted stock options covering an aggregate of 170,000 shares of its common stock at an exercise price of $0.25 per share and an aggregate price of $42,500 under the registrant's 2004 Stock Option/Stock Issuance Plan.

2. On April 5, 2005, the registrant granted stock options covering an aggregate of 115,000 shares of its common stock at an exercise price of $1.00 per share and an aggregate price of $115,000 under the registrant's 2002 Stock Option/Stock Issuance Plan.

3. On October 14, 2005, the registrant granted stock options covering an aggregate of 100,000 shares of its common stock at an exercise price of $1.00 per share and an aggregate price of $100,000 under the registrant's 2004 Stock Option/Stock Issuance Plan.

4. On December 15, 2005, the registrant granted stock options covering an aggregate of 71,042 shares of its common stock at an exercise price of $1.00 per share and an aggregate price of $71,042 under the registrant's 2002 Stock Option/Stock Issuance Plan.

5. On December 15, 2005, the registrant granted stock options covering an aggregate of 270,000 shares of its common stock at an exercise price of $1.00 per share and an aggregate price of $270,000 under the registrant's 2004 Stock Option/Stock Issuance Plan.

6. On December 9, 2006, the registrant granted stock options covering an aggregate of 642,000 shares of its common stock at an exercise price of $2.65 per share and an aggregate price of $1,701,300 under the registrant's 2006 Stock Option/Stock Issuance Plan.

7. On June 28, 2007, the registrant granted stock options covering an aggregate of 69,200 shares of its common stock at an exercise price of $5.00 per share and an aggregate price of $346,000 under the registrant's 2006 Stock Option/Stock Issuance Plan.

8. On October 1, 2007, the registrant granted stock options covering an aggregate of 6,200 shares of its common stock at an exercise price of $5.00 per share and an aggregate price of $31,000 under the registrant's 2006 Stock Option/Stock Issuance Plan.

9. On November 1, 2007, the registrant granted stock options covering an aggregate of 100,200 shares of its common stock at an exercise price of $5.00 per share and an aggregate price of $501,000 under the registrant's 2006 Stock Option/Stock Issuance Plan.

10. On November 12, 2007, the registrant granted stock options covering an aggregate of 300 shares of its common stock at an exercise price of $5.00 per share and an aggregate price of $1,500 under the registrant's 2006 Stock Option/Stock Issuance Plan.

11. On November 19, 2007, the registrant granted stock options covering an aggregate of 6,000 shares of its common stock at an exercise price of $5.00 per share and an aggregate price of $30,000 under the registrant's 2006 Stock Option/Stock Issuance Plan.

None of the foregoing transactions involved any underwriters, underwriting discounts or commissions, or any public offering, and the registrant believes each transaction was exempt from the registration requirements of the Securities Act in reliance on Rule 701 promulgated thereunder as transactions pursuant to compensatory benefit plans and contracts relating to compensation as provided under such Rule 701. The recipients of securities in such transactions represented their intention to acquire the securities for investment only and not with a view to or for sale in connection with any distribution thereof, and appropriate legends were affixed to the share certificates and instruments issued in such transactions.

ITEM 16. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES.

(a) Exhibits. The following exhibits are included herein or incorporated herein by reference:

Exhibit	Description
1.1*	Form of Underwriting Agreement
3.1**	Amended and Restated Certificate of Incorporation of the Registrant, as currently in effect
3.1.1	Form of Amended and Restated Certificate of Incorporation of Registrant, to be in effect upon the completion of this offering
3.2**	Bylaws of Registrant
3.2.1**	Amendment to Bylaws of Registrant
3.2.2	Form of Amended and Restated Bylaws of the Registrant, to be effective upon closing of the offering
4.1*	Specimen Common Stock Certificate of the Registrant
5.1*	Opinion of Baker & McKenzie LLP
10.1	Form of Indemnification Agreement between Registrant and its directors and officers
10.2**	2001 Stock Option Plan of Registrant and form of Stock Option Agreement thereunder
10.3**	2002 Stock Option/Stock Issuance Plan of Registrant and forms of Stock Option and Stock Purchase Agreements thereunder
10.4**	2004 Stock Option/Stock Issuance Plan of Registrant and forms of Stock Option and Stock Purchase Agreements thereunder
10.5**	2006 Stock Option/Stock Issuance Plan of Registrant and forms of Stock Option and Stock Purchase Agreements thereunder
10.5.1**	Amendment to 2006 Stock Option/Stock Issuance Plan of Registrant
10.5.2**	Second Amendment to 2006 Stock Option/Stock Issuance Plan of Registrant
10.6	2008 Equity Incentive Plan of Registrant, to be in effect upon the completion of this offering, and form of Stock Option Agreement thereunder
10.7**	Employment Agreement dated March 1, 2006 between Registrant and G.G. Pique
10.7.1**	Amendment to Employment Agreement dated January 1, 2008 between Registrant and G.G. Pique
10.8**	Employment Agreement dated November 1, 2007 between Registrant and Thomas Willardson
10.8.1**	Amendment to Employment Agreement dated February 25, 2008 between Registrant and Thomas Willardson
10.9**	Employment Agreement dated July 1, 2006 between Registrant and Richard Stover
10.9.1**	Amendment to Employment Agreement dated February 25, 2008 between Registrant and Richard Stover
10.10**	Employment Agreement dated July 1, 2006 between Registrant and Terrill Sandlin
10.10.1**	Amendment to Employment Agreement dated February 25, 2008 between Registrant and Terrill Sandlin
10.11**	Employment Agreement dated July 1, 2006 between Registrant and MariaElena Ross
10.11.1**	Amendment to Employment Agreement dated February 25, 2008 between Registrant and MariaElena Ross
10.12**	Independent Contractor Agreement dated January 23, 2008 between Registrant and Darby Engineering LLC
10.13**	Lease Agreement dated February 28, 2005 between Registrant and 2101 Williams Associates, LLC
10.13.1**	Amendment to Lease Agreement dated October 3, 2005 between Registrant and 2101 Williams Associates, LLC

10.13.2**	Second Amendment to Lease Agreement dated January 4, 2006 between Registrant and 2101 Williams Associates, LLC
10.13.3**	Third Amendment to Lease Agreement dated September 26, 2006 between Registrant and 2101 Williams Associates, LLC
10.14**	Lease Agreement dated February 15, 2008 between Registrant and Beretta Investment Group
10.15**	Lease Agreement dated August 7, 2006 between Energy Recovery Iberia, S.L. and REGUS Business Centre
10.16	Loan and Security Agreement dated March 27, 2008 between Registrant and Comerica Bank
10.16.1	First Modification to Loan and Security Agreement dated March 27, 2008 between Registrant and Comerica Bank
21.1**	List of subsidiaries of Registrant
23.1	Consent of BDO Seidman LLP, Independent Registered Public Accounting Firm
23.2*	Consent of Baker & McKenzie, LLP (included in Exhibit 5.01)
24.1**	Power of Attorney (see page II-8 to this registration statement on Form S-1)
99.1**	Consent of Person About to Become Director, executed by Dominique Trempont
99.2	Consent of Person About to Become Director, executed by Paul Cook

*To be filed by amendment.
**Previously filed.

(b) Financial Statement Schedules. The following financial statement schedule is included herewith:

SCHEDULE II
VALUATION AND QUALIFYING ACCOUNTS
(in thousands)

Description	Balance at Beginning of Period	Additions to Charged Costs and Expenses	Deductions	Balance at End of Period
Year Ended December 31, 2005				
Allowance for doubtful accounts	$ 46	$ 104	$ —	$ 150
Reserve for obsolete inventory	20	77	—	97
Income tax valuation allowance	1,395	—	(856)	539
Reserve for patent impairment	—	—	—	—
Warranty reserve	90	161	(141)	110
Year Ended December 31, 2006				
Allowance for doubtful accounts	150	80	—	230
Reserve for obsolete inventory	97	30	(72)	55
Income tax valuation allowance	539	—	(539)	—
Reserve for patent impairment	—	—	—	—
Warranty reserve	110	61	(86)	85
Year Ended December 31, 2007				
Allowance for doubtful accounts	230	(105)	(4)	121
Reserve for obsolete inventory	55	47	—	102
Income tax valuation allowance	—	—	—	—
Reserve for patent impairment	—	31	—	31
Warranty reserve	$ 85	$ 850	$ (67)	$ 868

All other schedules have been omitted because the information required to be presented in them is not applicable or is shown in the consolidated financial statements or related notes.

ITEM 17. UNDERTAKINGS.

The undersigned registrant hereby undertakes to provide to the underwriters at the closing specified in the underwriting agreement certificates in such denominations and registered in such names as required by the underwriters to permit prompt delivery to each purchaser.

Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of the registrant pursuant to the foregoing provisions, or otherwise, the registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the registrant of expenses incurred or paid by a director, officer or controlling person of the registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.

The undersigned registrant hereby undertakes that:

(1) For purposes of determining any liability under the Securities Act of 1933, the information omitted from the form of prospectus filed as part of this registration statement in reliance upon Rule 430A and contained in a form of prospectus filed by the registrant pursuant to Rule 424(b)(1) or (4) or 497(h) under the Securities Act shall be deemed to be part of this registration statement as of the time it was declared effective.

(2) For the purpose of determining any liability under the Securities Act of 1933, each post-effective amendment that contains a form of prospectus shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

(3) For purposes of determining liability under the Securities Act of 1933 in reliance upon Rule 430C, each prospectus filed pursuant to Rule 424(b) as part of a registration statement relating to an offering, other than registration statements filed in reliance on Rule 430B and other than prospectuses filed in reliance on Rule 430A, shall be deemed to be part of and included in the registration statement as of the date it is first used after effectiveness. Provided, however, that no statement made in a registration statement or prospectus that is part of the registration statement or made in a document incorporated or deemed incorporated by reference into the registration statement or prospectus that is part of the registration statement will, as to a purchaser with a time of contract of sale prior to such first use, supersede or modify any statement that was made in the registration statement or prospectus that was part of the registration statement or made in any such document immediately prior to such date of first use.

(4) For the purpose of determining liability of the registrant under the Securities Act of 1933 to any purchaser in the initial distribution of securities, in a primary offering of securities of the undersigned registrant pursuant to this registration statement, regardless of the underwriting method used to sell the securities to the purchaser, if the securities are offered or sold to such purchaser by means of any of the following communications, the undersigned registrant will be a seller to the purchaser and will be considered to offer or sell such securities to the purchaser:

(i) Any preliminary prospectus or prospectus of the undersigned registrant relating to the offering required to be filed pursuant to Rule 424;

(ii) Any free writing prospectus relating to the offering prepared by or on behalf of the undersigned registrant or used or referred to by the undersigned registrant;

(iii) the portion of any other free writing prospectus relating to the offering containing material information about the undersigned registrant or its securities provided by or on behalf of the undersigned registrant; and

(iv) Any other communication that is an offer in the offering made by the undersigned registrant to the purchaser.

SIGNATURES

Pursuant to the requirements of the Securities Act of 1933, the Registrant has duly caused this amendment number one to this registration statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of San Leandro, State of California, on the 12th day of May, 2008.

ENERGY RECOVERY, INC.

By: /s/ G.G. PIQUE
G.G. Pique
President and Chief Executive Officer

Pursuant to the requirements of the Securities Act of 1933, this amendment number one to this registration statement has been signed by the following persons in the capacities and on the 12th day of May, 2008.

Signature	Title
/s/ G.G. PIQUE G.G. Pique	President and Chief Executive Officer (Principal Executive Officer)
/s/ THOMAS D. WILLARDSON* Thomas D. Willardson	Chief Financial Officer (Principal Financial Officer)
/s/ MARILYN A. LOBEL* Marilyn A. Lobel	Chief Accounting Officer and Corporate Controller (Principal Accounting Officer)
/s/ HANS PETER MICHELET* Hans Peter Michelet	Executive Chairman
/s/ OLE PETER LORENTZEN* Ole Peter Lorentzen	Director
/s/ ARVE HANSTVEIT* Arve Hanstveit	Director
/s/ PETER DARBY* Peter Darby	Director
/s/ MARIUS SKAUGEN* Marius Skaugen	Director
/s/ FRED OLAV JOHANNESSEN* Fred Olav Johannessen	Director
/s/ JAMES MEDANICH* James Medanich	Director

*By: /s/ G.G. PIQUE
G.G. Pique
Attorney-in-Fact

EXHIBIT INDEX

Exhibit	Description
1.1*	Form of Underwriting Agreement
3.1**	Amended and Restated Certificate of Incorporation of the Registrant, as currently in effect
3.1.1	Form of Amended and Restated Certificate of Incorporation of Registrant, to be in effect upon the completion of this offering
3.2**	Bylaws of Registrant
3.2.1**	Amendment to Bylaws of Registrant
3.2.2	Form of Amended and Restated Bylaws of the Registrant, to be effective upon closing of the offering
4.1*	Specimen Common Stock Certificate of the Registrant
5.1*	Opinion of Baker & McKenzie LLP
10.1	Form of Indemnification Agreement between Registrant and its directors and officers
10.2**	2001 Stock Option Plan of Registrant and form of Stock Option Agreement thereunder
10.3**	2002 Stock Option/Stock Issuance Plan of Registrant and forms of Stock Option and Stock Purchase Agreements thereunder
10.4**	2004 Stock Option/Stock Issuance Plan of Registrant and forms of Stock Option and Stock Purchase Agreements thereunder
10.5**	2006 Stock Option/Stock Issuance Plan of Registrant and forms of Stock Option and Stock Purchase Agreements thereunder
10.5.1**	Amendment to 2006 Stock Option/Stock Issuance Plan of Registrant
10.5.2**	Second Amendment to 2006 Stock Option/Stock Issuance Plan of Registrant
10.6	2008 Equity Incentive Plan of Registrant, to be in effect upon the completion of this offering, and form of Stock Option Agreement thereunder
10.7**	Employment Agreement dated March 1, 2006 between Registrant and G.G. Pique
10.7.1**	Amendment to Employment Agreement dated January 1, 2008 between Registrant and G.G. Pique
10.8**	Employment Agreement dated November 1, 2007 between Registrant and Thomas Willardson
10.8.1**	Amendment to Employment Agreement dated February 25, 2008 between Registrant and Thomas Willardson
10.9**	Employment Agreement dated July 1, 2006 between Registrant and Richard Stover
10.9.1**	Amendment to Employment Agreement dated February 25, 2008 between Registrant and Richard Stover
10.10**	Employment Agreement dated July 1, 2006 between Registrant and Terrill Sandlin
10.10.1**	Amendment to Employment Agreement dated February 25, 2008 between Registrant and Terrill Sandlin
10.11**	Employment Agreement dated July 1, 2006 between Registrant and MariaElena Ross
10.11.1**	Amendment to Employment Agreement dated February 25, 2008 between Registrant and MariaElena Ross
10.12**	Independent Contractor Agreement dated January 23, 2008 between Registrant and Darby Engineering LLC
10.13**	Lease Agreement dated February 28, 2005 between Registrant and 2101 Williams Associates, LLC
10.13.1**	Amendment to Lease Agreement dated October 3, 2005 between Registrant and 2101 Williams Associates, LLC

10.13.2**	Second Amendment to Lease Agreement dated January 4, 2006 between Registrant and 2101 Williams Associates, LLC
10.13.3**	Third Amendment to Lease Agreement dated September 26, 2006 between Registrant and 2101 Williams Associates, LLC
10.14**	Lease Agreement dated February 15, 2008 between Registrant and Beretta Investment Group
10.15**	Lease Agreement dated August 7, 2006 between Energy Recovery Iberia, S.L. and REGUS Business Centre
10.16	Loan and Security Agreement dated March 27, 2008 between Registrant and Comerica Bank
10.16.1	First Modification to Loan and Security Agreement dated March 27, 2008 between Registrant and Comerica Bank
21.1**	List of subsidiaries of Registrant
23.1	Consent of BDO Seidman LLP, Independent Registered Public Accounting Firm
23.2*	Consent of Baker & McKenzie, LLP (included in Exhibit 5.01)
24.1**	Power of Attorney (see page II-8 to this registration statement on Form S-1)
99.1**	Consent of Person About to Become Director, executed by Dominique Trempont
99.2	Consent of Person About to Become Director, executed by Paul Cook

*To be filed by amendment.
**Previously filed.

Exhibit 3.1.1

AMENDED AND RESTATED CERTIFICATE OF INCORPORATION

OF

ENERGY RECOVERY, INC.

Energy Recovery, Inc., a corporation organized and existing under the laws of the State of Delaware (the "Corporation"), hereby certifies as follows:

A. The name of this corporation is Energy Recovery, Inc. The Corporation's original Certificate of Incorporation was filed with the Secretary of State of the State of Delaware on March 8, 2001.

B. This Amended and Restated Certificate of Incorporation has been duly approved by the Board of Directors of the Corporation in accordance with Sections 242 and 245 of the General Corporation Law of the State of Delaware (the "DGCL").

C. This Amended and Restated Certificate of Incorporation has been duly approved by written consent of the stockholders of the Corporation in accordance with Sections 228, 242 and 245 of the DGCL.

D. The text of the Certificate of Incorporation of this Corporation is hereby amended and restated to read in its entirety as follows:

ARTICLE I

The name of the corporation is Energy Recovery, Inc. (the "Corporation").

ARTICLE II

The address of the Corporation's registered office in the State of Delaware is 1201 Orange Street, Suite 600, in the City of Wilmington, County of New Castle, Delaware, 19801. The name of its registered agent at such address is Agents and Corporations, Inc.

ARTICLE III

The nature of the business or purposes to be conducted or promoted by the Corporation is to engage in any lawful act or activity for which corporations may be organized under the DGCL.

ARTICLE IV

Section 1. This Corporation is authorized to issue two classes of stock, to be designated, respectively, Common Stock and Preferred Stock. The total number of shares of all classes of stock which this Corporation is authorized to issue is Two Hundred Ten Million (210,000,000) shares, of which Two Hundred Million (200,000,000) shares are Common Stock, $0.001 par value, and Ten Million (10,000,000) shares are Preferred Stock, $0.001 par value (the "Preferred Stock").

Section 2. Each share of Common Stock shall entitle the holder thereof to one (1) vote on any matter submitted to a vote at a meeting of stockholders.

Section 3. The Preferred Stock may be issued from time to time in one or more series pursuant to a resolution or resolutions providing for such issue duly adopted by the Board of Directors (authority to do so being hereby expressly vested in the Board of Directors). The Board of Directors is further authorized, subject to limitations prescribed by law, to fix by resolution or resolutions the designations, powers, preferences and rights, and the qualifications, limitations or restrictions thereof, of any wholly unissued series of Preferred Stock, including without limitation authority to fix by resolution or resolutions the dividend rights, dividend rate, conversion rights, voting rights, rights and terms of redemption (including sinking fund provisions), redemption price or prices, and liquidation preferences of any such series, and the number of shares constituting any such series and the designation thereof, or any of the foregoing. The Board of Directors is further authorized to increase (but not above the total number of authorized shares of the class) or decrease (but not below the number of shares of any such series then outstanding) the number of shares of any series, the number of which was fixed by it, subsequent to the issuance of shares of such series then outstanding, subject to the powers, preferences and rights, and the qualifications, limitations and restrictions thereof stated in this Amended and Restated Certificate of Incorporation or the resolution of the Board of Directors originally fixing the number of shares of such series. If the number of shares of any series is so decreased, then the Corporation shall take all such steps as are necessary to cause the shares constituting such decrease to resume the status which they had prior to the adoption of the resolution originally fixing the number of shares of such series.

Section 4. Except as otherwise required by law, holders of Common Stock shall not be entitled to vote on any amendment to this Amended and Restated Certificate of Incorporation (including any certificate of designation filed with respect to any series of Preferred Stock) that relates solely to the terms of one or more outstanding series of Preferred Stock if the holders of such affected series are entitled, either separately or together as a class with the holders of one or more other such series, to vote thereon by law or pursuant to this Amended and Restated Certificate of Incorporation (including any certificate of designation filed with respect to any series of Preferred Stock).

ARTICLE V

Section 1. The number of directors that constitutes the entire Board of Directors shall be determined in the manner set forth in the Bylaws of the Corporation. At each annual meeting of stockholders, directors of the Corporation shall be elected to hold office until the expiration of the term for which they are elected and until their successors have been duly elected and qualified or until their earlier resignation or removal; except that if any such meeting shall not be so held, such election shall take place at a stockholders' meeting called and held in accordance with the DGCL.

Section 2. The directors of the Corporation shall be divided into three classes as nearly equal in size as is practicable, hereby designated Class I, Class II and Class III. Directors shall be assigned to each class in accordance with a resolution or resolutions adopted by the Board of Directors. At the first annual meeting of stockholders following the date hereof, the term of office of the Class I directors shall expire and Class I directors shall be elected for a full term of three years.

At the second annual meeting of stockholders following the date hereof, the term of office of the Class II directors shall expire and Class II directors shall be elected for a full term of three years. At the third annual meeting of stockholders following the date hereof, the term of office of the Class III directors shall expire and Class III directors shall be elected for a full term of three years. At each succeeding annual meeting of stockholders, directors shall be elected for a full term of three years to succeed the directors of the class whose terms expire at such annual meeting. If the number of directors is changed,

any newly created directorships or decrease in directorships shall be so apportioned among the classes as to make all classes as nearly equal in number as is practicable, provided that no decrease in the number of directors constituting the Board of Directors shall shorten the term of any incumbent director.

ARTICLE VI

Section 1. Any director or the entire Board of Directors may be removed from office at any time, but only for cause, and only by the affirmative vote of the holders of at least a majority of the voting power of the issued and outstanding capital stock of the Corporation entitled to vote in the election of directors.

Section 2. Except as otherwise provided for or fixed by or pursuant to the provisions of Article IV hereof in relation to the rights of the holders of Preferred Stock to elect directors under specified circumstances, newly created directorships resulting from any increase in the number of directors, created in accordance with the Bylaws of the Corporation, and any vacancies on the Board of Directors resulting from death, resignation, disqualification, removal or other cause shall be filled only by the affirmative vote of a majority of the remaining directors then in office, even though less than a quorum of the Board of Directors, or by a sole remaining director, and not by the stockholders. A person so elected by the Board of Directors to fill a vacancy or newly created directorship shall hold office until the next election of the class for which such director shall have been chosen until his or her successor shall have been duly elected and qualified, or until such director's earlier death, resignation or removal. No decrease in the number of directors constituting the Board of Directors shall shorten the term of any incumbent director.

ARTICLE VII

Section 1. The Corporation is to have perpetual existence.

Section 2. The business and affairs of the Corporation shall be managed by or under the direction of the Board of Directors. In addition to the powers and authority expressly conferred upon them by statute or by this Amended and Restated Certificate of Incorporation or the Bylaws of the Corporation, the directors are hereby empowered to exercise all such powers and do all such acts and things as may be exercised or done by the Corporation.

Section 3. In furtherance and not in limitation of the powers conferred by statute, the Board of Directors is expressly authorized to adopt, alter, amend or repeal the Bylaws of the Corporation. The affirmative vote of at least a majority of the Board of Directors then in office shall be required in order for the Board of Directors to adopt, amend, alter or repeal the Corporation's Bylaws. The Corporation's Bylaws may also be adopted, amended, altered or repealed by the stockholders of the Corporation. Notwithstanding the above or any other provision of this Amended and Restated Certificate of Incorporation, the Bylaws of the Corporation may not be amended, altered or repealed except in accordance with Article X of the Bylaws. No Bylaw hereafter legally adopted, amended, altered or repealed shall invalidate any prior act of the directors or officers of the Corporation that would have been valid if such Bylaw had not been adopted, amended, altered or repealed.

Section 4. The election of directors need not be by written ballot unless the Bylaws of the Corporation shall so provide.

Section 5. No stockholder will be permitted to cumulate votes at any election of directors.

ARTICLE VIII

Section 1. Any action required or permitted to be taken by the stockholders of the Corporation must be effected at a duly called annual or special meeting of stockholders of the Corporation and may not be effected by any consent in writing by such stockholders.

Section 2. Special meetings of stockholders of the Corporation may be called only by the Non-Executive Chairperson of the Board of Directors, the Chief Executive Officer, the President or the Board of Directors acting pursuant to a resolution adopted by a majority of the Board of Directors, and any power of stockholders to call a special meeting of stockholders is specifically denied. Only such business shall be considered at a special meeting of stockholders as shall have been stated in the notice for such meeting.

Section 3. Advance notice of stockholder nominations for the election of directors and of business to be brought by stockholders before any meeting of the stockholders of the Corporation shall be given in the manner and to the extent provided in the Bylaws of the Corporation.

ARTICLE IX

Section 1. To the fullest extent permitted by the DGCL as the same exists or as may hereafter be amended, a director of the Corporation shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director. If the DGCL is amended to authorize corporate action further eliminating or limiting the personal liability of directors, then the liability of a director of the Corporation shall be eliminated or limited to the fullest extent permitted by the DGCL, as so amended.

Section 2. The Corporation may indemnify to the fullest extent permitted by law any person made or threatened to be made a party to an action or proceeding, whether criminal, civil, administrative or investigative, by reason of the fact that he, she, his or her testator or intestate is or was a director, officer, employee or agent of the Corporation or any predecessor of the Corporation or serves or served at any other enterprise as a director, officer, employee or agent at the request of the Corporation or any predecessor of the Corporation or serves or served at any other enterprise as a director, officer, employee or agent at the request of the Corporation or any predecessor to the Corporation.

Section 3. Neither any amendment nor repeal of any Section of this Article IX, nor the adoption of any provision of this Amended and Restated Certificate of Incorporation or the Bylaws of the Corporation inconsistent with this Article IX, shall eliminate or reduce the effect of this Article IX in respect of any matter occurring, or any cause of action, suit, claim or proceeding accruing or arising or that, but for this Article IX, would accrue or arise, prior to such amendment, repeal or adoption of an inconsistent provision.

ARTICLE X

Meetings of stockholders may be held within or outside of the State of Delaware, as the Bylaws may provide. The books of the Corporation may be kept (subject to any provision contained in the statutes) outside of the State of Delaware at such place or places as may be designated from time to time by the Board of Directors or in the Bylaws of the Corporation.

ARTICLE XI

The Corporation reserves the right to amend or repeal any provision contained in this Amended and Restated Certificate of Incorporation in the manner prescribed by the laws of the State of Delaware and all rights conferred upon stockholders are granted subject to this reservation; *provided*, *however*, that notwithstanding any other provision of this Amended and Restated Certificate of Incorporation, or any provision of law that might otherwise permit a lesser vote or no vote, the Board of Directors acting pursuant to a resolution adopted by a majority of the Board of Directors and the affirmative vote of sixty-six and two-thirds percent (66 2/3%) of the then outstanding voting securities of the Corporation, voting together as a single class, shall be required for the amendment, repeal or modification of the provisions of Section 3 of Article IV, Section 2 of Article V, Article VI, Section 5 of Article VII, Article VIII or Article XI of this Amended and Restated Certificate of Incorporation.

IN WITNESS WHEREOF, Energy Recovery, Inc. has caused this Amended and Restated Certificate of Incorporation to be signed by its President and Chief Executive Officer on this day of __________, 2008.

____

G.G. Pique, President and Chief Executive Officer

Exhibit 3.2.2

BYLAWS

OF

ENERGY RECOVERY, INC.

(adopted April 18, 2001)

(restated __________, 2008)

ARTICLE 1

OFFICES

1.1 REGISTERED OFFICE

The corporation shall maintain a registered office and registered agent in the state of Delaware. The registered office and/or registered agent of the corporation may be changed from time to time by action of the board of directors.

1.2 OTHER OFFICES

The corporation may also have offices at such other places both within or outside the state of Delaware as the board of directors may from time to time determine or the business of the corporation may require.

1.3 BOOKS AND RECORDS

The books and records of the Corporation may be kept outside the State of Delaware at such place or places as may from time to time be designated by the Board of Directors.

ARTICLE 2

MEETINGS OF STOCKHOLDERS

2.1 PLACE OF MEETINGS

Meetings of stockholders of Energy Recovery, Inc. (the “**Company**”) shall be held at any place, within or outside the State of Delaware, determined by the Company’s board of directors (the “**Board**”). The Board may, in its sole discretion, determine that a meeting of stockholders shall not be held at any place, but may instead be held solely by means of remote communication as authorized by Section 211(a)(2) of the Delaware General Corporation Law (the “**DGCL**”). In the absence of any such designation or determination, stockholders’ meetings shall be held at the Company’s principal executive office.

2.2 ANNUAL MEETING

An annual meeting of stockholders shall be held for the election of directors at such date and time as may be designated by resolution of the Board from time to time. Any other proper business may be transacted at the annual meeting.

2.3 SPECIAL MEETING

A special meeting of the stockholders may be called at any time by the Board, Chief Executive Officer, or President (in the absence of a Chief Executive Officer).

If any person(s) other than the Board calls a special meeting, the request shall:

(a) be in writing;

(b) specify the time of such meeting and the general nature of the business proposed to be transacted; and

(c) be delivered personally or sent by registered mail or by facsimile transmission to the Non-Executive Chairperson of the Board, the Chief Executive Officer, the President (in the absence of a Chief Executive Officer) or the Secretary of the Company.

The officer(s) receiving the request shall cause notice to be promptly given to the stockholders entitled to vote at such meeting, in accordance with these bylaws, that a meeting will be held at the time requested by the person or persons calling the meeting. No business may be transacted at such special meeting other than the business specified in such notice to stockholders. Nothing contained in this paragraph of this Section 2.3 shall be construed as limiting, fixing, or affecting the time when a meeting of stockholders called by action of the Board may be held.

2.4 NOTICE OF STOCKHOLDERS' MEETINGS

Whenever stockholders are required or permitted to take any action at a meeting, a written notice of the meeting shall be given which shall state the place, if any, date and hour of the meeting, the means of remote communication, if any, by which stockholders and proxy holders may be deemed to be present in person and vote at such meeting, and, in the case of a special meeting, the purpose or purposes for which the meeting is called. Except as otherwise provided in the DGCL, the certificate of incorporation or these bylaws, the written notice of any meeting of stockholders shall be given not less than 10 nor more than 60 days before the date of the meeting to each stockholder entitled to vote at such meeting.

2.5 QUORUM

Except as otherwise provided by law, the certificate of incorporation or these bylaws, at each meeting of stockholders the presence in person or by proxy of the holders of shares of stock having a majority of the votes which could be cast by the holders of all outstanding shares of stock entitled to vote at the meeting shall be necessary and sufficient to constitute a quorum. If, however, such quorum is not present or represented at any meeting of the stockholders, then either (i) the chairperson of the meeting, or (ii) the stockholders entitled to vote at the meeting, present in person or represented by proxy, shall have the power to adjourn the meeting from time to time, in the manner provided in Section 2.6, until a quorum is present or represented.

2.6 ADJOURNED MEETING; NOTICE

Any meeting of stockholders, annual or special, may adjourn from time to time to reconvene at the same or some other place, and notice need not be given of the adjourned meeting if the time, place, if any, thereof, and the means of remote communications, if any, by which stockholders and proxy holders may be deemed to be present in person and vote at such adjourned meeting are announced at the meeting at which the adjournment is taken. At the adjourned meeting, the Company may transact any business which might have been transacted at the original meeting. If the adjournment is for more than 30 days, or if after the adjournment a new record date is fixed for the adjourned meeting, a notice of the adjourned meeting shall be given to each stockholder of record entitled to vote at the meeting.

2.7 CONDUCT OF BUSINESS

Meetings of stockholders shall be presided over by the Chief Executive Officer and the Non-Executive Chairperson of the Board, if any, or in the absence of the foregoing persons by a chairperson designated by the Board, or in the absence of such designation by a chairperson chosen at the meeting. The Secretary shall act as secretary of the meeting, but in his or her absence the chairperson of the meeting may appoint any person to act as secretary of the meeting. The chairperson of any meeting of stockholders shall determine the order of business and the procedure at the meeting, including such regulation of the manner of voting and the conduct of business.

2.8 VOTING

The stockholders entitled to vote at any meeting of stockholders shall be determined in accordance with the provisions of Section 2.11 of these bylaws, subject to Section 217 (relating to voting rights of fiduciaries, pledgors and joint owners of stock) and Section 218 (relating to voting trusts and other voting agreements) of the DGCL.

Except as may be otherwise provided in the certificate of incorporation, each stockholder entitled to vote at any meeting of stockholders shall be entitled to one vote for each share of capital stock held by such stockholder which has voting power upon the matter in question. Voting at meetings of stockholders need not be by written ballot and, unless otherwise required by law, need not be conducted by inspectors of election unless so determined by the holders of shares of stock having a majority of the votes which could be cast by the holders of all outstanding shares of stock entitled to vote thereon which are present in person or by proxy at such meeting. If authorized by the Board, such requirement of a written ballot shall be satisfied by a ballot submitted by electronic transmission (as defined in Section 8.2 of these bylaws), *provided* that any such electronic transmission must either set forth or be submitted with information from which it can be determined that the electronic transmission was authorized by the stockholder or proxy holder.

Except as otherwise required by law, the certificate of incorporation or these bylaws, in all matters other than the election of directors, the affirmative vote of a majority of the voting power of the shares present in person or represented by proxy at the meeting and entitled to vote on the subject matter shall be the act of the stockholders. Except as otherwise required by law, the certificate of incorporation or these bylaws, directors shall be elected by a plurality of the voting power of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors.

2.9 RECORD DATE FOR STOCKHOLDER NOTICE; VOTING; GIVING CONSENTS

In order that the Company may determine the stockholders entitled to notice of or to vote at any meeting of stockholders or any adjournment thereof, or entitled to express consent to corporate action in writing without a meeting, or entitled to receive payment of any dividend or other distribution or allotment of any rights, or entitled to exercise any rights in respect of any change, conversion or exchange of stock or for the purpose of any other lawful action, the Board may fix a record date, which record date shall not precede the date upon which the resolution fixing the record date is adopted by the Board and which record date:

(a) in the case of determination of stockholders entitled to notice of or to vote at any meeting of stockholders or adjournment thereof, shall, unless otherwise required by law, not be more than 60 nor less than 10 days before the date of such meeting;

(b) in the case of determination of stockholders entitled to express consent to corporate action in writing without a meeting, shall not be more than 10 days after the date upon which the resolution fixing the record date is adopted by the Board; and

(c) in the case of determination of stockholders for any other action, shall not be more than 60 days prior to such other action.

If no record date is fixed by the Board:

(a) the record date for determining stockholders entitled to notice of or to vote at a meeting of stockholders shall be at the close of business on the day next preceding the day on which notice is given, or, if notice is waived, at the close of business on the day next preceding the day on which the meeting is held;

(b) the record date for determining stockholders entitled to express consent to corporate action in writing without a meeting when no prior action of the Board is required by law, shall be the first date on which a signed written consent setting forth the action taken or proposed to be taken is delivered to the Company in accordance with applicable law, or, if prior action by the Board is required by law, shall be at the close of business on the day on which the Board adopts the resolution taking such prior action; and

(c) the record date for determining stockholders for any other purpose shall be at the close of business on the day on which the Board adopts the resolution relating thereto.

A determination of stockholders of record entitled to notice of or to vote at a meeting of stockholders shall apply to any adjournment of the meeting, *provided* that the Board may fix a new record date for the adjourned meeting.

2.10 PROXIES

Each stockholder entitled to vote at a meeting of stockholders may authorize another person or persons to act for such stockholder by proxy authorized by an instrument in writing or by a transmission permitted by law filed in accordance with the procedure established for the meeting, but no proxy shall be voted or acted upon after three years from its date, unless the proxy provides for a longer period. The revocability of a proxy that states on its face that it is irrevocable shall be governed by the provisions of Section 212 of the DGCL.

2.11 LIST OF STOCKHOLDERS ENTITLED TO VOTE

The officer who has charge of the stock ledger of the Company shall prepare and make, at least ten days before every meeting of stockholders, a complete list of the stockholders entitled to vote at the meeting, arranged in alphabetical order, and showing the address of each stockholder and the number of shares registered in the name of each stockholder. The Company shall not be required to include electronic mail addresses or other electronic contact information on such list. Such list shall be open to the examination of any stockholder, for any purpose germane to the meeting for a period of at least ten days prior to the meeting: (i) on a reasonably accessible electronic network, *provided* that the information required to gain access to such list is provided with the notice of the meeting, or (ii) during ordinary business hours, at the Company's principal place of business. In the event that the Company determines to make the list available on an electronic network, the Company may take reasonable steps to ensure that such information is available only to stockholders of the Company. If the meeting is to be held at a place, then the list shall be produced and kept at the time and place of the meeting during the whole time thereof, and may be inspected by any stockholder who is present. If the meeting is to be held solely by means of remote communication, then the list shall also be open to the examination of any stockholder during the whole time of the meeting on a reasonably accessible electronic network, and the information required to access such list shall be provided with the notice of the meeting.

ARTICLE 3

DIRECTORS

3.1 NUMBER OF DIRECTORS; TERM; POWERS

The board of directors shall consist of not less than three members, which number shall be fixed from time to time by action of the board of directors or the stockholders. The board of directors shall be divided into three classes, which shall be as nearly equal in number as is possible. At the first election of directors to such classified board of directors, directors of the first class shall be elected to hold office for a term expiring at the next succeeding annual meeting, directors of the second class shall be elected to hold office for a term expiring at the second succeeding annual meeting and directors of the third class shall be elected to hold office for a term expiring at the third succeeding annual meeting. Subject to the foregoing, at each annual meeting of stockholders following the meeting at which the board of directors is initially classified, the number of directors equal to the number of the class whose term expires at the time of such meeting shall be elected to serve until the third ensuing annual meeting of stockholders. Each director shall hold office until such director's successor is elected and qualified or until such director's earlier death, resignation or removal.

The business and affairs of the Company shall be managed by or under the direction of the Board, except as may be otherwise provided in the DGCL or the certificate of incorporation.

3.2 ELECTION; QUALIFICATION

Except as provided in Section 3.3 of these bylaws, directors shall be elected at each annual meeting of stockholders. Directors need not be stockholders unless so required by the certificate of incorporation or these bylaws. The certificate of incorporation or these bylaws may prescribe other qualifications for directors.

3.3 RESIGNATIONS AND VACANCIES

Any director may resign at any time upon notice given in writing or by electronic transmission to the Company. A resignation is effective when the resignation is delivered unless the resignation specifies a later effective date or an effective date determined upon the happening of an event or events. A resignation which is conditioned upon the director failing to receive a specified vote for reelection as a director may provide that it is irrevocable. Unless otherwise provided in the certificate of incorporation or these bylaws, when one or more directors resign from the Board, effective at a future date, a majority of the directors then in office, including those who have so resigned, shall have power to fill such vacancy or vacancies, the vote thereon to take effect when such resignation or resignations shall become effective.

Unless otherwise provided in the certificate of incorporation or these bylaws:

(a) Vacancies and newly created directorships resulting from any increase in the authorized number of directors elected by all of the stockholders having the right to vote as a single class may be filled by a majority of the directors then in office, although less than a quorum, or by a sole remaining director.

(b) Whenever the holders of any class or classes of stock or series thereof are entitled to elect one or more directors by the provisions of the certificate of incorporation, vacancies and newly created directorships of such class or classes or series may be filled by a majority of the directors elected by such class or classes or series thereof then in office, or by a sole remaining director so elected.

If at any time, by reason of death or resignation or other cause, the Company should have no directors in office, then any officer or any stockholder or an executor, administrator, trustee or guardian of a stockholder, or other fiduciary entrusted with like responsibility for the person or estate of a stockholder, may call a special meeting of stockholders in accordance with the provisions of the certificate of incorporation or these bylaws, or may apply to the Court of Chancery for a decree summarily ordering an election as provided in Section 211 of the DGCL.

If, at the time of filling any vacancy or any newly created directorship, the directors then in office constitute less than a majority of the whole Board (as constituted immediately prior to any such increase), the Court of Chancery may, upon application of any stockholder or stockholders holding at least 10% of the voting stock at the time outstanding having the right to vote for such directors, summarily order an election to be held to fill any such vacancies or newly created directorships, or to replace the directors chosen by the directors then in office as aforesaid, which election shall be governed by the provisions of Section 211 of the DGCL as far as applicable.

A director elected to fill a vacancy shall be elected for the unexpired term of his or her predecessor in office and until such director’s successor is elected and qualified, or until such director’s earlier death, resignation or removal.

3.4 PLACE OF MEETINGS; MEETINGS BY TELEPHONE

The Board may hold meetings, both regular and special, either within or outside the State of Delaware.

Unless otherwise restricted by the certificate of incorporation or these bylaws, members of the Board, or any committee designated by the Board, may participate in a meeting of the Board, or any committee, by means of conference telephone or other communications equipment by means of which all persons participating in the meeting can hear each other, and such participation in a meeting shall constitute presence in person at the meeting.

3.5 CONDUCT OF BUSINESS

Meetings of the Board shall be presided over by the Non-Executive Chairperson of the Board, if any, or in his or her absence by a chairperson designated by the Board, or in the absence of such designation by a chairperson chosen at the meeting. The Secretary shall act as secretary of the meeting, but in his or her absence the chairperson of the meeting may appoint any person to act as secretary of the meeting.

3.6 REGULAR MEETINGS

Regular meetings of the Board may be held without notice at such time and at such place as shall from time to time be determined by the Board.

3.7 SPECIAL MEETINGS; NOTICE

Special meetings of the Board for any purpose or purposes may be called at any time by the Chief Executive Officer, the President, the Secretary or any two directors.

Notice of the time and place of special meetings shall be:

(i) delivered personally by hand, by courier or by telephone;

(ii) sent by United States first-class mail, postage prepaid;

(iii) sent by facsimile; or

(iv) sent by electronic mail,

directed to each director at that director’s address, telephone number, facsimile number or electronic mail address, as the case may be, as shown on the Company’s records.

If the notice is (i) delivered personally by hand, by courier or by telephone, (ii) sent by facsimile or (iii) sent by electronic mail, it shall be delivered or sent at least 24 hours before the time of the holding of the meeting. If the notice is sent by United States mail, it shall be deposited in the United States mail at least four days before the time of the holding of the meeting. Any oral notice may be communicated to the director. The notice need not specify the place of the meeting (if the meeting is to be held at the Company’s principal executive office) nor the purpose of the meeting.

3.8 QUORUM; VOTING

At all meetings of the Board, a majority of the total authorized number of directors shall constitute a quorum for the transaction of business. If a quorum is not present at any meeting of the Board, then the directors present thereat may adjourn the meeting from time to time, without notice other than announcement at the meeting, until a quorum is present. A meeting at which a quorum is initially present may continue to transact business notwithstanding the withdrawal of directors, if any action taken is approved by at least a majority of the required quorum for that meeting.

The vote of a majority of the directors present at any meeting at which a quorum is present shall be the act of the Board, except as may be otherwise specifically provided by statute, the certificate of incorporation or these bylaws.

If the certificate of incorporation provides that one or more directors shall have more or less than one vote per director on any matter, every reference in these bylaws to a majority or other proportion of the directors shall refer to a majority or other proportion of the votes of the directors.

3.9 BOARD ACTION BY WRITTEN CONSENT WITHOUT A MEETING

Unless otherwise restricted by the certificate of incorporation or these bylaws, any action required or permitted to be taken at any meeting of the Board, or of any committee thereof, may be taken without a meeting if all members of the Board or committee, as the case may be, consent thereto in writing or by electronic transmission and the writing or writings or electronic transmission or transmissions are filed with the minutes of proceedings of the Board or committee. Such filing shall be in paper form if the minutes are maintained in paper form and shall be in electronic form if the minutes are maintained in electronic form.

3.10 FEES AND COMPENSATION OF DIRECTORS

Unless otherwise restricted by the certificate of incorporation or these bylaws, the Board shall have the authority to fix the compensation of directors.

3.11 REMOVAL OF DIRECTORS

Unless otherwise restricted by statute, the certificate of incorporation or these bylaws, any director or the entire Board may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors.

No reduction of the authorized number of directors shall have the effect of removing any director prior to the expiration of such director’s term of office.

ARTICLE 4

COMMITTEES

4.1 COMMITTEES OF DIRECTORS

The Board may designate one or more committees, each committee to consist of one or more of the directors of the Company. The Board may designate one or more directors as alternate members of any committee, who may replace any absent or disqualified member at any meeting of the committee. In the absence or disqualification of a member of a committee, the member or members thereof present at any meeting and not disqualified from voting, whether or not such member or members constitute a quorum, may unanimously appoint another member of the Board to act at the meeting in the place of any such absent or disqualified member. Any such committee, to the extent provided in the resolution of the Board or in these bylaws, shall have and may exercise all the powers and authority of the Board in the management of the business and affairs of the Company, and may authorize the seal of the Company to be affixed to all papers that may require it; but no such committee shall have the power or authority to (i) approve or adopt, or recommend to the stockholders, any action or matter (other than the election or removal of directors) expressly required by the DGCL to be submitted to stockholders for approval, or (ii) adopt, amend or repeal any bylaw of the Company.

4.2 COMMITTEE MINUTES

Each committee shall keep regular minutes of its meetings and report the same to the Board when required.

4.3 MEETINGS AND ACTIONS OF COMMITTEES

Meetings and actions of committees shall be governed by, and held and taken in accordance with, the provisions of:

(a) Section 3.5 (Place of Meetings; Meetings by Telephone);

(b) Section 3.7 (Regular Meetings);

(c) Section 3.8 (Special Meetings; Notice);

(d) Section 3.9 (Quorum; Voting);

(e) Section 3.10 (Board Action by Written Consent Without a Meeting); and

(f) Section 8.5 (Waiver of Notice)

with such changes in the context of those bylaws as are necessary to substitute the committee and its members for the Board and its members*However*:

(g) the time of regular meetings of committees may be determined either by resolution of the Board or by resolution of the committee;

(h) special meetings of committees may also be called by resolution of the Board; and

(i) notice of special meetings of committees shall also be given to all alternate members, who shall have the right to attend all meetings of the committee. The Board may adopt rules for the government of any committee not inconsistent with the provisions of these bylaws.

4.4 SUBCOMMITTEES

Unless otherwise provided in the certificate of incorporation, these bylaws or the resolutions of the Board designating the committee, a committee may create one or more subcommittees, each subcommittee to consist of one or more members of the committee, and delegate to a subcommittee any or all of the powers and authority of the committee.

ARTICLE 5

OFFICERS

5.1 OFFICERS

The officers of the Company shall be a President and a Secretary. The Company may also have, at the discretion of the Board, a Chief Executive Officer, one or more Vice Presidents, a Chief Financial Officer, a Treasurer, one or more Assistant Treasurers, one or more Assistant Secretaries, and any such other officers as may be appointed in accordance with the provisions of these bylaws. Any number of offices may be held by the same person.

5.2 APPOINTMENT OF OFFICERS

The Board shall appoint the officers of the Company, except such officers as may be appointed in accordance with the provisions of Section 5.3 of these bylaws.

5.3 SUBORDINATE OFFICERS

The Board may appoint, or empower the Chief Executive Officer or, in the absence of a Chief Executive Officer, the President, to appoint, such other officers and agents as the business of the Company may require. Each of such officers and agents shall hold office for such period, have such authority, and perform such duties as are provided in these bylaws or as the Board may from time to time determine.

5.4 REMOVAL AND RESIGNATION OF OFFICERS

Any officer may be removed, either with or without cause, by an affirmative vote of the majority of the Board at any regular or special meeting of the Board or, except in the case of an officer chosen by the Board, by any officer upon whom such power of removal may be conferred by the Board.

Any officer may resign at any time by giving written notice to the Company. Any resignation shall take effect at the date of the receipt of that notice or at any later time specified in that notice. Unless otherwise specified in the notice of resignation, the acceptance of the resignation shall not be necessary to

make it effective. Any resignation is without prejudice to the rights, if any, of the Company under any contract to which the officer is a party.

5.5 VACANCIES IN OFFICES

Any vacancy occurring in any office of the Company shall be filled by the Board or as provided in Section 5.3.

5.6 REPRESENTATION OF SHARES OF OTHER CORPORATIONS

Unless otherwise directed by the Board, the President or any other person authorized by the Board or the President is authorized to vote, represent and exercise on behalf of the Company all rights incident to any and all shares of any other corporation or corporations standing in the name of the Company. The authority granted herein may be exercised either by such person directly or by any other person authorized to do so by proxy or power of attorney duly executed by such person having the authority.

5.7 AUTHORITY AND DUTIES OF OFFICERS

Except as otherwise provided in these bylaws, the officers of the Company shall have such powers and duties in the management of the Company as may be designated from time to time by the Board and, to the extent not so provided, as generally pertain to their respective offices, subject to the control of the Board.

ARTICLE 6

INDEMNIFICATION

6.1 INDEMNIFICATION OF DIRECTORS AND OFFICERS IN THIRD PARTY PROCEEDINGS

Subject to the other provisions of this Article VI, the Company shall indemnify, to the fullest extent permitted by the DGCL, as now or hereinafter in effect, any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (a "**Proceeding**") (other than an action by or in the right of the Company) by reason of the fact that such person is or was a director or officer of the Company, or is or was a director or officer of the Company serving at the request of the Company as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by such person in connection with such Proceeding if such person acted in good faith and in a manner such person reasonably believed to be in or not opposed to the best interests of the Company, and, with respect to any criminal action or proceeding, had no reasonable cause to believe such person's conduct was unlawful. The termination of any Proceeding by judgment, order, settlement, conviction, or upon a plea of *nolo contendere* or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which such person reasonably believed to be in or not opposed to the best interests of the Company, and, with respect to any criminal action or proceeding, had reasonable cause to believe that such person's conduct was unlawful.

6.2 INDEMNIFICATION OF DIRECTORS AND OFFICERS IN ACTIONS BY OR IN THE RIGHT OF THE COMPANY

Subject to the other provisions of this Article VI, the Company shall indemnify, to the fullest extent permitted by the DGCL, as now or hereinafter in effect, any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action or suit by or in the right of the Company to procure a judgment in its favor by reason of the fact that such person is or was a director or officer of the Company, or is or was a director or officer of the Company serving at the request of the Company as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection with the defense or settlement of such action or suit if such person acted in good faith and in a manner such person reasonably believed to be in or not opposed to the best interests of the Company; except that no indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the Company unless and only to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper.

6.3 SUCCESSFUL DEFENSE

To the extent that a present or former director or officer of the Company has been successful on the merits or otherwise in defense of any action, suit or proceeding described in Section 6.1 or Section 6.2, or in defense of any claim, issue or matter therein, such person shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection therewith.

6.4 INDEMNIFICATION OF OTHERS

Subject to the other provisions of this Article VI, the Company shall have power to indemnify its employees and agents to the extent not prohibited by the DGCL or other applicable law. The Board shall have the power to delegate to such person or persons the determination of whether employees or agents shall be indemnified.

6.5 ADVANCED PAYMENT OF EXPENSES

Expenses (including attorneys' fees) incurred by an officer or director of the Company in defending any Proceeding shall be paid by the Company in advance of the final disposition of such Proceeding upon receipt of an undertaking by or on behalf of the person to repay such amounts if it shall ultimately be determined that the person is not entitled to be indemnified under this Article V or the DGCL. Such expenses (including attorneys' fees) incurred by former directors and officers or other employees and agents may be so paid upon such terms and conditions, if any, as the Company deems appropriate.

Notwithstanding the foregoing, unless otherwise determined pursuant to Section 6.8, no advance shall be made by the Company to an officer of the Company (except by reason of the fact that such officer is or was a director of the Company, in which event this paragraph shall not apply) in any Proceeding if a determination is reasonably and promptly made (i) by a majority vote of the directors who are not parties to such Proceeding, even though less than a quorum, or (ii) by a committee of such directors designated by majority vote of such directors, even though less than a quorum, or (iii) if there are no such directors, or if such directors so direct, by independent legal counsel in a written opinion, that facts known to the decision-making party at the time such determination is made demonstrate clearly and convincingly that such person acted in bad faith or in a manner that such person did not believe to be in or not opposed to the best interests of the Company.

6.6 LIMITATION ON INDEMNIFICATION AND ADVANCEMENT OF EXPENSES

Subject to the requirements in section 6.3 and the DGCL, the Company shall not be required to provide indemnification or, with respect to clauses (i), (iii) and (iv) below, advance expenses to any person pursuant to this Article VI:

(a) in connection with any Proceeding (or part thereof) initiated by such person except (i) as otherwise required by law, (ii) in specific cases if the Proceeding was authorized by the Board, or (iii) as is required to be made under Section 6.7;

(b) in connection with any Proceeding (or part thereof) against such person providing for an accounting or disgorgement of profits pursuant to the provisions of Section 16(b) of the Securities Exchange Act of 1934, as amended, or similar provisions of any federal, state or local statutory law or common law;

(c) for amounts for which payment has actually been made to or on behalf of such person under any statute, insurance policy or indemnity provision, except with respect to any excess beyond the amount paid; or

(d) if prohibited by applicable law.

6.7 DETERMINATION; CLAIM

If a claim for indemnification or advancement of expenses under this Article VI is not paid in full within 60 days after a written claim therefor has been received by the Company, the claimant may file suit to recover the unpaid amount of such claim and, if successful in whole or in part, shall be entitled to be paid the expense of prosecuting such claim. In any such suit, the Company shall have the burden of proving that the claimant was not entitled to the requested indemnification or advancement of expenses under applicable law.

6.8 NON-EXCLUSIVITY OF RIGHTS

The indemnification and advancement of expenses provided by, or granted pursuant to, this Article VI shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under the certificate of incorporation or any statute, bylaw, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in such person's official capacity and as to action in another capacity while holding such office. The Company is specifically authorized to enter into individual contracts with any or all of its directors, officers, employees or agents respecting indemnification and advancement of expenses, to the fullest extent not prohibited by the DGCL or other applicable law.

6.9 INSURANCE

The Company may purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the Company, or is or was serving at the request of the Company as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise against any liability asserted against such person and incurred by such person in any such capacity, or arising out of such person's status as such, whether or not the Company would have the power to indemnify such person against such liability under the provisions of the DGCL.

6.10 SURVIVAL

The rights to indemnification and advancement of expenses conferred by this Article VI shall continue as to a person who has ceased to be a director, officer, employee or agent and shall inure to the benefit of the heirs, executors and administrators of such a person.

6.11 EFFECT OF REPEAL OR MODIFICATION

Any repeal or modification of this Article VI shall not adversely affect any right or protection hereunder of any person in respect of any act or omission occurring prior to the time of such repeal or modification.

6.12 CERTAIN DEFINITIONS

For purposes of this Article VI, references to the **"Company"** shall include, in addition to the resulting corporation, any constituent corporation (including any constituent of a constituent) absorbed in a consolidation or merger which, if its separate existence had continued, would have had power and authority to indemnify its directors, officers, employees or agents, so that any person who is or was a director, officer, employee or agent of such constituent corporation, or is or was serving at the request of such constituent corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, shall stand in the same position under the provisions of this Article VI with respect to the resulting or surviving corporation as such person would have with respect to

such constituent corporation if its separate existence had continued. For purposes of this Article VI, references to **"other enterprises"** shall include employee benefit plans; references to **"fines"** shall include any excise taxes assessed on a person with respect to an employee benefit plan; and references to **"serving at the request of the Company"** shall include any service as a director, officer, employee or agent of the Company which imposes duties on, or involves services by, such director, officer, employee or agent with respect to an employee benefit plan, its participants or beneficiaries; and a person who acted in good faith and in a manner such person reasonably believed to be in the interest of the participants and beneficiaries of an employee benefit plan shall be deemed to have acted in a manner **"not opposed to the best interests of the Company"** as referred to in this Article VI.

ARTICLE 7

STOCK

7.1 STOCK CERTIFICATES; PARTLY PAID SHARES

The shares of the Company shall be represented by certificates, *provided* that the Board may provide by resolution or resolutions that some or all of any or all classes or series of its stock shall be uncertificated shares. Any such resolution shall not apply to shares represented by a certificate until such certificate is surrendered to the Company. Every holder of stock represented by certificates shall be entitled to have a certificate signed by, or in the name of the Company by the President or a Vice-President, and by the Treasurer or an Assistant Treasurer, or the Secretary or an Assistant Secretary of the Company representing the number of shares registered in certificate form. Any or all of the signatures on the certificate may be a facsimile. In case any officer, transfer agent or registrar who has signed or whose facsimile signature has been placed upon a certificate has ceased to be such officer, transfer agent or registrar before such certificate is issued, it may be issued by the Company with the same effect as if such person were such officer, transfer agent or registrar at the date of issue. The Company shall not have power to issue a certificate in bearer form.

The Company may issue the whole or any part of its shares as partly paid and subject to call for the remainder of the consideration to be paid therefor. Upon the face or back of each stock certificate issued to represent any such partly paid shares, or upon the books and records of the Company in the case of uncertificated partly paid shares, the total amount of the consideration to be paid therefor and the amount paid thereon shall be stated. Upon the declaration of any dividend on fully paid shares, the Company shall declare a dividend upon partly paid shares of the same class, but only upon the basis of the percentage of the consideration actually paid thereon.

7.2 SPECIAL DESIGNATION ON CERTIFICATES

If the Company is authorized to issue more than one class of stock or more than one series of any class, then the powers, the designations, the preferences, and the relative, participating, optional or other special rights of each class of stock or series thereof and the qualifications, limitations or restrictions of such preferences and/or rights shall be set forth in full or summarized on the face or back of the certificate that the Company shall issue to represent such class or series of stock; *provided* that, except as otherwise provided in Section 202 of the DGCL, in lieu of the foregoing requirements there may be set forth on the face or back of the certificate that the Company shall issue to represent such class or series of stock a statement that the Company will furnish without charge to each stockholder who so requests the powers, the designations, the preferences, and the relative, participating, optional or other special rights of each

class of stock or series thereof and the qualifications, limitations or restrictions of such preferences and/or rights.

7.3 LOST CERTIFICATES

Except as provided in this Section 7.3, no new certificates for shares shall be issued to replace a previously issued certificate unless the latter is surrendered to the Company and cancelled at the same time. The Company may issue a new certificate of stock or uncertificated shares in the place of any certificate theretofore issued by it, alleged to have been lost, stolen or destroyed, and the Company may require the owner of the lost, stolen or destroyed certificate, or such owner's legal representative, to give the Company a bond sufficient to indemnify it against any claim that may be made against it on account of the alleged loss, theft or destruction of any such certificate or the issuance of such new certificate or uncertificated shares.

7.4 DIVIDENDS

The Board, subject to any restrictions contained in the certificate of incorporation or applicable law, may declare and pay dividends upon the shares of the Company's capital stock. Dividends may be paid in cash, in property, or in shares of the Company's capital stock, subject to the provisions of the certificate of incorporation.

The Board may set apart out of any of the funds of the Company available for dividends a reserve or reserves for any proper purpose and may abolish any such reserve.

7.5 STOCK TRANSFER AGREEMENTS

The Company shall have power to enter into and perform any agreement with any number of stockholders of any one or more classes of stock of the Company to restrict the transfer of shares of stock of the Company of any one or more classes owned by such stockholders in any manner not prohibited by the DGCL.

7.6 REGISTERED STOCKHOLDERS

The Company:

(a) shall be entitled to recognize the exclusive right of a person registered on its books as the owner of shares to receive dividends and to vote as such owner;

(b) shall be entitled to hold liable for calls and assessments the person registered on its books as the owner of shares; and

(c) shall not be bound to recognize any equitable or other claim to or interest in such share or shares on the part of another person, whether or not it shall have express or other notice thereof, except as otherwise provided by the laws of Delaware.

7.7 TRANSFERS

Transfers of record of shares of stock of the Company shall be made only upon its books by the holders thereof, in person or by an attorney duly authorized, and upon the surrender of a certificate or certificates for a like number of shares, properly endorsed.

ARTICLE 8

MANNER OF GIVING NOTICE AND WAIVER

8.1 NOTICE OF STOCKHOLDER MEETINGS

Notice of any meeting of stockholders, if mailed, is given when deposited in the United States mail, postage prepaid, directed to the stockholder at such stockholder's address as it appears on the Company's records. An affidavit of the Secretary or an Assistant Secretary of the Company or of the transfer agent or other agent of the Company that the notice has been given shall, in the absence of fraud, be *prima facie* evidence of the facts stated therein.

8.2 NOTICE BY ELECTRONIC TRANSMISSION

Without limiting the manner by which notice otherwise may be given effectively to stockholders pursuant to the DGCL, the certificate of incorporation or these bylaws, any notice to stockholders given by the Company under any provision of the DGCL, the certificate of incorporation or these bylaws shall be effective if given by a form of electronic transmission consented to by the stockholder to whom the notice is given. Any such consent shall be revocable by the stockholder by written notice to the Company. Any such consent shall be deemed revoked if:

(a) the Company is unable to deliver by electronic transmission two consecutive notices given by the Company in accordance with such consent; and

(b) such inability becomes known to the Secretary or an Assistant Secretary of the Company or to the transfer agent, or other person responsible for the giving of notice.

However, the inadvertent failure to treat such inability as a revocation shall not invalidate any meeting or other action.

Any notice given pursuant to the preceding paragraph shall be deemed given:

(a) if by facsimile telecommunication, when directed to a number at which the stockholder has consented to receive notice;

(b) if by electronic mail, when directed to an electronic mail address at which the stockholder has consented to receive notice;

(c) if by a posting on an electronic network together with separate notice to the stockholder of such specific posting, upon the later of (i) such posting and (ii) the giving of such separate notice; and

(d) if by any other form of electronic transmission, when directed to the stockholder.

An affidavit of the Secretary or an Assistant Secretary or of the transfer agent or other agent of the Company that the notice has been given by a form of electronic transmission shall, in the absence of fraud, be *prima facie* evidence of the facts stated therein.

An **"electronic transmission"** means any form of communication, not directly involving the physical transmission of paper, that creates a record that may be retained, retrieved, and reviewed by a recipient thereof, and that may be directly reproduced in paper form by such a recipient through an automated process.

Notice by a form of electronic transmission shall not apply to Sections 164, 296, 311, 312 or 324 of the DGCL.

8.3 NOTICE TO STOCKHOLDERS SHARING AN ADDRESS

Except as otherwise prohibited under the DGCL, without limiting the manner by which notice otherwise may be given effectively to stockholders, any notice to stockholders given by the Company under the provisions of the DGCL, the certificate of incorporation or these bylaws shall be effective if given by a single written notice to stockholders who share an address if consented to by the stockholders at that address to whom such notice is given. Any such consent shall be revocable by the stockholder by written notice to the Company. Any stockholder who fails to object in writing to the Company, within 60 days of having been given written notice by the Company of its intention to send the single notice, shall be deemed to have consented to receiving such single written notice.

8.4 NOTICE TO PERSON WITH WHOM COMMUNICATION IS UNLAWFUL

Whenever notice is required to be given, under the DGCL, the certificate of incorporation or these bylaws, to any person with whom communication is unlawful, the giving of such notice to such person shall not be required and there shall be no duty to apply to any governmental authority or agency for a license or permit to give such notice to such person. Any action or meeting which shall be taken or held without notice to any such person with whom communication is unlawful shall have the same force and effect as if such notice had been duly given. In the event that the action taken by the Company is such as to require the filing of a certificate under the DGCL, the certificate shall state, if such is the fact and if notice is required, that notice was given to all persons entitled to receive notice except such persons with whom communication is unlawful.

8.5 WAIVER OF NOTICE

Whenever notice is required to be given under any provision of the DGCL, the certificate of incorporation or these bylaws, a written waiver, signed by the person entitled to notice, or a waiver by electronic transmission by the person entitled to notice, whether before or after the time of the event for which notice is to be given, shall be deemed equivalent to notice. Attendance of a person at a meeting shall constitute a waiver of notice of such meeting, except when the person attends a meeting for the express purpose of objecting at the beginning of the meeting, to the transaction of any business because the meeting is not lawfully called or convened. Neither the business to be transacted at, nor the purpose of, any regular or special meeting of the stockholders need be specified in any written waiver of notice or any waiver by electronic transmission unless so required by the certificate of incorporation or these bylaws.

ARTICLE 9

GENERAL MATTERS

9.1 FISCAL YEAR

The fiscal year of the corporation shall end on December 31st of each year.

9.2 SEAL

The Company may adopt a corporate seal, which shall be in such form as may be approved from time to time by the Board. The Company may use the corporate seal by causing it or a facsimile thereof to be impressed or affixed or in any other manner reproduced.

9.3 ANNUAL REPORT

The Company shall cause an annual report to be sent to the stockholders of the Company to the extent required by applicable law. If and so long as there are fewer than 100 holders of record of the Company’s shares, the requirement of sending an annual report to the stockholders of the Company is expressly waived (to the extent permitted under applicable law).

9.4 CONSTRUCTION; DEFINITIONS

Unless the context requires otherwise, the general provisions, rules of construction, and definitions in the DGCL shall govern the construction of these bylaws. Without limiting the generality of this provision, the singular number includes the plural, the plural number includes the singular, and the term “person” includes both a corporation and a natural person.

ARTICLE 10

AMENDMENTS

These bylaws may be adopted, amended or repealed by the stockholders entitled to vote. However, the Company may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors. The fact that such power has been so conferred upon the directors shall not divest the stockholders of the power, nor limit their power to adopt, amend or repeal bylaws.

A bylaw amendment adopted by stockholders which specifies the votes that shall be necessary for the election of directors shall not be further amended or repealed by the Board.

ENERGY RECOVERY, INC.

CERTIFICATE OF AMENDMENT OF BYLAWS

The undersigned hereby certifies that he or she is the duly elected, qualified, and acting Secretary or Assistant Secretary of Energy Recovery, Inc., a Delaware corporation (the "**Company**"), and that the foregoing bylaws, comprising twenty (20) pages, were amended and restated on__________by the Company's board of directors.

The undersigned has executed this certificate as of__________.

____
(*signature*)

____
(*print name*)

____
(*title*)

ENERGY RECOVERY, INC.

INDEMNIFICATION AGREEMENT

THIS AGREEMENT is entered into, effective as of_______, 20__ by and between Energy Recovery, Inc., a Delaware corporation (the "Company"), and _____ __"Indemnitee").

WHEREAS, it is essential to the Company to retain and attract as directors and officers the most capable persons available;

WHEREAS, Indemnitee is a director and/or officer of the Company;

WHEREAS, both the Company and Indemnitee recognize the increased risk of litigation and other claims currently being asserted against directors and officers of corporations;

WHEREAS, the Bylaws of the Company require the Company to indemnify and advance expenses to its directors and officers to the fullest extent permitted under Delaware law, and the Indemnitee serves as a director and/or officer of the Company in part in reliance on the Company's Bylaws; and

WHEREAS, in recognition of Indemnitee's need for (i) substantial protection against personal liability based on Indemnitee's reliance on the aforesaid Bylaws, (ii) specific contractual assurance that the protection promised by the Bylaws will be available to Indemnitee (regardless of, among other things, any amendment to or revocation of the Bylaws or any change in the composition of the Company's Board of Directors or acquisition transaction relating to the Company) and (iii) an inducement to provide effective services to the Company as a director and/or officer, the Company wishes to provide in this Agreement for the indemnification of and the advancing of expenses to Indemnitee to the fullest extent (whether partial or complete) permitted under Delaware law and as set forth in this Agreement, and, to the extent insurance is maintained, to provide for the continued coverage of Indemnitee under the Company's directors' and officers' liability insurance policies.

NOW, THEREFORE, in consideration of the above premises and of Indemnitee continuing to serve the Company directly or, at its request, with another enterprise, and intending to be legally bound hereby, the parties agree as follows:

1. Certain Definitions.

(a) "Board" shall mean the Board of Directors of the Company.

(b) "Affiliate" shall mean any corporation or other person or entity that directly, or indirectly through one or more intermediaries, controls or is controlled by or is under common control with, the person specified, including, without limitation, with respect to the Company, any direct or indirect subsidiary of the Company.

(c) A "Change in Control" shall be deemed to have occurred if (i) any "person" (as such term is used in Sections 13(d) and 14(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")) (other than a trustee or other fiduciary holding securities under an employee benefit plan of the Company or a corporation owned directly or indirectly by the stockholders of the Company in substantially the same proportions as their ownership of stock of the Company, and other than any person holding shares of the Company on the date that the Company first registers under the Act or any transferee of such individual if such transferee is a spouse or lineal descendant of the transferee or a trust for the benefit of the individual, his or her spouse or lineal descendants), is or becomes the "beneficial owner" (as defined in Rule 13d-3 under the Exchange Act), directly or

indirectly, of securities of the Company representing 30% or more of the total voting power represented by the Company's then outstanding Voting Securities, (ii) during any period of two consecutive years, individuals who at the beginning of such period constitute the Board and any new director whose election by the Board or nomination for election by the Company's stockholders was approved by a vote of at least two-thirds (2/3) of the directors then still in office who either were directors at the beginning of the period or whose election or nomination for election was previously so approved, cease for any reason to constitute a majority of the Board, (iii) the stockholders of the Company approve a merger or consolidation of the Company with any other entity, other than a merger or consolidation that would result in the Voting Securities of the Company outstanding immediately prior thereto continuing to represent (either by remaining outstanding or by being converted into Voting Securities of the surviving entity) at least 80% of the total voting power represented by the Voting Securities of the Company or such surviving entity outstanding immediately after such merger or consolidation or (iv) the stockholders of the Company approve a plan of complete liquidation of the Company or an agreement for the sale or disposition by the Company (in one transaction or a series of transactions) of all or substantially all of the Company's assets.

(d) "Expenses" shall mean any expense, liability or loss, including attorneys' fees, judgments, fines, ERISA excise taxes and penalties, amounts paid or to be paid in settlement, any interest, assessments or other charges imposed thereon, any federal, state, local or foreign taxes imposed as a result of the actual or deemed receipt of any payments under this Agreement and all other costs and obligations, paid or incurred in connection with investigating, defending, being a witness in, participating in (including on appeal) or preparing for any of the foregoing in, any Proceeding relating to any Indemnifiable Event.

(e) "Indemnifiable Event" shall mean any event or occurrence that takes place either prior to or after the execution of this Agreement, related to the fact that Indemnitee is or was a director or officer of the Company or an Affiliate of the Company, or while a director or officer is or was serving at the request of the Company or an Affiliate of the Company as a director, officer, employee, trustee, agent or fiduciary of another foreign or domestic corporation, partnership, joint venture, employee benefit plan, trust or other enterprise or was a director, officer, employee or agent of a foreign or domestic corporation that was a predecessor corporation of the Company or of another enterprise at the request of such predecessor corporation, or related to anything done or not done by Indemnitee in any such capacity, whether or not the basis of the Proceeding is alleged action in an official capacity as a director, officer, employee or agent or in any other capacity while serving as a director, officer, employee or agent of the Company or an Affiliate of the Company, as described above.

(f) "Independent Counsel" shall mean the person or body appointed in connection with Section 3.

(g) "Proceeding" shall mean any threatened, pending or completed action, suit or proceeding or any alternative dispute resolution mechanism (including an action by or in the right of the Company or an Affiliate of the Company) or any inquiry, hearing or investigation, whether formal or informal, whether conducted by the Company or an Affiliate of the Company or any other party, that Indemnitee in good faith believes might lead to the institution of any such action, suit or proceeding, whether civil, criminal, administrative, investigative or other.

(h) "Reviewing Party" shall mean the person or body appointed in accordance with Section 3.

(i) "Voting Securities" shall mean any securities of the Company that vote generally in the election of directors.

2. Agreement to Indemnify.

(a) General Agreement. In the event Indemnitee was, is or becomes a party to or witness or other participant in, or is threatened to be made a party to or witness or other participant in, a Proceeding by reason of (or arising in part out of) an Indemnifiable Event, the Company shall indemnify Indemnitee from and against any and all Expenses to the fullest extent permitted by law, as the same exists or may hereafter be amended or interpreted (but in the case of any such amendment or interpretation, only to the extent that such amendment or interpretation permits the Company to provide broader indemnification rights than were permitted prior thereto). The parties hereto intend that this Agreement shall provide for indemnification in excess of that expressly permitted by statute, including, without limitation, any indemnification provided by the Company's Certificate of Incorporation, its Bylaws, vote of its stockholders or disinterested directors or applicable law.

(b) Initiation of Proceeding. Notwithstanding anything in this Agreement to the contrary, Indemnitee shall not be entitled to indemnification pursuant to this Agreement in connection with any Proceeding initiated by Indemnitee against the Company or any director or officer of the Company unless (i) the Company has joined in or the Board has consented to the initiation of such Proceeding, (ii) the Proceeding is one to enforce indemnification rights under Section 5 or (iii) the Proceeding is instituted after a Change in Control (other than a Change in Control approved by a majority of the directors on the Board who were directors immediately prior to such Change in Control) and Independent Counsel has approved its initiation.

(c) Expense Advances. All Expenses incurred by or on behalf of Indemnitee prior to the final disposition of a Proceeding shall be advanced by the Company to Indemnitee within 30 days after the receipt by the Company of a written request for such advance unless and until there has been a final determination by a court of competent jurisdiction that Indemnitee is not entitled to be indemnified for such Expenses. Notwithstanding the foregoing, to the extent the Indemnitee has been successful on the merits or otherwise in the defense of any Proceeding, Indemnitee shall be indemnified against all Expenses actually and reasonably incurred by Indemnitee in connection therewith. Indemnitee shall qualify for advances upon the execution and delivery to the Company of this Agreement which shall constitute an undertaking providing that the Indemnitee undertakes to the fullest extent permitted by law to reimburse the advance if and to the extent that it is ultimately determined by a court of competent jurisdiction in a final judgment, not subject to appeal, that Indemnitee is not entitled to be indemnified by the Company. No other form of undertaking shall be required other than the execution of this Agreement. Indemnitee's obligation to reimburse the Company for advances shall be unsecured and no interest shall be charged thereon. This Section 2(c) shall not apply to any claim made by Indemnitee for which indemnity is excluded pursuant to Section 2(b) or 2(f).

(d) Mandatory Indemnification. Notwithstanding any other provision of this Agreement, to the extent that Indemnitee has been successful on the merits or otherwise in defense of any Proceeding relating in whole or in part to an Indemnifiable Event or in defense of any issue or matter therein, Indemnitee shall be indemnified against all Expenses incurred in connection therewith.

(e) Partial Indemnification. If Indemnitee is entitled under any provision of this Agreement to indemnification by the Company for some or a portion of Expenses, but not, however, for the total amount thereof, the Company shall nevertheless indemnify Indemnitee for the portion thereof to which Indemnitee is entitled.

(f) Prohibited Indemnification. No indemnification pursuant to this Agreement shall be paid by the Company on account of any Proceeding in which a final judgment is rendered against Indemnitee or Indemnitee enters into a settlement, in each case (i) for an accounting of profits made from the purchase or sale by Indemnitee of securities of the Company pursuant to the provisions of Section 16(b) of the Exchange Act or similar provisions of any federal, state or local laws; (ii) for which payment has actually been made to or on behalf of Indemnitee under any insurance policy or other indemnity provision, except with respect to any excess beyond the amount paid under any insurance policy or other indemnity provision; or (iii) for which payment is prohibited by law. Notwithstanding anything to the contrary stated or implied in this Section 2(f), indemnification pursuant to this Agreement relating to any Proceeding against Indemnitee for an accounting of profits made from the purchase or sale by Indemnitee of securities of the Company pursuant to the provisions of Section 16(b) of the Exchange Act or similar provisions of any federal, state or local laws shall not be prohibited if Indemnitee ultimately establishes in any Proceeding that no recovery of such profits from Indemnitee is permitted under Section 16(b) of the Exchange Act or similar provisions of any federal, state or local laws.

3. Reviewing Party. Prior to any Change in Control, the Reviewing Party shall be any appropriate person or body consisting of a member or members of the Board or any other person or body appointed by the Board who is not a party to the particular Proceeding with respect to which Indemnitee is seeking indemnification; provided that if all members of the Board are parties to the particular Proceeding with respect to which Indemnitee is seeking indemnification, the Independent Counsel referred to below shall become the Reviewing Party; after a Change in Control, the Independent Counsel referred to below shall become the Reviewing Party. With respect to all matters arising before a Change in Control for which Independent Counsel shall be the Reviewing Party and all matters arising after a Change in Control, in each case concerning the rights of Indemnitee to indemnity payments and Expense Advances under this Agreement or any other agreement or under applicable law or the Company's Certificate of Incorporation or Bylaws now or hereafter in effect relating to indemnification for Indemnifiable Events, the Company shall seek legal advice only from Independent Counsel selected by Indemnitee and approved by the Company (which approval shall not be unreasonably withheld or delayed), and who has not otherwise performed services for the Company or the Indemnitee (other than in connection with indemnification matters) within the last five years. The Independent Counsel shall not include any person who, under the applicable standards of professional conduct then prevailing, would have a conflict of interest in representing either the Company or Indemnitee in an action to determine Indemnitee's rights under this Agreement. Such counsel, among other things, shall render its written opinion to the Company and Indemnitee as to whether and to what extent the Indemnitee should be permitted to be indemnified under applicable law. The Company agrees to pay the reasonable fees of the Independent Counsel and to indemnify fully such counsel against any and all expenses (including attorneys' fees), claims, liabilities, loss and damages arising out of or relating to this Agreement or the engagement of Independent Counsel pursuant hereto.

4. Indemnification Process and Appeal.

(a) Indemnification Payment. Indemnitee shall be entitled to indemnification of Expenses, and shall receive payment thereof, from the Company in accordance with this Agreement as soon as practicable after Indemnitee has made written demand on the Company for indemnification, but in no event later than thirty (30) days after demand, unless the Reviewing Party has given a written opinion to the Company that Indemnitee is not entitled to indemnification under applicable law. Indemnitee shall cooperate with the Reviewing Party making a determination with respect to Indemnitee's entitlement to indemnification, including providing to the Reviewing Party upon reasonable advance request any documentation or information which is not privileged

or otherwise protected from disclosure and which is reasonably available to Indemnitee and reasonably necessary to such determination. In the event the Reviewing Party has failed to make such determination within thirty (30) days after the Company's receipt of Indemnitee's written demand for indemnification, the requisite determination that Indemnitee is entitled to indemnification shall be deemed to have been made.

(b) Suit to Enforce Rights. Regardless of any action by the Reviewing Party, if Indemnitee has not received full indemnification within thirty (30) days after making a demand in accordance with Section 4(a), Indemnitee shall have the right to enforce its indemnification rights under this Agreement by commencing litigation in any court in the State of California or the State of Delaware having subject matter jurisdiction thereof seeking an initial determination by the court or challenging any determination by the Reviewing Party or any aspect thereof. The Company hereby consents to service of process and to appear in any such proceeding. The Company shall be precluded from asserting in any such proceeding that the procedures and presumptions of this Agreement are not valid, binding and enforceable and shall stipulate in any such court that the Company is bound by all the provisions of this Agreement. The remedy provided for in this Section 4 shall be in addition to any other remedies available to Indemnitee at law or in equity.

(c) Defense to Indemnification, Burden of Proof, and Presumptions. It shall be a defense to any action brought by Indemnitee against the Company to enforce this Agreement that it is not permissible under applicable law for the Company to indemnify Indemnitee for the amount claimed. In connection with any such action or any determination by the Reviewing Party or otherwise as to whether Indemnitee is entitled to be indemnified hereunder, the burden of proving such a defense or determination shall be on the Company. Neither the failure of the Reviewing Party or the Company (including its Board, independent legal counsel or its stockholders) to have made a determination prior to the commencement of such action by Indemnitee that indemnification of the claimant is proper under the circumstances because Indemnitee has met the standard of conduct set forth in applicable law, nor an actual determination by the Reviewing Party or Company (including its Board, independent legal counsel or its stockholders) that the Indemnitee had not met such applicable standard of conduct, shall be a defense to the action or create a presumption that the Indemnitee has not met the applicable standard of conduct. For purposes of this Agreement, the termination of any claim, action, suit or proceeding, by judgment, order, settlement (whether with or without court approval), conviction or upon a plea of nolo contendere or its equivalent, shall not create a presumption that Indemnitee did not meet any particular standard of conduct or have any particular belief or that a court has determined that indemnification is not permitted by applicable law. For purposes of any determination of good faith under any applicable standard of conduct, Indemnitee shall be deemed to have acted in good faith if Indemnitee's action is based on the records or books of account of the Company, including financial statements, or on information supplied to Indemnitee by the officers of the Company in the course of their duties, or on the advice of legal counsel for the Company or the Board or counsel selected by any committee of the Board or on information or records given or reports made to the Company by an independent certified public accountant or by an appraiser, investment banker, compensation consultant, or other expert selected with reasonable care by the Company or the Board or any committee of the Board. The provisions of the preceding sentence shall not be deemed to be exclusive or to limit in any way the other circumstances in which the Indemnitee may be deemed to have met the applicable standard of conduct. The knowledge and/or actions, or failure to act, or any director, officer, agent or employee of the Company shall not be imputed to Indemnitee for purposes of determining the right to indemnification under this Agreement.

5. Indemnification for Expenses Incurred in Enforcing Rights. The Company shall indemnify Indemnitee against any and all Expenses that are incurred by Indemnitee in connection with any action brought by Indemnitee for (i) indemnification or advance payment of Expenses by the Company under this Agreement or any other agreement or under applicable law or the Company's Certificate of Incorporation or Bylaws now or hereafter in effect relating to indemnification for Indemnifiable Events, regardless of whether Indemnitee is ultimately successful in such action, unless as a part of such action a court of competent jurisdiction over such action determines that each of the material assertions made by Indemnitee as a basis for such action was not made in good faith or was frivolous; and/or (ii) recovery under directors' and officers' liability insurance policies maintained by the Company; but only in the event that Indemnitee ultimately is determined to be entitled to such indemnification or insurance recovery, as the case may be. In addition, the Company shall, if so requested by Indemnitee, advance the foregoing Expenses to Indemnitee, subject to and in accordance with Section 2(c).

6. Notification and Defense of Proceeding.

(a) Notice. Promptly after receipt by Indemnitee of notice of the commencement of any Proceeding, Indemnitee shall, if a claim in respect thereof is to be made against the Company under this Agreement, notify the Company of the commencement thereof; but the omission so to notify the Company will not relieve the Company from any liability that it may have to Indemnitee, except as provided in Section 6(c).

(b) Defense. With respect to any Proceeding as to which Indemnitee notifies the Company of the commencement thereof, the Company will be entitled to participate in the Proceeding at its own expense and except as otherwise provided below, to the extent the Company so wishes, it may assume the defense thereof with counsel reasonably satisfactory to Indemnitee. After notice from the Company to Indemnitee of its election to assume the defense of any Proceeding, the Company shall not be liable to Indemnitee under this Agreement or otherwise for any Expenses subsequently incurred by Indemnitee in connection with the defense of such Proceeding other than reasonable costs of investigation or as otherwise provided below. Indemnitee shall have the right to employ legal counsel in such Proceeding, but all Expenses related thereto incurred after notice from the Company of its assumption of the defense shall be at Indemnitee's expense unless: (i) the employment of legal counsel by Indemnitee has been authorized by the Company, (ii) Indemnitee has reasonably determined that there may be a conflict of interest between Indemnitee and the Company in the defense of the Proceeding, (iii) after a Change in Control, the employment of counsel by Indemnitee has been approved by the Independent Counsel or (iv) the Company shall not in fact have employed counsel to assume the defense of such Proceeding, in each of which cases all Expenses of the Proceeding shall be borne by the Company. The Company shall not be entitled to assume the defense of any Proceeding brought by or on behalf of the Company, or as to which Indemnitee shall have made the determination provided for in (ii) above or under the circumstances provided for in (iii) and (iv) above.

(c) Settlement of Claims. The Company shall not be liable to indemnify Indemnitee under this Agreement or otherwise for any amounts paid in settlement of any Proceeding effected without the Company's written consent, such consent not to be unreasonably withheld; provided, however, that if a Change in Control has occurred, the Company shall be liable for indemnification of Indemnitee for amounts paid in settlement if the Independent Counsel has approved the settlement. The Company shall not settle any Proceeding in any manner that would impose any penalty or limitation on Indemnitee without Indemnitee's written consent. The Company shall not be liable to indemnify the Indemnitee under this Agreement with regard to any judicial award if the Company was not given a reasonable and timely opportunity as a result of Indemnitees' failure to provide notice, at its expense, to participate in the defense of such

action, and the lack of such notice materially prejudiced the Company's ability to participate in defense of such action. The Company's liability hereunder shall not be excused if participation in the Proceeding by the Company was barred by this Agreement.

7. Establishment of Trust. In the event of a Change in Control, the Company shall, upon written request by Indemnitee, create a Trust for the benefit of the Indemnitee and from time to time upon written request of Indemnitee shall fund the Trust in an amount sufficient to satisfy any and all Expenses reasonably anticipated at the time of each such request to be incurred in connection with investigating, preparing for, participating in, and/or defending any Proceeding relating to an Indemnifiable Event. The amount or amounts to be deposited in the Trust pursuant to the foregoing funding obligation shall be determined by the Independent Counsel. The terms of the Trust shall provide that (i) the Trust shall not be revoked or the principal thereof invaded without the written consent of the Indemnitee, (ii) the Trustee shall advance, within thirty (30) days of a request by the Indemnitee, any and all Expenses to the Indemnitee (and the Indemnitee hereby agrees to reimburse the Trust under the same circumstances for which the Indemnitee would be required to reimburse the Company under Section 2(c) of this Agreement), (iii) the Trust shall continue to be funded by the Company in accordance with the funding obligation set forth above, (iv) the Trustee shall promptly pay to the Indemnitee all amounts for which the Indemnitee shall be entitled to indemnification pursuant to this Agreement or otherwise no later than thirty (30) days after notice pursuant to Section 4(a) and (v) all unexpended funds in the Trust shall revert to the Company upon a final determination by the Independent Counsel or a court of competent jurisdiction, as the case may be, that the Indemnitee has been fully indemnified under the terms of this Agreement. The Trustee shall be chosen by the Indemnitee. Nothing in this Section 7 shall relieve the Company of any of its obligations under this Agreement. All income earned on the assets held in the Trust shall be reported as income by the Company for federal, state, local and foreign tax purposes. The Company shall pay all costs of establishing and maintaining the Trust and shall indemnify the Trustee against any and all expenses (including attorneys' fees), claims, liabilities, loss and damages arising out of or relating to this Agreement or the establishment and maintenance of the Trust.

8. Non-Exclusivity. The rights of Indemnitee hereunder shall be in addition to any other rights Indemnitee may have under the Company's Certificate of Incorporation, Bylaws, applicable law or otherwise; provided, however, that this Agreement shall supersede any prior indemnification agreement between the Company and the Indemnitee. To the extent that a change in applicable law (whether by statute or judicial decision) permits greater indemnification than would be afforded currently under the Company's Certificate of Incorporation, Bylaws, applicable law or this Agreement, it is the intent of the parties that Indemnitee enjoy by this Agreement the greater benefits so afforded by such change.

9. Liability Insurance. For the duration of Indemnitee's service as a director and/or officer of the Company, and thereafter for so long as Indemnitee shall be subject to any pending or possible Proceeding by reason of (or arising in part out of) an Indemnifiable Event, the Company shall use commercially reasonable efforts (taking into account the scope and amount of coverage available relative to the cost thereof) to cause to be maintained in effect policies of directors' and officers' liability insurance providing coverage for directors and/or officers of the Company that is at least substantially comparable in scope and amount to that provided by the Company's current policies of directors' and officers' liability insurance. Notwithstanding the foregoing, the Company shall not be required to maintain said policies of directors' and officers' liability insurance during any time period in which such insurance is not reasonably available or if it is determined in good faith by the then directors of the Company either that: (a) the premium cost of such insurance is substantially disproportionate to the amount of coverage provided thereunder, or (b) the protection provided by such insurance is so limited by exclusions, deductions or otherwise that there is insufficient benefit to warrant the cost of maintaining such insurance.

The Company shall provide Indemnitee with a copy of all directors' and officers' liability insurance applications, binders, policies, declarations, endorsements and other related materials, and shall provide Indemnitee with a reasonable opportunity to review and comment on the same.

10. Amendment of this Agreement. No supplement, modification or amendment of this Agreement shall be binding unless executed in writing by both of the parties hereto. No waiver of any of the provisions of this Agreement shall be binding unless in the form of a writing signed by the party against whom enforcement of the waiver is sought, and no such waiver shall operate as a waiver of any other provisions hereof (whether or not similar), nor shall such waiver constitute a continuing waiver. Except as specifically provided herein, no failure to exercise or any delay in exercising any right or remedy hereunder shall constitute a waiver thereof.

11. Subrogation. In the event of payment under this Agreement, the Company shall be subrogated to the extent of such payment to all of the rights of recovery of Indemnitee, who shall execute all papers required and shall do everything that may be necessary to secure such rights, including the execution of such documents necessary to enable the Company effectively to bring suit to enforce such rights.

12. No Duplication of Payments. The Company shall not be liable under this Agreement to make any payment in connection with any claim made against Indemnitee to the extent Indemnitee has otherwise received payment (under any insurance policy, Bylaw or otherwise) of the amounts otherwise indemnifiable hereunder.

13. Duration of Agreement. All agreements and obligations of the Company contained herein shall continue during the period Indemnitee is a director, officer, employee or other agent of the Company (or is or was serving at the request of the Company as a director, officer, employee or other agent of another corporation, partnership, joint venture, trust, employee benefit plan or other enterprise) and shall continue thereafter so long as Indemnitee shall be subject to any possible claim or threatened, pending or completed action, suit or proceeding, whether civil or criminal, arbitrational, administrative or investigative, by reason of the fact that Indemnitee was serving in the capacity referred to herein.

14. Binding Effect. This Agreement shall be binding upon and inure to the benefit of and be enforceable by the parties hereto and their respective successors (including any direct or indirect successor by purchase, merger, consolidation or otherwise to all or substantially all of the business and/or assets of the Company), assigns, spouses, heirs and personal and legal representatives. The Company shall require and cause any successor (whether direct or indirect by purchase, merger, consolidation or otherwise) to all, substantially all or a substantial part, of the business and/or assets of the Company, by written agreement in form and substance satisfactory to Indemnitee, expressly to assume and agree to perform this Agreement in the same manner and to the same extent that the Company would be required to perform if no such succession had taken place. The indemnification provided under this Agreement shall continue as to Indemnitee for any action taken or not taken while serving in an indemnified capacity pertaining to an Indemnifiable Event even though Indemnitee may have ceased to serve in such capacity at the time of any Proceeding.

15. Severability. If any provision (or portion thereof) of this Agreement shall be held by a court of competent jurisdiction to be invalid, void or otherwise unenforceable, (a) the remaining provisions shall remain enforceable to the fullest extent permitted by law; (b) such provision or provisions shall be deemed reformed to the extent necessary to conform to applicable law and to give the maximum effect to the intent of the parties hereto; and (c) to the fullest extent possible, the provisions of this Agreement (including, without limitation, each portion of this Agreement containing any provision held to be invalid, void or otherwise unenforceable, that is not itself invalid, void or unenforceable) shall be construed so as to give effect to the intent manifested by the provision held invalid, void or unenforceable.

16. Contribution. To the fullest extent permissible under applicable law, whether or not the indemnification provided for in this Agreement is available to Indemnitee for any reason whatsoever, the Company shall pay all or a portion of the amount that would otherwise be incurred by Indemnitee for Expenses in connection with any claim relating to an Indemnifiable Event, as is deemed fair and reasonable in light of all of the circumstances of such Proceeding in order to reflect (i) the relative benefits received by the Company and Indemnitee as a result of the event(s) and/or transaction(s) giving cause to such Proceeding; and/or (ii) the relative fault of the Company (and its directors, officers, employees and agents) and Indemnitee in connection with such event(s) and/or transaction(s).

17. Governing Law. This Agreement shall be governed by and construed and enforced in accordance with the laws of the State of Delaware applicable to contracts made and to be performed in such State without giving effect to its principles of conflicts of laws. The Company and Indemnitee hereby irrevocably and unconditionally (i) agree that any action or proceeding arising out of or in connection with this Agreement may be brought in the Delaware Court of Chancery, (ii) consent to submit to the jurisdiction of the Delaware Court of Chancery for purposes of any action or proceeding arising out of or in connection with this Agreement, (iii) waive any objection to the laying of venue of any such action or proceeding in the Delaware Court of Chancery, and (iv) waive, and agree not to plead or to make, any claim that any such action or proceeding brought in the Delaware Court of Chancery has been brought in an improper or inconvenient forum.

18. Notices. All notices, demands and other communications required or permitted hereunder shall be made in writing and shall be deemed to have been duly given if delivered by hand, against receipt or mailed, postage prepaid, certified or registered mail, return receipt requested and addressed to the Company at:

Energy Recovery, Inc.

1908 Doolittle Drive

San Leandro, CA 94577

Attention: Chief Executive Officer

and to Indemnitee at the address set forth below Indemnitee’s signature hereto. Notice of change of address shall be effective only when given in accordance with this Section. All notices complying with this Section shall be deemed to have been received on the date of hand delivery or on the third business day after mailing.

19. Counterparts. This Agreement may be executed in one or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

(*signature page follows*)

IN WITNESS WHEREOF, the parties hereto have duly executed and delivered this Indemnification Agreement as of the day specified above.

ENERGY RECOVERY, INC., a Delaware corporation

____
(*Signature*)

By: __________________________________
Title: ______________________________

"INDEMNITEE", an individual

____
(*Signature*)

____
(*Print name*)

____
(*Street address*)

____
(*City, State and ZIP*)

Exhibit 10.6

Energy Recovery, Inc.
2008 Equity Incentive Plan
(As Adopted March 25, 2008)

TABLE OF CONTENTS

		Page
ARTICLE 1.	INTRODUCTION	1
ARTICLE 2.	ADMINISTRATION	1
2.1	Committee Composition	1
2.2	Committee Responsibilities	1
2.3	Delegation of Authority	2
ARTICLE 3.	SHARES AVAILABLE FOR GRANTS	2
3.1	Basic Limitation	2
3.2	Annual Increase in Shares	2
3.3	Shares Returned to Reserve	3
3.4	Code Section 162(m) Limitations on Awards	3
ARTICLE 4.	ELIGIBILITY	3
4.1	Incentive Stock Options	3
4.2	Other Grants	3
4.3	Non-U.S. Participants	3
ARTICLE 5.	OPTIONS	4
5.1	Stock Option Agreement	4
5.2	Number of Shares	4
5.3	Exercise Price	4
5.4	Exercisability and Term	4
5.5	Modification or Assumption of Options	4
5.6	Buyout Provisions	5
ARTICLE 6.	PAYMENT FOR OPTION SHARES	5
6.1	General Rule	5
6.2	Surrender of Stock	5
6.3	Exercise/Sale	5
6.4	Other Forms of Payment	5
ARTICLE 7.	STOCK APPRECIATION RIGHTS	5
7.1	SAR Agreement	5
7.2	Number of Shares	5
7.3	Exercise Price	5
7.4	Exercisability and Term	6
7.5	Exercise of SARs	6
7.6	Modification or Assumption of SARs	6
ARTICLE 8.	RESTRICTED SHARES	6
8.1	Restricted Stock Agreement	6
8.2	Payment for Awards	6
8.3	Vesting Conditions	6

		Page
8.4	Voting and Dividend Rights	7
ARTICLE 9.	STOCK UNITS	7
9.1	Stock Unit Agreement	7
9.2	Payment for Awards	7
9.3	Vesting Conditions	7
9.4	Voting and Dividend Rights	7
9.5	Form and Time of Settlement of Stock Units	8
9.6	Creditors' Rights	8
ARTICLE 10.	PROTECTION AGAINST DILUTION	8
10.1	Adjustments	8
10.2	Dissolution or Liquidation	9
10.3	Reorganizations	9
10.4	Acceleration	10
ARTICLE 11.	LIMITATION ON RIGHTS	10
11.1	Retention Rights	10
11.2	Stockholders' Rights	10
11.3	Regulatory Requirements	11
11.4	Section 409A	11
11.5	No Representations or Covenants with Respect to Tax Qualification	11
11.6	Transferability of Awards	11
ARTICLE 12.	WITHHOLDING TAXES	12
12.1	General	12
12.2	Share Withholding	12
ARTICLE 13.	FUTURE OF THE PLAN	12
13.1	Term of the Plan	12
13.2	Amendment or Termination	12
13.3	Stockholder Approval	12
ARTICLE 14.	DEFINITIONS	13

Energy Recovery, Inc.
2008 Equity Incentive Plan

ARTICLE 1. INTRODUCTION.

The Plan was adopted by the Board to be effective immediately prior to the effectiveness of the IPO, subject to the approval of the Company's stockholders. The purpose of the Plan is to promote the long-term success of the Company and the creation of stockholder value by (a) encouraging Employees, Outside Directors and Consultants to focus on critical long-range objectives, (b) encouraging the attraction and retention of Employees, Outside Directors and Consultants with exceptional qualifications and (c) linking Employees, Outside Directors and Consultants directly to stockholder interests through increased stock ownership. The Plan seeks to achieve this purpose by providing for Awards in the form of Restricted Shares, Stock Units, Options (which may constitute ISOs or NSOs) or stock appreciation rights.

The Plan shall be governed by, and construed in accordance with, the laws of the State of California (except its choice-of-law provisions).

ARTICLE 2. ADMINISTRATION.

2.1 Committee Composition. The Committee shall administer the Plan. The Committee shall consist exclusively of two or more directors of the Company, who shall be appointed by the Board. In addition, each member of the Committee shall meet the following requirements:

(a) Any listing standards prescribed by the principal securities market on which the Company's equity securities are traded;

(b) Such requirements as the Internal Revenue Service may establish for outside directors acting under plans intended to qualify for exemption under section 162(m)(4)(C) of the Code;

(c) Such requirements as the Securities and Exchange Commission may establish for administrators acting under plans intended to qualify for exemption under Rule 16b-3 (or its successor) under the Exchange Act; and

(d) Any other requirements imposed by applicable law, regulations or rules.

2.2 Committee Responsibilities. The Committee shall (a) select the Employees, Outside Directors and Consultants who are to receive Awards under the Plan, (b) determine the type, number, vesting requirements and other features and conditions of such Awards, (c) interpret the Plan, (d) make all other decisions relating to the operation of the Plan and (e) carry out any other duties delegated to it by the Board. The Committee may adopt such

rules or guidelines as it deems appropriate to implement the Plan, including rules and procedures relating to the operation and administration of the Plan in order to accommodate the specific requirements of local laws and procedures, as further set forth under Section 4.3 below. The Committee's determinations under the Plan shall be final and binding on all persons.

2.3 Delegation of Authority. The Board may also appoint a secondary committee of the Board, which shall be composed of the entire Board or of one or more directors of the Company who need not satisfy the requirements of Section 2.1. Such secondary committee may administer the Plan with respect to Employees and Consultants who are not Outside Directors and are not considered executive officers of the Company under section 16 of the Exchange Act, may grant Awards under the Plan to such Employees and Consultants and may determine all features and conditions of such Awards. Within the limitations of this Section 2.3, any reference in the Plan to the Committee shall include such secondary committee. Further, to the extent permitted by applicable law, the Board may from time to time delegate to one or more officers of the Company the authority to grant or amend Awards to Employees and Consultants who are not Outside Directors and are not considered executive officers of the Company under section 16 of the Exchange Act. For the avoidance of doubt, provided it meets the limitation in the preceding sentence, this delegation shall include the right to modify Awards as necessary to accommodate changes in the laws or regulations, including in jurisdictions outside the United States. Any delegation hereunder shall be subject to the restrictions and limits that the Board specifies at the time of such delegation, and the Board may at any time rescind the authority so delegated or appoint a new delegatee. At all times, the delegatee appointed under this Section 2.3 shall serve in such capacity at the pleasure of the Board.

ARTICLE 3. SHARES AVAILABLE FOR GRANTS.

3.1 Basic Limitation. Common Stock issued pursuant to the Plan may be authorized but unissued shares or treasury shares. The aggregate number of shares of Common Stock authorized for issuance or transfer under the Plan is 1,000,000 shares of Common Stock, plus the additional Common Stock described in Sections 3.2 and 3.3. The number of shares of Common Stock that are subject to Awards outstanding at any time under the Plan shall not exceed the number of shares of Common Stock that then remain available for issuance under the Plan. All Common Stock available under the Plan may be issued upon the exercise of ISOs. The limitations of this Section 3.1 and Section 3.2 shall be subject to adjustment pursuant to Article 10.

3.2 Annual Increase in Shares. As of the first day of each fiscal year of the Company, commencing on January 1, 2009, the aggregate number of shares of Common Stock that may be issued or transferred under the Plan shall automatically increase by a number equal to the lowest of (a) 5% of the total number of shares of Common Stock then outstanding on a non-diluted basis, (b) 2,500,000 shares of Common Stock or (c) the number determined by the Board. Anything to the contrary herein notwithstanding, the maximum aggregate number of shares of Common Stock that may be issued or transferred pursuant to Awards under the Plan during the term of the Plan shall not exceed 10,000,000 shares of Common Stock, subject to Article 10.

3.3 Shares Returned to Reserve. If Options, SARs or Stock Units under this Plan are forfeited or terminate for any other reason before being exercised or settled, then the Common Stock subject to such Options, SARs or Stock Units shall again become available for issuance under this Plan. If Restricted Shares or Common Stock issued upon the exercise of Options under this Plan are reacquired by the Company pursuant to a forfeiture provision or for any other reason, then such Common Stock shall again become available for issuance under this Plan. If SARs are exercised, then only the number of shares of Common Stock (if any) actually issued in settlement of such SARs shall reduce the number available under Section 3.1 and the balance shall again become available for issuance under the Plan. If Stock Units are settled, then only the number of shares of Common Stock (if any) actually issued in settlement of such Stock Units shall reduce the number available under Section 3.1 and the balance shall again become available for issuance under the Plan.

3.4 Code Section 162(m) Limitations on Awards. Subject to adjustment pursuant to Article 10, where it is intended to comply with Section 162(m) of the Code, no Employee shall be eligible to be granted in a single calendar year one or more Awards which in the aggregate cover more than 500,000 shares of Common Stock, except that in the calendar year in which an individual's Service as an Employee first commences, such Employee shall be eligible to be granted one or more Awards which in the aggregate cover up to 800,000 shares of Common Stock. To the extent required by Section 162(m) of the Code, in applying the foregoing limitation with respect to a Participant, if any Option, SAR, grant of Restricted Shares or Stock Units is canceled, the canceled Award shall continue to count against the maximum number of shares of Common Stock with respect to which an Award may be granted to an Employee.

ARTICLE 4. ELIGIBILITY.

4.1 Incentive Stock Options. Only Employees who are common-law employees of the Company, a Parent or a Subsidiary shall be eligible for the grant of ISOs. In addition, an Employee who owns more than 10% of the total combined voting power of all classes of outstanding stock of the Company or any of its Parents or Subsidiaries shall not be eligible for the grant of an ISO unless the requirements set forth in section 422(c)(5) of the Code are satisfied.

4.2 Other Grants. Only Employees, Outside Directors and Consultants shall be eligible for the grant of Restricted Shares, Stock Units, NSOs or SARs.

4.3 Non-U.S. Participants. Notwithstanding any provision of the Plan to the contrary, in order to comply with the laws in countries outside the United States in which the Company and its Subsidiaries or Affiliates operate or have eligible Employees, Outside Directors or Consultants, the Committee, in its sole discretion, shall have the power and authority to: (i) determine which Subsidiaries and Affiliates shall be covered by the Plan; (ii) determine which eligible Employees, Outside Directors or Consultants outside the United States are eligible to participate in the Plan; (iii) modify the terms and conditions of any Award granted to eligible Employees, Outside Directors or Consultants outside the United States to comply with applicable laws of jurisdictions outside of the United States; (iv) establish subplans and modify exercise procedures and other terms and procedures and rules, to the extent such actions may be necessary

or advisable, including adoption of rules, procedures or subplans applicable to particular Subsidiaries or Affiliates or Participants residing in particular locations; provided, however, that no such subplans and/or modifications shall increase the share limitations contained in Sections 3.1 and 3.2 hereof; and (v) take any action, before or after an Award is made, that it deems advisable to obtain approval or comply with any necessary local governmental regulatory exemptions or approvals. Without limiting the generality of the foregoing, the Committee is specifically authorized to adopt rules, procedures and subplans with provisions that limit or modify rights on death, disability or on termination of employment, available methods of exercise or settlement of an Award, payment of income, social insurance contributions and payroll taxes, the shifting of employer tax liability to the Participant, the withholding procedures, the conversion of local currency and handling of any stock certificates or other indicia of ownership which may vary with local requirements. Notwithstanding the foregoing, the Committee may not take any actions hereunder, and no Awards shall be granted, that would violate the Exchange Act, the Code, any securities law or governing statute or any other applicable law.

ARTICLE 5. OPTIONS.

5.1 Stock Option Agreement. Each grant of an Option under the Plan shall be evidenced by a Stock Option Agreement between the Optionee and the Company. Such Option shall be subject to all applicable terms of the Plan and may be subject to any other terms that are not inconsistent with the Plan. The Stock Option Agreement shall specify whether the Option is an ISO or an NSO. The provisions of the various Stock Option Agreements entered into under the Plan need not be identical.

5.2 Number of Shares. Each Stock Option Agreement shall specify the number of shares of Common Stock subject to the Option and shall provide for the adjustment of such number in accordance with Article 10.

5.3 Exercise Price. Each Stock Option Agreement shall specify the Exercise Price; provided that the Exercise Price shall in no event be less than 100% of the Fair Market Value of a share of Common Stock on the date of grant.

5.4 Exercisability and Term. Each Stock Option Agreement shall specify the date or event when all or any installment of the Option is to become exercisable. The Stock Option Agreement shall also specify the term of the Option; provided that the term of an ISO shall in no event exceed ten years from the date of grant. A Stock Option Agreement may provide for accelerated exercisability in the event of the Optionee’s death, disability or other events and may provide for expiration prior to the end of its term in the event of the termination of the Optionee’s Service.

5.5 Modification or Assumption of Options. Within the limitations of the Plan, the Committee may modify, reprice, extend or assume outstanding options or may accept the cancellation of outstanding options (whether granted by the Company or by another issuer) in return for the grant of new options for the same or a different number of shares and at the same or a different exercise price. The foregoing notwithstanding, no modification of an Option shall, without the consent of the Optionee, alter or impair his or her rights or obligations under such

Option, unless such modification is necessary or desirable to comply with applicable law, as determined by the Board.

5.6 Buyout Provisions. The Committee may at any time (a) offer to buy out for a payment in cash or cash equivalents an Option previously granted or (b) authorize an Optionee to elect to cash out an Option previously granted, in either case at such time and based upon such terms and conditions as the Committee shall establish.

ARTICLE 6. PAYMENT FOR OPTION SHARES.

6.1 General Rule. The entire Exercise Price of Common Stock issued upon exercise of Options shall be payable in cash or cash equivalents at the time when such Common Stock is purchased, except that the Committee at its sole discretion may accept payment of the Exercise Price in any other form(s) described in this Article 6. However, if the Optionee is an Outside Director or executive officer of the Company, he or she may pay the Exercise Price in a form other than cash or cash equivalents only to the extent permitted by section 13(k) of the Exchange Act.

6.2 Surrender of Stock. With the Committee's consent, all or any part of the Exercise Price may be paid by surrendering, or attesting to the ownership of, Common Stock that is already owned by the Optionee. Such Common Stock shall be valued at its Fair Market Value on the date when the new Common Stock is purchased under the Plan.

6.3 Exercise/Sale. With the Committee's consent, all or any part of the Exercise Price and any withholding taxes may be paid by delivering (on a form prescribed by the Company) an irrevocable direction to a securities broker approved by the Company to sell all or part of the Common Stock being purchased under the Plan and to deliver all or part of the sales proceeds to the Company.

6.4 Other Forms of Payment. With the Committee's consent, all or any part of the Exercise Price and any withholding taxes may be paid in any other form that is consistent with applicable laws, regulations and rules.

ARTICLE 7. STOCK APPRECIATION RIGHTS.

7.1 SAR Agreement. Each grant of a SAR under the Plan shall be evidenced by an SAR Agreement between the Optionee and the Company. Such SAR shall be subject to all applicable terms of the Plan and may be subject to any other terms that are not inconsistent with the Plan. The provisions of the various SAR Agreements entered into under the Plan need not be identical.

7.2 Number of Shares. Each SAR Agreement shall specify the number of shares of Common Stock to which the SAR pertains and shall provide for the adjustment of such number in accordance with Article 10.

7.3 Exercise Price. Each SAR Agreement shall specify the Exercise Price; provided that the Exercise Price shall in no event be less than 100% of the Fair Market Value of a share of Common Stock on the date of grant.

7.4 Exercisability and Term. Each SAR Agreement shall specify the date when all or any installment of the SAR is to become exercisable. The SAR Agreement shall also specify the term of the SAR. A SAR Agreement may provide for accelerated exercisability in the event of the Optionee's death, disability or other events and may provide for expiration prior to the end of its term in the event of the termination of the Optionee's Service.

7.5 Exercise of SARs. Upon exercise of a SAR, the Optionee (or any person having the right to exercise the SAR after his or her death) shall receive from the Company consideration in the form of (a) Common Stock, (b) cash or (c) a combination of Common Stock and cash, as the Committee shall determine. Each SAR Agreement shall specify the amount and/or Fair Market Value of the consideration that the Optionee will receive upon exercising the SAR; provided that the aggregate consideration shall not exceed the amount by which the Fair Market Value (on the date of exercise) of the Common Stock subject to the SAR exceeds the Exercise Price of the SAR. A SAR Agreement may also provide for an automatic exercise of the SAR subject to any applicable requirements.

7.6 Modification or Assumption of SARs. Within the limitations of the Plan, the Committee may modify, reprice, extend or assume outstanding SARs or may accept the cancellation of outstanding SARs (whether granted by the Company or by another issuer) in return for the grant of new SARs for the same or a different number of shares and at the same or a different exercise price. The foregoing notwithstanding, no modification of a SAR shall, without the consent of the Optionee, alter or impair his or her rights or obligations under such SAR, unless such modification is necessary or desirable to comply with applicable law, as determined by the Board.

ARTICLE 8. RESTRICTED SHARES.

8.1 Restricted Stock Agreement. Each grant of Restricted Shares under the Plan shall be evidenced by a Restricted Stock Agreement between the recipient and the Company. Such Restricted Shares shall be subject to all applicable terms of the Plan and may be subject to any other terms that are not inconsistent with the Plan. The provisions of the various Restricted Stock Agreements entered into under the Plan need not be identical.

8.2 Payment for Awards. Restricted Shares may be sold or awarded under the Plan for such consideration as the Committee may determine, including (without limitation) cash, cash equivalents and property. If the Participant is an Outside Director or executive officer of the Company, he or she may pay for Restricted Shares with a promissory note only to the extent permitted by section 13(k) of the Exchange Act. Within the limitations of the Plan, the Committee may accept the cancellation of outstanding options in return for the grant of Restricted Shares.

8.3 Vesting Conditions. Each Award of Restricted Shares may or may not be subject to vesting. Vesting shall occur, in full or in installments, upon satisfaction of the conditions specified in the Restricted Stock Agreement. The Committee may include among such conditions the requirement that the performance of the Company or a business unit of the Company for a specified period of one or more fiscal years equal or exceed a target determined in advance by the Committee. The Committee shall determine such performance. Such target

shall be based on one or more of the criteria set forth in Appendix A or, for Awards not intended to comply with Section 162(m) of the Code, such other performance criteria determined by the Board. The Committee shall identify such target not later than the 90th day of such period or prior to the expiry of 25% of the period, whichever date occurs earlier. A Restricted Stock Agreement may provide for accelerated vesting in the event of the Participant's death, disability or other events.

8.4 Voting and Dividend Rights. The holders of Restricted Shares awarded under the Plan shall have the same voting, dividend and other rights as the Company's other stockholders. A Restricted Stock Agreement, however, may require that the holders of Restricted Shares invest any cash dividends received in additional Restricted Shares. Such additional Restricted Shares shall be subject to the same conditions and restrictions as the Award with respect to which the dividends were paid.

ARTICLE 9. STOCK UNITS.

9.1 Stock Unit Agreement. Each grant of Stock Units under the Plan shall be evidenced by a Stock Unit Agreement between the recipient and the Company. Such Stock Units shall be subject to all applicable terms of the Plan and may be subject to any other terms that are not inconsistent with the Plan. The provisions of the various Stock Unit Agreements entered into under the Plan need not be identical.

9.2 Payment for Awards. To the extent that an Award is granted in the form of Stock Units, no cash consideration shall be required of the Award recipients.

9.3 Vesting Conditions. Each Award of Stock Units may or may not be subject to vesting. Vesting shall occur, in full or in installments, upon satisfaction of the conditions specified in the Stock Unit Agreement. The Committee may include among such conditions the requirement that the performance of the Company or a business unit of the Company for a specified period of one or more fiscal years equal or exceed a target determined in advance by the Committee. The Committee shall determine such performance. Such target shall be based on one or more of the criteria set forth in Appendix A or, for Awards not intended to comply with Section 162(m) of the Code, such other performance criteria determined by the Board. The Committee shall identify such target not later than the 90th day of such period or prior to the expiry of 25% of the period, whichever date occurs earlier. A Stock Unit Agreement may provide for accelerated vesting in the event of the Participant's death, disability or other events.

9.4 Voting and Dividend Rights. The holders of Stock Units shall have no voting rights. Prior to settlement or forfeiture, any Stock Unit awarded under the Plan may, at the Committee's discretion, carry with it a right to dividend equivalents. Such right entitles the holder to be credited with an amount equal to all cash dividends paid on one share of Common Stock while the Stock Unit is outstanding. Dividend equivalents may be converted into additional Stock Units. Settlement of dividend equivalents may be made in the form of cash, in the form of Common Stock, or in a combination of both. Prior to distribution, any dividend equivalents that are not paid shall be subject to the same conditions and restrictions as the Stock Units to which they attach.

9.5 Form and Time of Settlement of Stock Units. Settlement of vested Stock Units may be made in the form of (a) cash, (b) Common Stock or (c) any combination of both, as determined by the Committee. The actual number of Stock Units eligible for settlement may be larger or smaller than the number included in the original Award, based on predetermined performance factors. Methods of converting Stock Units into cash may include (without limitation) a method based on the average Fair Market Value of Common Stock over a series of trading days. Vested Stock Units may be settled in a lump sum or in installments. The distribution may occur or commence when all vesting conditions applicable to the Stock Units have been satisfied or have lapsed, or it may be deferred to any later date. Until an Award of Stock Units is settled, the number of such Stock Units shall be subject to adjustment pursuant to Article 10.

9.6 Creditors' Rights. A holder of Stock Units shall have no rights other than those of a general creditor of the Company. Stock Units represent an unfunded and unsecured obligation of the Company, subject to the terms and conditions of the applicable Stock Unit Agreement.

ARTICLE 10. PROTECTION AGAINST DILUTION.

10.1 Adjustments. In the event of a subdivision of the outstanding Common Stock, a declaration of a dividend payable in Common Stock or a combination or consolidation of the outstanding Common Stock (by reclassification or otherwise) into a lesser number of shares of Common Stock, corresponding adjustments shall automatically be made in each of the following:

(a) The number of Options, SARs, Restricted Shares and Stock Units available for future Awards under Article 3, including the 1,000,000 share limitation set forth in Section 3.1 and the 10,000,000 share limitation set forth in Section 3.2;

(b) The limitations set forth in Sections 5.2, 7.2, 8.3 and 9.3;

(c) The number of shares of Common Stock covered by each outstanding Option and SAR;

(d) The Exercise Price under each outstanding Option and SAR; or

(e) The number of Stock Units included in any prior Award that has not yet been settled.

In the event of a declaration of an extraordinary dividend payable in a form other than Common Stock in an amount that has a material effect on the price of Common Stock, a recapitalization, a spin-off or a similar occurrence, the Committee shall make such adjustments as it, in its sole discretion, deems appropriate in one or more of the foregoing. Except as provided in this Article 10, a Participant shall have no rights by reason of any issuance by the Company of stock of any class or securities convertible into stock of any class, any subdivision or consolidation of shares

of stock of any class, the payment of any stock dividend or any other increase or decrease in the number of shares of stock of any class.

10.2 Dissolution or Liquidation. To the extent not previously exercised or settled, Options, SARs and Stock Units shall terminate immediately prior to the dissolution or liquidation of the Company.

10.3 Reorganizations. In the event that the Company is a party to a merger or consolidation, all outstanding Awards shall be subject to the agreement of merger or consolidation approved by the Board of Directors, provided that such agreement shall provide for one or more of the following:

(a) The continuation of such outstanding Awards by the Company (if the Company is the surviving corporation).

(b) The assumption of such outstanding Awards by the surviving corporation or its parent, provided that the assumption of Options or SARs shall comply with Section 424(a) of the Code (whether or not the Options are ISOs).

(c) The substitution by the surviving corporation or its parent of new awards for such outstanding Awards, provided that the substitution of Options or SARs shall comply with Section 424(a) of the Code (whether or not the Options are ISOs).

(d) The acceleration of the exercisability of 100% of the then unexercisable portion of such Options and SARs and acceleration of vesting of 100% of the then unvested portion of the Common Stock subject to such Options and SARs. The acceleration of exercisability of such Options and SARs and vesting of such Common Stock may be contingent on the closing of such merger or consolidation. The Optionee shall be able to exercise such Options and SARs during a period of not less than five full business days preceding the closing date of such merger or consolidation, unless (i) a shorter period is required to permit a timely closing of such merger or consolidation and (ii) such shorter period still offers the Optionees a reasonable opportunity to exercise such Options and SARs. Any exercise of such Options and SARs during such period may be contingent on the closing of such merger or consolidation.

(e) The cancellation of outstanding Options and SARs and a payment to the Optionees equal to the excess of (i) the Fair Market Value of the Common Stock subject to such Options and SARs (whether or not such Options and SARs are then exercisable or such Common Stock are then vested) as of the closing date of such merger or consolidation over (ii) their Exercise Price. Such payment shall be made in the form of cash, cash equivalents, or securities of the surviving corporation or its parent with a Fair Market Value equal to the required amount. Such payment may be made in installments and may be deferred until the date or dates when such Options and SARs would have become exercisable or

such Common Stock would have vested. Such payment may be subject to vesting based on the Optionee's continuing Service, provided that the vesting schedule shall not be less favorable to the Optionee than the schedule under which such Options and SARs would have become exercisable or such Common Stock would have vested. If the Exercise Price of the Common Stock subject to such Options and SARs exceeds the Fair Market Value of such Common Stock, then such Options and SARs may be cancelled without making a payment to the Optionees. For purposes of this Subsection (e), the Fair Market Value of any security shall be determined without regard to any vesting conditions that may apply to such security.

(f) The cancellation of outstanding Stock Units and a payment to the Participants equal to the Fair Market Value of the Common Stock subject to such Stock Units (whether or not such Stock Units are then vested) as of the closing date of such merger or consolidation. Such payment shall be made in the form of cash, cash equivalents, or securities of the surviving corporation or its parent with a Fair Market Value equal to the required amount. Such payment may be made in installments and may be deferred until the date or dates when such Stock Units would have vested. Such payment may be subject to vesting based on the Participant's continuing Service, provided that the vesting schedule shall not be less favorable to the Participant than the schedule under which such Stock Units would have vested. For purposes of this Subsection (f), the Fair Market Value of any security shall be determined without regard to any vesting conditions that may apply to such security.

10.4 Acceleration. The Committee shall have the discretion, exercisable either at the time the Award is granted or at any time while the Award remains outstanding, to provide for the automatic acceleration of vesting upon the occurrence of a Change in Control, whether or not the Award is to be assumed or replaced in the Change in Control, or in connection with a termination of a Participant's Service following a Change in Control.

ARTICLE 11.LIMITATION ON RIGHTS.

11.1 Retention Rights. Neither the Plan nor any Award granted under the Plan shall be deemed to give any individual a right to remain an Employee, Outside Director or Consultant. The Company and its Parents, Subsidiaries and Affiliates reserve the right to terminate the Service of any Employee, Outside Director or Consultant at any time, with or without cause, subject to applicable laws, the Company's certificate of incorporation and by-laws and a written employment agreement (if any).

11.2 Stockholders' Rights. A Participant shall have no dividend rights, voting rights or other rights as a stockholder with respect to any Common Stock covered by his or her Award prior to the time when a stock certificate for such Common Stock is issued or, if applicable, the time when he or she becomes entitled to receive such Common Stock by filing any required notice of exercise and paying any required Exercise Price. No adjustment shall be made for cash dividends or other rights for which the record date is prior to such time, except as expressly provided in the Plan.

11.3 Regulatory Requirements. Any other provision of the Plan notwithstanding, the obligation of the Company to issue Common Stock under the Plan shall be subject to all applicable laws, rules and regulations and such approval by any regulatory body as may be required. The Company reserves the right to restrict, in whole or in part, the delivery of Common Stock pursuant to any Award prior to the satisfaction of all legal requirements relating to the issuance of such Common Stock, to its registration, qualification or listing or to an exemption from registration, qualification or listing (including any Non-U.S. requirements).

11.4 Section 409A. Except as provided in Section 11.5 hereof, to the extent that the Committee determines that any Award granted under the Plan is subject to Section 409A of the Code, the agreement evidencing such Award shall incorporate the terms and conditions required by Section 409A of the Code. To the extent applicable, the Plan and Award agreements shall be interpreted in accordance with Section 409A of the Code and Department of Treasury regulations and other interpretive guidance issued thereunder, including without limitation any such regulations or other guidance that may be issued after the Plan effective date. Notwithstanding any provision of the Plan to the contrary, in the event that, following the Plan effective date, the Committee determines that any Award may be subject to Section 409A of the Code and related Department of Treasury guidance (including such Department of Treasury guidance as may be issued after the Plan effective date), the Committee may adopt such amendments to the Plan and the applicable Award agreement or adopt other policies and procedures (including amendments, policies and procedures with retroactive effect), or take any other actions, that the Committee determines are necessary or appropriate to (a) exempt the Award from Section 409A of the Code and/or preserve the intended tax treatment of the benefits provided with respect to the Award, or (b) comply with the requirements of Section 409A of the Code and related Department of Treasury guidance and thereby avoid the application of any penalty taxes under such Section.

11.5 No Representations or Covenants with Respect to Tax Qualification. Although the Company may endeavor to (1) qualify an Award for favorable tax treatment under the laws of the United States or jurisdictions outside of the United States (e.g., incentive stock options under Section 422 of the Code or French-qualified stock options) or (2) avoid adverse tax treatment (e.g., under Section 409A of the Code), the Company makes no representation to that effect and expressly disavows any covenant to maintain favorable or avoid unfavorable tax treatment, anything to the contrary in this Plan, including Section 11.4 hereof, notwithstanding. The Company shall be unconstrained in its corporate activities without regard to the potential negative tax impact on holders of Awards under the Plan.

11.6 Transferability of Awards. No right or interest of a Participant in any Award may be pledged, encumbered, or hypothecated to or in favor of any party other than the Company, or shall be subject to any lien, obligation, or liability of such Participant to any other party other than the Company or a Parent, Subsidiary or Affiliate. Except as otherwise provided by the Committee, no Award shall be assigned, transferred, or otherwise disposed of by a Participant other than by will or the laws of descent and distribution or pursuant to beneficiary designation procedures approved from time to time by the Committee. The Committee, by express provision in the Award Agreement or an amendment thereto may permit an Award (other than an Incentive Stock Option) to be transferred to, exercised by and paid to certain persons or entities related to the Participant, including, but not limited to, members of the

Participant's family, charitable institutions, or trusts or other entities whose beneficiaries or beneficial owners are members of the Participant's family and/or charitable institutions, or to such other persons or entities as may be expressly approved by the Committee, pursuant to such conditions and procedures as the Committee may establish. Any permitted transfer shall be subject to the condition that the Committee receive evidence satisfactory to it that the transfer is being made for estate and/or tax planning purposes (or to a "blind trust" in connection with the Participant's termination of employment or service with the Company or a Subsidiary to assume a position with a governmental, charitable, educational or similar non-profit institution) and on a basis consistent with the Company's lawful issue of securities.

ARTICLE 12.WITHHOLDING TAXES.

12.1 General. To the extent required by applicable federal, state, local or foreign law, a Participant or his or her successor shall make arrangements satisfactory to the Company for the satisfaction of any withholding tax obligations that arise in connection with the Plan. The Company shall not be required to issue any Common Stock or make any cash payment under the Plan until such obligations are satisfied.

12.2 Share Withholding. To the extent that applicable law subjects a Participant to tax withholding obligations, the Company shall have the right to satisfy all or part of such obligations by withholding all or a portion of any Common Stock that otherwise would be issued to the Participant. In addition, the Committee may permit such Participant to satisfy all or any part of such obligations by surrendering all or a portion of any Common Stock that he or she previously acquired. Such Common Stock shall be valued at its Fair Market Value on the date when it is withheld or surrendered.

ARTICLE 13. FUTURE OF THE PLAN.

13.1 Term of the Plan. The Plan, as set forth herein, shall become effective immediately prior to the effective date of the IPO. The Plan shall remain in effect until the earlier of (a) the date when the Plan is terminated under Section 13.2 or (b) the seventh anniversary of the date when the Board adopted the Plan.

13.2 Amendment or Termination. The Board may, at any time and for any reason, amend or terminate the Plan. No Awards shall be granted under the Plan after the termination thereof. The termination of the Plan, or any amendment thereof, shall not affect any Award previously granted under the Plan. Notwithstanding anything in the foregoing, the Board shall have the right to unilaterally amend, modify or discontinue the Plan, or any provision of the Plan or any provision of an Award agreement and, in each case, without the consent of any Participant, provided such amendment, modification or discontinuance is necessary or desirable to comply with applicable law, as determined by the Board.

13.3 Stockholder Approval. An amendment of the Plan shall be subject to the approval of the Company's stockholders only to the extent required by applicable laws, regulations or rules. However, section 162(m) of the Code may require that the Company's stockholders approve:

(a) The Plan not later than the first regular meeting of stockholders that occurs in the fourth calendar year following the calendar year in which the Company's IPO occurred; and

(b) The performance criteria set forth in Appendix A not later than the first meeting of stockholders that occurs in the fifth year following the year in which the Company's stockholders previously approved such criteria.

ARTICLE 14. DEFINITIONS.

14.1 "**Affiliate**" means any entity other than a Subsidiary, if the Company and/or one or more Subsidiaries own not less than 50% of such entity.

14.2 "**Award**" means any award of an Option, a SAR, a Restricted Share or a Stock Unit under the Plan.

14.3 "**Board**" means the Company's Board of Directors, as constituted from time to time.

14.4 "**Change in Control**" means:

(a) The consummation of a merger or consolidation of the Company with or into another entity or any other corporate reorganization, if persons who were not stockholders of the Company immediately prior to such merger, consolidation or other reorganization own immediately after such merger, consolidation or other reorganization 50% or more of the voting power of the outstanding securities of each of (i) the continuing or surviving entity and (ii) any direct or indirect parent corporation of such continuing or surviving entity;

(b) The sale, transfer or other disposition of all or substantially all of the Company's assets;

(c) A change in the composition of the Board, as a result of which fewer than 50% of the incumbent directors are directors who either:

(i) Had been directors of the Company on the date 24 months prior to the date of such change in the composition of the Board (the "Original Directors"); or

(ii) Were appointed to the Board, or nominated for election to the Board, with the affirmative votes of at least a majority of the aggregate of (A) the Original Directors who were in office at the time of their appointment or nomination and (B) the directors whose appointment or nomination was previously approved in a manner consistent with this Paragraph (ii); or

(d) Any transaction as a result of which any person is the "beneficial owner" (as defined in Rule 13d-3 under the Exchange Act), directly or

indirectly, of securities of the Company representing at least 50% of the total voting power represented by the Company's then outstanding voting securities. For purposes of this Subsection (d), the term "person" shall have the same meaning as when used in sections 13(d) and 14(d) of the Exchange Act but shall exclude (i) a trustee or other fiduciary holding securities under an employee benefit plan of the Company or of a Parent or Subsidiary and (ii) a corporation owned directly or indirectly by the stockholders of the Company in substantially the same proportions as their ownership of the common stock of the Company.

A transaction shall not constitute a Change in Control if its sole purpose is to change the state of the Company's incorporation or to create a holding company that will be owned in substantially the same proportions by the persons who held the Company's securities immediately before such transaction.

14.5 "**Code**" means the Internal Revenue Code of 1986, as amended.

14.6 "**Committee**" means a committee of the Board, as described in Article 2.

14.7 "**Common Stock**" means one share of the common stock of the Company.

14.8 "**Company**" means Energy Recovery, Inc., a Delaware corporation.

14.9 "**Consultant**" means a consultant or adviser who provides bona fide services to the Company, a Parent, a Subsidiary or an Affiliate as an independent contractor.

14.10 "**Employee**" means a common-law employee of the Company, a Parent, a Subsidiary or an Affiliate.

14.11 "**Exchange Act**" means the Securities Exchange Act of 1934, as amended.

14.12 "**Exercise Price**," in the case of an Option, means the amount for which one share of Common Stock may be purchased upon exercise of such Option, as specified in the applicable Stock Option Agreement. "Exercise Price," in the case of a SAR, means an amount, as specified in the applicable SAR Agreement, which is subtracted from the Fair Market Value of one share of Common Stock in determining the amount payable upon exercise of such SAR.

14.13 "**Fair Market Value**" means, (a) if the Common Stock is traded on any established stock exchange, the closing price of a share as quoted on the principal exchange on which the Common Stock is listed, as reported in the *Wall Street Journal* (or such other source as the Company may deem reliable for such purposes) for such date, or if no sale occurred on such date, the first trading date immediately prior to such date during which a sale occurred; or (b) if the Common Stock is not traded on an exchange but are regularly quoted on a national market or other quotation system, the closing sales price on such date as quoted on such market or system, or if no sales occurred on such date, then on the date immediately prior to such date on which sales prices are reported; or (c) in the absence of an established market for the Common Stock of the type described in (a) or (b) of this Section 14.13, the fair market value established by the Committee acting in good faith. Such determination shall be conclusive and binding on all persons.

14.14 “**IPO**” means the initial public offering of the Company’s Common Stock.

14.15 “**ISO**” means an incentive stock option described in section 422(b) of the Code.

14.16 “**NSO**” means a stock option not described in sections 422 or 423 of the Code.

14.17 “**Option**” means an ISO or NSO granted under the Plan and entitling the holder to purchase Common Stock.

14.18 “**Optionee**” means an individual or estate who holds an Option or SAR.

14.19 “**Outside Director**” means a member of the Board who is not an Employee.

14.20 “**Parent**” means any corporation (other than the Company) in an unbroken chain of corporations ending with the Company, if each of the corporations other than the Company owns stock possessing 50% or more of the total combined voting power of all classes of stock in one of the other corporations in such chain. A corporation that attains the status of a Parent on a date after the adoption of the Plan shall be considered a Parent commencing as of such date.

14.21 “**Participant**” means an individual or estate who holds an Award.

14.22 “**Plan**” means this Energy Recovery, Inc. 2008 Equity Incentive Plan, as amended from time to time.

14.23 “**Restricted Share**” means a share of Common Stock awarded under the Plan.

14.24 “**Restricted Stock Agreement**” means the agreement between the Company and the recipient of a Restricted Share that contains the terms, conditions and restrictions pertaining to such Restricted Share.

14.25 “**SAR**” means a stock appreciation right granted under the Plan.

14.26 “**SAR Agreement**” means the agreement between the Company and an Optionee that contains the terms, conditions and restrictions pertaining to his or her SAR.

14.27 “**Service**” means service as an Employee, Outside Director or Consultant.

14.28 “**Stock Option Agreement**” means the agreement between the Company and an Optionee that contains the terms, conditions and restrictions pertaining to his or her Option.

14.29 “**Stock Unit**” means a bookkeeping entry representing the equivalent of one share of Common Stock, as awarded under the Plan.

14.30 “**Stock Unit Agreement**” means the agreement between the Company and the recipient of a Stock Unit that contains the terms, conditions and restrictions pertaining to such Stock Unit.

14.31 “**Subsidiary**” means any corporation (other than the Company) in an unbroken chain of corporations beginning with the Company, if each of the corporations other than the last corporation in the unbroken chain owns stock possessing 50% or more of the total combined voting power of all classes of stock in one of the other corporations in such chain. A corporation that attains the status of a Subsidiary on a date after the adoption of the Plan shall be considered a Subsidiary commencing as of such date.

Appendix A

Performance Criteria for Restricted Shares and Stock Units

The performance goals that may be used by the Committee for such awards shall consist of: operating profits (including EBITDA), net profits, earnings per share, profit returns and margins, revenues, stockholder return and/or value, stock price and working capital. Performance goals may be measured solely on a corporate, Subsidiary or business unit basis, or a combination thereof. Further, performance criteria may reflect absolute entity performance or a relative comparison of entity performance to the performance of a peer group of entities or other external measure of the selected performance criteria. Profit, earnings and revenues used for any performance goal measurement shall exclude: gains or losses on operating asset sales or dispositions; asset write-downs; litigation or claim judgments or settlements; accruals for historic environmental obligations; effect of changes in tax law or rate on deferred tax liabilities; accruals for reorganization and restructuring programs; uninsured catastrophic property losses; the cumulative effect of changes in accounting principles; and any extraordinary non-recurring items as described in Accounting Principles Board Opinion No. 30 and/or in management's discussion and analysis of financial performance appearing in the Company's annual report to stockholders for the applicable year.

ENERGY RECOVERY, INC.

2008 EQUITY INCENTIVE PLAN

STOCK OPTION GRANT NOTICE AND
STOCK OPTION AGREEMENT

You (the “Optionee”) have been granted the following option (the “Option”) to purchase shares of the Common Stock of Energy Recovery, Inc. (the “Company”):

Name of Optionee:	
Total Number of shares of Common Stock:	
Type of Option:	
Exercise Price per Share:	
Date of Grant:	
Vesting Commencement Date:	
Vesting Schedule:	[This Option becomes exercisable with respect to the first 25% of the shares subject to this Option when you complete 12 months of continuous Service from the Vesting Commencement Date. Thereafter, this Option becomes exercisable with respect to an additional 1/48th of the shares subject to this Option when you complete each month of Service.]
Expiration Date:	«ExpDate». This Option expires earlier if your Service terminates earlier, as described in the Stock Option Agreement.

This Option is granted under and governed by the terms and conditions of the Stock Option Agreement, which is attached to and made a part of this document, and the 2008 Equity Incentive Plan (the “Plan”). Unless otherwise defined herein, the terms defined in the Plan shall have the same defined meanings in this Grant Notice and the Stock Option Agreement.

By your signature, you agree to be bound by the terms and conditions of the Plan, the Stock Option Agreement and this Grant Notice. You have reviewed the Stock Option Agreement, the Plan and this Grant Notice in their entirety, have had an opportunity to obtain the advice of counsel prior to executing this Grant Notice and fully understand all provisions of this Grant Notice, the Stock Option Agreement and the Plan. You hereby agree to accept as binding, conclusive and final all decisions or interpretations of the Committee upon any questions arising under the Plan or relating to the Option.

OPTIONEE:	**ENERGY RECOVERY, INC.**
________________________	By: ________________________
	Title: ________________________

STOCK OPTION AGREEMENT

1. Grant of Option. Pursuant to the Stock Option Grant Notice (the “Grant Notice”) to which this Stock Option Agreement (this “Agreement”) is attached, Energy Recovery, Inc., a Delaware corporation (the “Company”), has granted to the Optionee an Option under the Company’s 2008 Equity Incentive Plan (the “Plan”) to purchase the number of shares of Common Stock indicated in the Grant Notice at the exercise price per share set forth in the Grant Notice (the “Exercise Price”), and subject to the terms and conditions of the Plan, which is incorporated herein by reference. In the event of a conflict between the terms and conditions of the Plan and this Agreement, the terms and conditions of the Plan shall prevail.

If designated in the Grant Notice as an Incentive Stock Option (“ISO”), this Option is intended to qualify as an Incentive Stock Option as defined in Section 422 of the Code. Nevertheless, to the extent that it exceeds the $100,000 rule of Code Section 422(d), this Option shall be treated as a Nonstatutory Stock Option (“NSO”). Further, if for any reason this Option (or portion thereof) shall not qualify as an ISO, then, to the extent of such nonqualification, such Option (or portion thereof) shall be regarded as a NSO granted under the Plan. In no event shall the Committee, the Company or any Parent, Subsidiary or Affiliate or any of their respective employees or directors have any liability to the Optionee (or any other person) due to the failure of the Option to qualify for any reason as an ISO.

2. Exercise of Option.

a. Right to Exercise. This Option shall be exercisable during its term in accordance with the Vesting Schedule set out in the Grant Notice and with the applicable provisions of the Plan and this Agreement.

b. Method of Exercise. This vested portion of the Option shall be exercisable by delivery of a notice of exercise in such form as may be designated by the Committee from time to time, which shall state the election to exercise the Option, the number of shares of Common Stock with respect to which the Option is being exercised, and such other representations and agreements as may be required by the Company. The notice of exercise shall be accompanied by payment of the aggregate Exercise Price as to all of the shares of Common Stock subject to the exercised Option. To the extent permitted by applicable law, payment may be made in one (or a combination of two or more) of the following forms:

i. Personal check, a cashier’s check or a money order.

ii. Certificates for shares of Common Stock of the Company already owned by the Optionee, along with any forms needed to effect a transfer of those shares to the Company. The Fair Market Value of the shares of Common Stock, determined as of the effective date of the Option exercise, will be applied to the Exercise Price. Instead of surrendering shares of Common Stock, the Optionee may attest to the ownership of those shares on a form provided by the Company and have the same number of shares of Common Stock subtracted from the Common Stock issued to the Optionee.

iii. Irrevocable directions to a securities broker approved by the Company to sell all or a portion of the shares of Common Stock subject to the exercised Option and to deliver to the Company from the sale proceeds an amount sufficient to pay the

Exercise Price and any withholding taxes. (The balance of the sale proceeds, if any, will be delivered to the Optionee.)

No Common Stock shall be issued pursuant to the exercise of an Option unless such issuance and such exercise comply with applicable laws. Assuming such compliance, for income tax purposes the shares of Common Stock shall be considered transferred to the Optionee on the date on which the Option is exercised with respect to such shares.

c. Restrictions on Exercise. This Option may not be exercised until such time as the Plan has been approved by the stockholders of the Company, or if the issuance of such Common Stock upon such exercise or the method of payment of consideration for such Common Stock would constitute a violation of any applicable law.

d. Responsibility for Exercise. The Optionee is responsible for taking any and all actions as may be required to exercise this Option in a timely manner and for properly executing any such documents as may be required for exercise in accordance with such rules and procedures as may be established from time to time. The Company and/or any Parent, Subsidiary or Affiliate shall have no duty or obligation to notify the Optionee of the Expiration Date of this Option.

3. Termination of Service.

a. General Rule. Except as provided below in Sections 3(b) and 3(c), and subject to the Plan, to the extent vested on the Optionee's date of termination of Service, this Option may be exercised for three (3) months after termination of the Optionee's Service with the Company or a Parent, Subsidiary or Affiliate of the Company. In no event shall this Option be exercised later than the Expiration Date set forth in the Grant Notice.

b. Death; Disability. Upon the termination of the Optionee's Service with the Company or a Parent, Subsidiary or Affiliate of the Company by reason of his or her total and permanent disability or death, the vesting of the Option shall be accelerated effective upon the date of the Optionee's termination of Service and the Option may be exercised for twelve (12) months thereafter, provided that in no event shall this Option be exercised later than the Expiration Date set forth in the Grant Notice. For all purposes under this Agreement, "total and permanent disability" means that the Optionee is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted, or can be expected to last, for a continuous period of not less than one year.

c. Cause. Upon the termination of the Optionee's Service by the Company or a Parent, Subsidiary or Affiliate of the Company for cause (as determined by the Committee), the Option shall expire on the date of the Optionee's termination from Service.

d. Leave of Absence and Part-Time Work. For purposes of this Option, the Optionee's Service does not terminate when the Optionee goes on a military leave, a sick leave or another *bona fide* leave of absence, if the leave was approved by the Company in writing. However, the Optionee's Service terminates when the approved leave ends, unless the Optionee immediately return to active work. If the Optionee goes on a leave of absence, then the vesting schedule specified in the Grant Notice may be adjusted in accordance with the Company's leave of absence policy or the terms of the Optionee's leave. If the Optionee commences working on a part-time basis, then the vesting schedule specified in the Grant Notice may be adjusted in accordance with

the Company's part-time work policy or the terms of an agreement between the Optionee and the Company pertaining to the Optionee's part-time schedule.

4. Non-Transferability of Option. This Option may not be transferred in any manner otherwise than by will or by the laws of descent or distribution and may be exercised during the lifetime of the Optionee only by the Optionee. The terms of the Plan and this Agreement shall be binding upon the executors, heirs, successors and assigns of the Optionee. Regardless of any marital property settlement agreement, the Company is not obligated to honor a notice of exercise from the Optionee's former spouse, nor is the Company obligated to recognize the Optionee's former spouse's interest in the Option in any other way.

5. Term of Option. This Option may be exercised only within the term set out in the Grant Notice, and may be exercised during such term only in accordance with the Plan and the terms of this Option.

6. Tax Obligations.

a. Tax Withholding. The Optionee will not be permitted to exercise the Option unless the Optionee makes appropriate arrangements with the Company (or the Parent, Subsidiary or Affiliate employing or retaining the Optionee) for the satisfaction of all Federal, state, local and foreign income and employment tax withholding requirements applicable to the Option exercise. With the Company's consent, these arrangements may include withholding shares from the Common Stock that otherwise would be issued to the Optionee upon exercise of the Option. The value of this Common Stock, determined as of the effective date of the Option exercise, will be applied to the withholding taxes. The Optionee acknowledges and agrees that the Company may refuse to honor the exercise and refuse to deliver the Common Stock if such withholding amounts are not delivered at the time of exercise.

b. Notice of Disqualifying Disposition of ISO Shares. If the Option granted to the Optionee herein is an ISO, and if the Optionee sells or otherwise disposes of any of the Common Stock acquired pursuant to the ISO on or before the later of (i) the date two (2) years after the Date of Grant, or (ii) the date one (1) year after the date of exercise, the Optionee shall immediately notify the Company in writing of such disposition. The Optionee agrees that the Optionee may be subject to income tax withholding by the Company on the compensation income recognized by the Optionee.

7. Restrictions on Resale. The Optionee agrees not to sell any Common Stock at a time when applicable laws, Company policies or an agreement between the Company and its underwriters prohibit a sale. This restriction will apply as long as the Optionee's Service continues and for such period of time after the termination of the Optionee's Service as the Company may specify.

8. Retention Rights. The Optionee acknowledges and agrees that the vesting of the Option pursuant to the Vesting Schedule hereof is earned only by continuing Service at the will of the Company (or the Parent, Subsidiary or Affiliate employing or retaining the Optionee) and not through the act of being hired, being granted this Option or acquiring shares of Common Stock hereunder. The Optionee further acknowledges and agrees that this Agreement, the transactions contemplated hereunder and the Vesting Schedule set forth herein do not constitute an express or implied promise of continued engagement by the Company or a Parent, Subsidiary or Affiliate of the Company in any capacity for the vesting period or for any period, or at all, and shall not interfere in any way with the Optionee's right or the right of the Company (or the Parent,

Subsidiary or Affiliate employing or retaining the Optionee) to terminate the Optionee's Service at any time, with or without cause.

9. Stockholder Rights. The Optionee, or the Optionee's estate or heirs, have no rights as a stockholder of the Company until shares of Common Stock have been issued to the Optionee upon exercise of the Option. No adjustments are made for dividends or other rights if the applicable record date occurs before the date that such shares of Common Stock are issued, except as described in the Plan.

10. Adjustments. In the event of a stock split, a stock dividend or a similar change in the Company's Common Stock, the number of shares of Common Stock covered by this Option and the Exercise Price per share will be adjusted pursuant to the Plan.

11. Limitations Applicable to Section 16 Persons. Notwithstanding any other provision of the Plan or this Agreement, if the Optionee is subject to Section 16 of the Exchange Act, the Plan, the Option and this Agreement shall be subject to any additional limitations set forth in any applicable exemptive rule under Section 16 of the Exchange Act (including any amendment to Rule 16b-3 of the Exchange Act) that are requirements for the application of such exemptive rule. To the extent permitted by applicable law, this Agreement shall be deemed amended to the extent necessary to conform to such applicable exemptive rule.

12. Entire Agreement; Governing Law. The Plan, the Grant Notice and this Agreement constitute the entire agreement of the parties with respect to the subject matter hereof and supersede in their entirety all prior undertakings and agreements of the Company and the Optionee with respect to the subject matter hereof. This Agreement may be amended only by another written agreement between the parties. This Agreement will be interpreted and enforced under the laws of the State of California (without regard to its choice-of-law provisions). For purposes of litigating any dispute that arises directly or indirectly from the relationship of the parties evidenced by this grant or the Agreement, the parties hereby submit to and consent to the exclusive jurisdiction of the State of California and agree that such litigation shall be conducted only in the courts of Alameda county, California, or the federal courts for the United States for the Northern District of California, and no other courts, where this grant is made and/or to be performed.

13. Section 409A. Notwithstanding any other provision of the Plan, this Agreement or the Grant Notice, the Plan, this Agreement and the Grant Notice shall be interpreted in accordance with, and incorporate the terms and conditions required by, Section 409A of the U.S. Internal Revenue Code of 1986, as amended (together with any Department of Treasury regulations and other interpretive guidance issued thereunder, including without limitation any such regulations or other guidance that may be issued after the date hereof, "Section 409A"). The Company reserves the right, to the extent the Company deems necessary or advisable in its sole discretion, to unilaterally amend or modify the Plan, this Agreement or the Grant Notice or adopt other policies and procedures (including amendments, policies and procedures with retroactive effect), or take any other actions, as the Committee determines are necessary or appropriate to ensure that this Option qualifies for exemption from, or complies with the requirements of, Section 409A; provided, however, that the Company makes no representation that the Option will be exempt from, or will comply with, Section 409A, and makes no undertakings to preclude Section 409A of the Code from applying to the Option or to ensure that it complies with Section 409A.

Exhibit 10.16

LOAN AND SECURITY AGREEMENT
(ACCOUNTS AND INVENTORY)

OBLIGOR #	NOTE #	AGREEMENT DATE March 27, 2008
CREDIT LIMIT **$9,000,000**	**INTEREST RATE** **Base Rate or LIBOR plus 2.75%**	**OFFICER NO./INITIALS**

THIS AGREEMENT is entered into on March 27, 2008, between**COMERICA BANK** ("Bank") as secured party, whose Western Division headquarters office is 333 West Santa Clara Street, San Jose, California and the undersigned ("Borrower"), whose sole place of business (if it has only one), chief executive office (if it has more than one place of business) or residence (if an individual) is located at the address set forth below its name on the signature page to this Agreement. The parties agree as follows:

1. DEFINITIONS.

1.1 "Accounts" shall mean and includes all presently existing and hereafter arising accounts, including without limitation all accounts receivable, contract rights and other forms of right to payment for monetary obligations or receivables for property sold or to be sold, leased, licensed, assigned or otherwise disposed of, or for services rendered or to be rendered (including without limitation all health-care-insurance receivables) owing to Borrower, and any supporting obligations, credit insurance, guaranties or security therefor, irrespective of whether earned by performance.

1.2 "Adjusted Quick Ratio" shall mean, as of an applicable date of determination, a ratio of Cash plus Eligible Accounts to Current Liabilities (excluding Subordinated Debt) plus (to the extent not already included therein) all Indebtedness to Bank including Letter of Credit Obligations.

1.2 "Agreement" shall mean and includes this Loan and Security Agreement (Accounts and Inventory), any concurrent or subsequent rider to this Loan and Security Agreement (Accounts and Inventory) and any extensions, supplements, amendments or modifications to this Loan and Security Agreement (Accounts and Inventory) and/or to any such rider.

1.3 "Bank Expenses" shall mean and includes: all costs or expenses required to be paid by Borrower under this Agreement which are paid or advanced by Bank; taxes and insurance premiums of every nature and kind of Borrower paid by Bank; filing, recording, publication and search fees, appraiser fees, auditor fees and costs, and title insurance premiums paid or incurred by Bank in connection with Bank's transactions with Borrower; costs and expenses incurred by Bank in collecting the Accounts (with or without suit) to correct any default or enforce any provision of this Agreement, or in gaining possession of, maintaining, handling, preserving, storing, shipping, selling, disposing of, preparing for sale and/or advertising to sell the Collateral, whether or not a sale is consummated; costs and expenses of suit incurred by Bank in enforcing or defending this Agreement or any portion hereof, including, but not limited to, expenses incurred by Bank in attempting to obtain relief from any stay, restraining order, injunction or similar process which prohibits Bank from exercising any of its rights or remedies; and reasonable attorneys' fees and expenses incurred by Bank in advising, structuring, drafting, reviewing, amending, terminating, enforcing, defending or concerning this Agreement, or any portion hereof or any agreement related hereto, whether or not suit is brought. Bank Expenses shall include Bank's in-house legal charges at reasonable rates.

1.4 "Base Rate" shall mean that variable rate of interest so announced by Bank at its headquarters office in San Jose, California as its "Base Rate" from time to time and which serves as the basis upon which effective rates of interest are calculated for those loans making reference thereto.

1.5 "Borrower's Books" shall mean and includes all of Borrower's books and records including but not limited to minute books; ledgers; records indicating, summarizing or evidencing Borrower's assets, (including, without limitation, the Accounts) liabilities, business operations or financial condition, and all information relating thereto, computer programs; computer disk or tape files; computer printouts; computer runs; and other computer prepared information and equipment of any kind.

1.6 "Cash" means unrestricted cash and cash equivalents.

1.7 "Collateral" shall mean and includes all personal property of Borrower, including without limitation each and all of the following: the Accounts; the Inventory; the General Intangibles; the Negotiable Collateral; Borrower's Books; all Borrower's deposit accounts; all Borrower's investment property (including without limitation securities and securities entitlements); all goods, instruments documents, policies and certificates of insurance, deposits, money or other personal property of Borrower in which Bank receives a security interest and which now or later come into the possession, custody or control of Bank; all Borrower's equipment and fixtures; all additions, accessions, attachments, parts, replacements, substitutions, renewals, interest, dividends, distributions or rights of any kind for or with respect to any of the foregoing (including without limitation any stock splits, stock rights, voting rights and preferential rights) any supporting obligations for any of the foregoing; and the products and proceeds of any of the foregoing, including, but not limited to proceeds of insurance covering the Collateral, and any and all Accounts, General Intangibles, Negotiable Collateral, Inventory, equipment, money, deposit accounts, investment property, equipment, fixtures or other tangible and intangible property of Borrower

resulting from the sale or other disposition of the Collateral and the proceeds thereof and any supporting obligations or security therefor and any right to payment thereunder, and including, without limitation, cash or other property which were proceeds and are recovered by a bankruptcy trustee or otherwise as a preferential transfer by Borrower. Notwithstanding anything to the contrary contained herein, Collateral shall not include any waste or other materials which have been or may be designated as toxic or hazardous by Bank. Notwithstanding the foregoing, the Collateral shall not include any Copyrights, Patents, Trademarks, servicemarks and applications therefor, now owned or hereafter acquired, or any claims for damages by way of any past, present and future infringement of any of the foregoing; provided, however, that the Collateral shall include all accounts and general intangibles that consist of rights to payment from the sale, licensing or disposition of all or any part of, or rights in, the Intellectual Property (the "Rights to Payment"). Notwithstanding the foregoing, if and only if a judicial authority (including a U.S. Bankruptcy Court) holds that a security interest in the underlying Intellectual Property is necessary to have a security interest in the Rights to Payment, then the Collateral shall automatically, and effective as of December 1, 2005, include the Intellectual Property but only to the extent necessary to permit perfection Bank's security interest in the Rights to Payment and Bank shall have no right, title and interest in the Intellectual Property other than to perfect its security interest in the Rights to Payment.

1.7 "Copyrights" shall mean any and all copyright rights, copyright applications, copyright registrations and like protections in each work or authorship and derivative work thereof, whether published or unpublished and whether or not the same also constitutes a trade secret, now or hereafter existing, created, acquired or held.

1.8 "Credit" shall mean all Indebtedness, except that Indebtedness arising pursuant to any other separate contract, instrument, note or other separate agreement which, by its terms, provides for a specified interest rate and term.

1.9 "Credit Limit" shall mean Nine Million Dollars ($9,000,000).

1.10 "Current Liabilities" shall mean, in respect of a Person and as of any applicable date of determination, all liabilities of such Person that should be classified as current in accordance with GAAP.

1.11 "Daily Balance" shall mean the amount determined by taking the amount of the Credit owed at the beginning of a given day, adding any new Credit advanced or incurred on such date, and subtracting any payments or collections which are deemed to be paid and are applied by Bank in reduction of the Credit on that date under the provisions of this Agreement.

1.11 "Debt" shall mean, as of any applicable date of determination, all items of indebtedness, obligation or liability of a Person, whether matured or unmatured, liquidated or unliquidated, direct or indirect, absolute or contingent, joint or several, that should be classified as liabilities in accordance with GAAP. In the case of Borrower, the term "Debt" shall include, without limitation, the Indebtedness.

1.12 "Eligible Accounts" shall mean and includes those Accounts of Borrower which are due and payable within ninety (90) days, or less, from the date of invoice, have been validly assigned to Bank and strictly comply with all of Borrower's warranties and representations to Bank.

1 .13 "Event of Default" shall mean one or more of those events described in Section 7 contained herein below.

1.13 "GAAP" shall mean, as of any applicable period, generally accepted accounting principles in effect during such period.

1.14 "General Intangibles" shall mean and includes all of Borrower's present and future general intangibles and other personal property (including without limitation all payment intangibles, electronic chattel paper, contract rights, rights arising under common law, statutes, or regulations, choses or things in action, goodwill, patents, trade names, trademarks, servicemarks, copyrights, blueprints, drawings, plans, diagrams, schematics, purchase orders, customer lists, monies due or recoverable from pension funds, route lists, rights to payment (including without limitation, rights to payment evidenced by chattel paper, documents or instruments) and other rights under any royalty or licensing agreements, infringement claims, software (including without limitation any computer program that is embedded in goods that consist solely of the medium in which the program is embedded), information contained on computer disks or tapes, literature, reports, catalogs, insurance premium rebates, tax refunds, and tax refund claims), other than goods, Accounts, Inventory, Negotiable Collateral, and Borrowers Books.

1.15 "Indebtedness" shall mean and includes any and all loans, advances, Letter of Credit Obligations, overdrafts, debts, liabilities (including, without limitation, any and all amounts charged to Borrower's loan account pursuant to any agreement authorizing Bank to charge Borrower's loan account), obligations, lease payments, guaranties, covenants and duties owing by Borrower to Bank of any kind and description whether advanced pursuant to or evidenced by this Agreement; by any note or other Instrument; or by any other agreement between Bank and Borrower and whether or not for the payment of money, whether direct or indirect, absolute or contingent, due or to become due now existing or hereafter arising, including, without limitation, any interest, fees, expenses, costs and other amounts owed to Bank that but for the provisions of the United States Bankruptcy Code would have accrued after the commencement of any Insolvency Proceeding, and including, without limitation, any debt, liability, or obligations owing from Borrower to others which Bank may have obtained by assignment, participation, purchase or otherwise, and further including, without limitation, all

interest not paid when due and all Bank Expenses which Borrower is required to pay or reimburse by this Agreement, by law, (ILLEGIBLE) otherwise.

1.16 "Insolvency Proceeding" shall mean and includes any proceeding or case commenced by or against Borrower, or any guarantor of Borrower's Indebtedness, or any of Borrower's account debtors, under any provisions of the United States Bankruptcy Code, as amended, or any other bankruptcy or insolvency law, including, but not limited to assignments for the benefit of creditors, formal or informal moratoriums, composition or extensions with some or all creditors, any proceeding seeking a reorganization, arrangement or any other relief under the United States Bankruptcy Code, as amended, or any other bankruptcy or insolvency law.

1 .17 "Intellectual Property means all of Borrower's right, title, and interest in and to the following:

a. Copyrights, Trademarks and Patents;

b. Any and all trade secrets, and any and all intellectual property rights in computer software and computer software products now or hereafter existing, created, acquired or held;

c. Any and all design rights which may be available to Borrower now or hereafter existing, created, acquired or held;

d. Any and all claims for damages by way of past, present and future infringement of any of the rights included above, with the right, but not the obligation, to sue for and collect such damages for said use or infringement of the intellectual property rights identified above;

e. All licenses or other rights to use any of the Copyrights, Patents or Trademarks, and all license fees and royalties arising from such use to the extent permitted by such license or rights;

f. All amendments, renewals and extensions of any of the Copyrights, Trademarks or Patents; and

g. All proceeds and products of the foregoing, including without limitation all payments under insurance or any indemnity or warranty payable in respect of any of the foregoing.

1.18 "Inventory" shall mean and includes all present and future inventory in which Borrower has any interest, including, but not limited to, goods held by Borrower for sale or lease or to be furnished under a contract of service and all of Borrower's present and future raw materials, work in process, finished goods (including without limitation any computer program embedded in any of the foregoing goods and any supporting information provided in connection therewith that (i) is associated with the goods in such a manner that the program customarily is considered part of the goods or that (ii) by becoming the owner of the goods, a person acquires a right to use the program in connection with the goods), together with any advertising materials and packing and shipping materials, wherever located and any documents of title representing any of the above, and any equipment, fixtures or other property used in the storing, moving, preserving, identifying, accounting for and shipping or preparing for the shipping of inventory, and any and all other items hereafter acquired by Borrower by way of substitution, replacement, return, repossession or otherwise, and all additions and accessions thereto, and the resulting product or mass, and any documents of title respecting any of the above.

1.19 "Judicial Officer or Assignee" shall mean and includes any trustee, receiver, controller, custodian, assignee for the benefit of creditors or any other person or entity having powers or duties like or similar to the powers and duties of trustee, receiver, controller, custodian or assignee for the benefit of creditors.

1.20 "Letter of Credit" or "Letters of Credit" shall mean any standby letters of credit, documentary letters of credit OR Warranty Letters of Credit hereafter issued by Bank at the request of Borrower pursuant to this Agreement.

1.21 "Letter of Credit Agreement" means in respect of each standby letter of credit and Warranty Letter of Credit issued pursuant to this Agreement, the application of Borrower requesting Bank to issue such Letter of Credit (including the terms and conditions on the reverse side thereof or otherwise provided therein and including any separate indemnity agreement delivered in connection therewith), in the form and substance acceptable to Bank.

1.22 "Letter of Credit Fees" shall mean the fees payable to Bank in connection with letters of credit issued by it pursuant to Article 2.

1.23 "Letter of Credit Obligations" shall mean, as of any applicable date of determination, the sum of the undrawn amount of any letter(s) of credit issued by Bank upon the application of and/or for the account of Borrower, plus any unpaid reimbursement obligations owing by Borrower to Bank in respect of any such letter(s) of credit.

1.24 “Net Income” shall mean the net income (or loss) of a person for any period of determination, determined in accordance with GAAP but excluding in any event:

a. any gains or losses on the sale or other disposition, not in the ordinary course of business, of investments or fixed or capital assets, and any taxes on the excluded gains and any tax deductions or credits on account on any excluded losses; and

b. in the case of Borrower, net earnings of any Person in which Borrower has an ownership interest, unless such net earnings shall have actually been received by Borrower in the form of cash distributions.

1.25 “Negotiable Collateral” shall mean and include all of Borrower’s present and future letters of credit, advises of credit, letter-of-credit rights, certificates of deposit, notes, drafts, money, documents (including without limitation all negotiable documents), instruments (including without limitation all promissory notes), tangible chattel paper or any other similar property.

1.26 “Patents” means all patents, patent applications and like protections including without limitation improvements, divisions, continuations, renewals, reissues, extensions and continuations-in-part of the same.

1.27 “Permitted Liens” means the following:

a. Any Liens existing on the date of closing and disclosed in the Schedule (excluding Liens to be satisfied with the proceeds of the Advances) or arising under this Agreement or the other Loan Documents;

b. Liens for taxes, fees, assessments or other governmental charges or levies, either not delinquent or being contested in good faith by appropriate proceedings and for which Borrower maintains adequate reserves, provided the same have no priority over any of Bank’s security interests;

c. Liens (i) upon or in any equipment acquired or held by Borrower or any of its Subsidiaries to secure the purchase price of such equipment or indebtedness incurred solely for the purpose of financing the acquisition or lease of such equipment, or (ii) existing on such equipment at the time of its acquisition, provided that the Lien is confined solely to the property so acquired and improvements thereon, and the proceeds of such equipment; and

d. Liens incurred in connection with the extension, renewal or refinancing of the indebtedness secured by Liens of the type described in clauses (a) through (c) above, provided that any extension, renewal or replacement Lien shall be limited to the property encumbered by the existing Lien and the principal amount of the indebtedness being extended, renewed or refinanced does not increase.

1.28 “Person” or “person” shall mean and includes any individual, corporation, partnership, joint venture, firm, association, trust, unincorporated association, joint stock company, government, municipality, political subdivision or agency or other entity.

1.29 “Quick Assets” shall mean, as of any applicable date of determination, unrestricted cash, certificates of deposit or marketable securities and net accounts receivable arising from the sale of goods and services, and United States government securities and/or claims against the United States government of Borrower and its subsidiaries.

1.30 “Subordinated Debt” shall mean indebtedness of the Borrower to any Person which has been subordinated to the Indebtedness pursuant to a Subordination Agreement in form and content satisfactory to Bank.

1.31 “Subordination Agreement” shall mean any subordination agreement, which is in form and substance satisfactory to Bank, and which makes any or all present and future indebtedness of Borrower to any Person subordinate to the Indebtedness.

1.32 “Tangible Effective Net Worth” shall mean, with respect to any Person and as of any applicable date of determination, Tangible Net Worth plus Subordinated Debt.

1.33 “Tangible Net Worth” shall mean, with respect to any Person and as of any applicable date of determination, the excess of:

a. the net book value of all assets of such Person (excluding affiliate receivables, patents, patent rights, trademarks, trade names, franchises, copyrights, licenses, goodwill, and all other intangible assets of such Person) after all appropriate deductions in accordance with GAAP (including, without limitation, reserves for doubtful receivables, obsolescence, depreciation and amortization), less

b. all Debt of such Person at such time.

1.34 "Trademarks" means any trademark and servicemark rights, whether registered or not, applications to register and registrations of the same and like protections, and the entire goodwill of the business of Borrower connected with and symbolized by such trademarks.

1.35 "Warranty" shall mean Borrower's guarantee that the finished goods or services which are intended for export from the United States will function as intended during the warranty period.

1.36 "Warranty Letter of Credit" shall mean standby letter of credit which is issued or caused to be issued by Bank to support the obligations of Borrower with respect to a Warranty or a standby letter of credit which by its terms becomes a Warranty Letter of Credit, which Warranty Letter of Credit shall be secured by cash collateral in an amount not less than such Letter of Credit Obligation.

Any and all terms used in the foregoing definitions and elsewhere in this Agreement shall be construed and defined in accordance with the meaning and definition of such terms under and pursuant to the California Uniform Commercial Code (hereinafter referred to as the "Uniform Commercial Code") as amended, revised or replaced from time to time. Notwithstanding the foregoing, the parties intend that the terms used herein which are defined in the Uniform Commercial Code have, at all times, the broadest and most inclusive meanings possible. Accordingly, if the Uniform Commercial Code shall in the future be amended or held by a court to define any term used herein more broadly or inclusively than the Uniform Commercial Code in effect on the date of this Agreement, then such term, as used herein, shall be given such broadened meaning. If the Uniform Commercial Code shall in the future be amended or held by a court to define any term used herein more narrowly, or less inclusively, than the Uniform Commercial Code in effect on the date of this Agreement, such amendment or holding shall be disregarded in defining terms used in this Agreement.

2. LOAN AND TERMS OF PAYMENT.

For value received, Borrower promises to pay to the order of Bank such amount, as provided for below, together with interest, as provided for below.

2.1 Upon the request of Borrower, made at any time and from time to time during the term hereof, and so long as no Event of Default has occurred, Bank shall lend to Borrower an amount equal to the Credit Limit minus all Letter of Credit Obligations. If at any time for any reason, the amount of Indebtedness owed by Borrower to Bank pursuant to this Section 2.1 and Section 2.3 of this Agreement is greater than the aggregate amount available to be drawn under this Section 2.1, Borrower shall immediately pay to Bank, in cash, the amount of such excess.

2.2 Except as hereinbelow provided, the Credit shall bear interest, on the Daily Balance owing, at a fluctuating rate of interest equal to **SEE LIBOR ADDENDUM ATTACHED**.

All interest chargeable under this Agreement that is based upon a per annum calculation shall be computed on the basis of a three hundred sixty (360) day year for actual days elapsed. The Base Rate as of the date of this Agreement is five and one quarter percent (5.25%) per annum. In the event that the Base Rate announced is, from time to time hereafter, changed, adjustment in the Base Rate shall be made and based on the Base Rate in effect on the date of such change. The Base Rate, as adjusted, shall apply to the Credit until the Base Rate is adjusted again.

All interest payable by Borrower under the Credit shall be due and payable on the first day of each calendar month during the term of this Agreement. A late payment charge equal to five percent (5%) of each late payment may be charged on any payment not received by Bank within ten (10) calendar days after the payment due date, but acceptance of payment of this charge shall not waive any Event of Default under this Agreement. Upon the occurrence of an Event of Default hereunder, and without constituting a waiver of any such Event of Default, then during the continuation thereof, at Bank's option, the Credit shall bear interest, on the Daily Balance owing, at a rate equal to three percent (3%) per year in excess of the rate applicable immediately prior to the occurrence of the Event of Default, and such rate of interest shall fluctuate thereafter from time to time at the same time and in the same amount as any fluctuation in the date of interest applicable immediately prior to any such occurrence.

2.3 Subject to the terms and conditions of this Agreement, Bank agrees to issue or cause to be issued Letters of Credit for the account of Borrower during the term of this Agreement in the aggregate outstanding face amount not to exceed (i) the Credit Limit, minus (ii) the then outstanding Daily Balance. Each Letter of Credit shall have an initial expiration date not later than twelve (12) months from its date of issuance (subject to renewals), unless such Letter of Credit is a Warranty Letter of Credit, then an expiration date not later than thirty six (36) months from its date of issuance (subject to renewals). All Letters of Credit shall be, in form and substance, acceptable to Bank in its sole discretion and shall be subject to the terms and conditions of Bank's form of standard Letter of Credit Application and Agreement. The obligation of Borrower to immediately reimburse Bank for drawings made under letters of credit shall be absolute, unconditional and irrevocable in accordance with the terms of this Agreement and the Letter of Credit Application and Agreement with respect to each such letter of credit. Borrower shall indemnify, defend, protect and hold Bank harmless from any loss, cost, expense, or liability, including, without limitation, reasonable attorney's fees incurred by Bank, whether in-house or outside counsel is used, arising out of or in connection with any letters of credit.

a. No Letter of Credit shall be issued pursuant to Section 2.3 hereof unless, as of the requested date for issuance:

(1) the stated amount of the letter of credit requested, plus the stated amounts of all other outstanding letters of credit, plus the amount of all unreimbursed drawings and payments made on letters of credit, plus all advances outstanding under the Credit shall not exceed the Credit Limit; and all undrawn amounts under all such Letters of Credit shall be deemed to constitute advances for the purpose of calculating availability under the Credit;

(2) the execution of the Letter of Credit Agreement with respect to the letter of credit requested will not violate the terms and conditions of any contract, agreement or other borrowing of Borrower;

(3) all Letters of Credit shall be, in form and substance, acceptable to Bank in its sole discretion and shall be subject to the terms and conditions of Bank's form of standard Letter of Credit Application and Agreement;

(4) no order, judgment or decree of any court, arbitrator or governmental authority shall purport by its terms to enjoin or restrain Bank from issuing the letter of credit, and no law, rule, regulation, request or directive (whether or not having the force of law) of or from any governmental authority shall prohibit or request that Bank refrain from issuing, the letter of credit requested or letters of credit generally;

(5) Bank shall have received the issuance fee required in connection with the issuance of such letter of credit; and

(6) all of the conditions set forth in Section 5 are satisfied as of the date of such request and shall be satisfied as of the date requested for issuance of such Letter of Credit.

b. Letter of Credit Commission. Borrower shall pay to Bank a letter of credit commission upon the date of issuance of each standby letter of credit in the amount equal to one and one quarter percent (1.25%) per annum on the average outstanding amount of such standby letter of credit. Such commissions (for so long as such letters of credit shall be outstanding) shall be paid quarterly in arrears on the last banking day of each March, June, September and December of each calendar year, and shall be fully earned and non-refundable on the date of payment thereof.

c. Standard Fees. In connection with the letters of credit, Borrower will pay Bank, letter of credit issuance fees and standard administration, payment and cancellation charges assessed by Bank, at the times, in the amounts customarily charged by Bank at such time with respect to its letters of credit generally.

d. Draws Under Letters of Credit.

(1) Upon receipt of any draw against a letter of credit, Bank shall promptly notify Borrower of the amount of such draw and the date for payment of such draw. Borrower hereby agrees to deposit with Bank, on the first Business Day subsequent to such notice, funds sufficient to pay all Letter of Credit Obligations with respect to such draws, which may be the proceeds of an advance, if made by Bank in its sole discretion.

(2) In the event that Borrower fails to deposit funds sufficient to pay Letter of Credit Obligations with respect to any draw (whether through an advance or otherwise) on a timely basis, from the date of Bank's payment on such draw until such Letter of Credit Obligations resulting from such draw shall have been paid, Borrower shall not be entitled to request or receive any advance or to request or receive any other Credits or the issuance of letters of credit hereunder and the amount of the related Letter of Credit Obligation shall bear interest at the Default Rate for Loans bearing interest at the Base Rate, which interest shall be payable on demand.

e. Obligations Irrevocable. The obligations of Borrower to make payments with respect to Letter of Credit Obligations shall be irrevocable and not subject to any qualification or exception whatsoever, including:

(1) invalidity or unenforceability of this Agreement or any of the other Related Loan Documents or any of their provisions;

(2) the existence of any claim, set-off, defense or other right which Borrower may have against a beneficiary named in a letter of credit, or any other Person;

(3) any draft, certificate or any other document presented in connection with a Letter of Credit proving to be forged, fraudulent, invalid or insufficient in any respect or any statement therein being untrue or inaccurate in any respect, except to the extent resulting from the willful misconduct or gross negligence on the part of Bank;

(4) the occurrence of any Default or Event of Default;

(5) payment by Bank under any Letter of Credit against presentation of a draft or accompanying certificate which does not strictly comply with the terms of the Letter of Credit;

(6) any failure, omission, delay or lack on the part of Bank or any party to this Agreement or any of the Related Documents to enforce, assert or exercise any right, power or remedy conferred upon Bank or any such party under this Agreement or any Documents, or any other acts or omissions on the part of Bank or any such party;

(7) the voluntary or involuntary liquidation, dissolution, sale or other disposition of all or substantially all the assets of Borrower; the receivership, insolvency, bankruptcy, assignment for the benefit of creditors, reorganization, arrangements, composition with creditors or readjustment or other similar proceedings affecting Borrower, or any of its assets, or any allegation or contest of the validity of this Agreement or any of the Related Documents, in any such proceedings; and

(8) any other circumstance or happening whatsoever, whether or not similar to any of the foregoing, and any other event or action that would, in the absence of this clause and other than as a result of the misconduct or gross negligence of Bank, result in the release or discharge by operation of law of Borrower from the performance or observance of any obligation, covenant or agreement contained in this Agreement or any of the Related Documents.

f. Indemnification. Borrower agrees indemnify, defend and hold Bank harmless from and against any and all claims, damages, losses, liabilities, costs or expenses whatsoever which Bank may incur (or which may be claimed against Bank by any Person) by reason of or in connection with the execution and delivery or transfer of, or payment or failure to pay under, any Letter of Credit; provided, however, that Borrower shall not be required to indemnify Bank pursuant to this Section 2.3(f) for claims, damages, losses, liabilities, costs or expenses to the extent, but only to the extent, caused by the willful and wrongful failure or willful and wrongful misconduct or gross negligence of Bank. Nothing in this Section is intended nor shall be deemed to limit, reduce or otherwise affect in any manner whatsoever the reimbursement obligations of Borrower contained in this Agreement.

2.5 Borrower shall pay to Bank, on the effective date of this Agreement a commitment fee of $9,000, which fee shall be deemed fully earned upon such effective date and shall not be refundable under any circumstance.

3. TERM.

3.1 This Agreement shall remain in full force and effect until September 30, 2008, unless earlier terminated by notice by Borrower. Notice of such termination by Borrower shall be effectuated by mailing of a registered or certified letter not less than thirty (30) days prior to the effective date of such termination, addressed to Bank at the address set forth herein and the termination shall be effective as of the date so fixed in such notice.

3.2 Notwithstanding the foregoing, should Borrower be in default of one or more of the provisions of this Agreement, Bank may terminate this Agreement at any time without notice. Notwithstanding the foregoing, should either Bank or Borrower become insolvent or unable to meet its debts as they mature, or fail, suspend, or go out of business, the other party shall have the right to terminate this Agreement at any time without notice. On the date of termination all Indebtedness shall become immediately due and payable without notice or demand; no notice of termination by Borrower shall be effective until Borrower shall have paid all Indebtedness to Bank in full. Notwithstanding termination, until all Indebtedness has been fully satisfied, Bank shall retain its security interest in all existing Collateral and Collateral arising thereafter, and Borrower shall continue to perform all of its obligations.

3.3 After termination and when Bank has received payment in full of Borrower's Indebtedness to Bank, Bank shall reassign to Borrower all Collateral held by Bank, and shall execute a termination of all security agreements and security interests given by Borrower to Bank.

4. CREATION OF SECURITY INTEREST.

4.1 Borrower hereby grants to Bank a continuing security interest in all presently existing and hereafter arising Collateral in order to secure prompt repayment of any and all Indebtedness owed by Borrower to Bank and in order to secure prompt performance by Borrower of each and all of its covenants and obligations under this Agreement and otherwise created. Bank's security interest in the Collateral shall attach to all Collateral without further act on the part of Bank or Borrower. In the event that any Collateral, including proceeds, is evidenced by or consists of Negotiable Collateral, Borrower, immediately upon the request of Bank, shall (a) endorse or assign such Negotiable Collateral to Bank, (b) deliver actual physical possession of such Negotiable Collateral to Bank, and (c) mark conspicuously all of its records pertaining to such Negotiable Collateral with a legend, in form and substance satisfactory to Bank (and in the case of Negotiable Collateral consisting of tangible chattel paper, immediately mark all such tangible chattel paper with a conspicuous legend in form and substance satisfactory to Bank), indicating that the Negotiable Collateral is subject to the security interest granted to Bank hereunder.

4.2 Bank's security interest in the Accounts shall attach to all Accounts without further act on the part of Bank or Borrower. Upon request from Bank, Borrower shall provide Bank with schedules describing all Accounts created or acquired by Borrower (including without limitation agings listing the names and addresses of, and amounts owing by date by account debtors), and shall execute and deliver written assignments of all Accounts to Bank all in a form acceptable to Bank; provided, however, Borrower's failure to execute and deliver such schedules and/or assignments shall not affect or limit Bank's security interest and other rights in and to the Accounts. Together with each schedule, Borrower shall furnish Bank with copies of Borrower's customers' invoices or the equivalent, and original shipping or delivery receipts for all merchandise sold, and Borrower warrants the genuineness thereof. Upon the occurrence of an Event of Default, Bank or Bank's designee may notify customers or account debtors of Bank's security interest in the Collateral and direct such customers or account debtors to make payments directly to Bank, but unless and until Bank does so or gives Borrower other written instructions, Borrower shall collect all Accounts for Bank, receive in trust all payments thereon as Bank's trustee, and, if so requested to do so from Bank, Borrower shall immediately deliver said payments to Bank in their original form as received from the account debtor and all letters of credit, advices of credit, instruments, documents, chattel paper or any similar property evidencing or constituting Collateral. Notwithstanding anything to the contrary contained herein, if sales of inventory are made for cash, Borrower shall immediately deliver to Bank, in identical form, all such cash, checks, or other forms of payment which Borrower receives. The receipt of any check or other item of payment by Bank shall not be considered a payment on account until such check or other item of payment is honored when presented for payment, in which event, said check or other item of payment shall be deemed to have been paid to Bank two (2) calendar days after the date Bank actually receives such check or other item of payment.

4.3 Bank's security interest in inventory shall attach to all inventory without further act on the part of Bank or Borrower. Borrower will at Borrower's expense pledge, assemble and deliver such inventory to Bank or to a third party as Bank's bailee; or hold the same in trust for Bank's account or store the same in a warehouse in Bank's name; or deliver to Bank documents of title representing said Inventory; or evidence of Bank's security interest in some other manner acceptable to Bank. Until a default by Borrower under this Agreement or any other Agreement between Borrower and Bank, Borrower may, subject to the provisions hereof and consistent herewith, sell the Inventory, but only in the ordinary course of Borrower's business. A sale of inventory in Borrower's ordinary course of business does not include an exchange or a transfer in partial or total satisfaction of a debt owing by Borrower.

4.4 Concurrently with Borrower's execution of this Agreement, and at any time or times hereafter at the request of Bank, Borrower shall (a) execute and deliver to Bank security agreements, mortgages, assignments, certificates of title, affidavits, reports, notices, schedules of accounts, letters of authority and all other documents that Bank may reasonably request, in form satisfactory to Bank, to perfect and maintain perfected Bank's security interest in the Collateral and in order to fully consummate all of the transactions contemplated under this Agreement, (b) cooperate with Bank in obtaining a control agreement in form and substance satisfactory to Bank with respect to all deposit accounts, electronic chattel paper, investment property, and letter-of-credit rights, and (c) in the event that any Collateral is in the possession of a third party, Borrower shall join with Bank in notifying such third party of Bank's security interest and obtaining an acknowledgment from such third party that it is holding such Collateral for the benefit of Bank. By authenticating or becoming bound by this Agreement, Borrower authorizes the filing of initial financing statement(s), and any amendment(s) covering the Collateral to perfect and maintain perfected Bank's security interest in the Collateral. Upon the occurrence of an Event of Default, Borrower hereby irrevocably makes, constitutes and appoints Bank (and any of Bank's officers, employees or agents designated by Bank) as Borrower's true and lawful attorney-in-fact with power to sign the name of Borrower on any security agreement, mortgage, assignment, certificate of title, affidavit, letter of authority, notice of other similar documents which must be executed and/or filed in order to perfect or continue perfected Bank's security interest in the Collateral, and to take such actions in its own name or in Borrower's name as Bank, in its sole discretion, deems necessary or appropriate to establish exclusive possession or control (as defined in the Uniform Commercial Code) over any Collateral of such nature that perfection of Bank's security interest may be accomplished by possession or control.

4.5 Borrower shall make appropriate entries in Borrower's Books disclosing Bank's security interest in the Accounts. Bank (through any of its officers, employees or agents) shall have the right at any time or times hereafter, provided that reasonable notice is provided, during Borrower's usual business hours, or during the usual business hours of any third party having control over the records of Borrower, to inspect and verify Borrower's Books in order to verify the amount or condition of, or any other matter, relating to, said Collateral and Borrower's financial condition.

4.6 Borrower appoints Bank or any other person whom Bank may designate as Borrower's attorney-in-fact, with power, effective only upon the occurrence of an Event of Default: to endorse Borrower's name on any checks, notes, acceptances, money order, drafts or other forms of payment or security that may come into Bank's possession; to sign Borrower's name on any invoice or bill of lading relating to any Accounts, on drafts against account debtors, on schedules and assignments of Accounts, on verifications of Accounts and on notices to account debtors; to establish a lock box arrangement and/or to notify the post office authorities to change the address for delivery of Borrower's mail addressed to Borrower to an address designated by Bank, to receive and open all mail addressed to Borrower, and to retain all mail relating to the Collateral and forward all other mail to Borrower; to send, whether in writing or by telephone, requests for verification of Accounts; and to do all things necessary to carry out this Agreement. Borrower ratifies and approves all acts of the attorney-in-fact. Neither Bank nor its attorney-in-fact will be liable for any acts or omissions or for any error of judgment or mistake of fact or law. This power being coupled with an interest, is irrevocable so long as any Accounts in which Bank has a security interest remain unpaid and until the Indebtedness has been fully satisfied.

4.7 In order to protect or perfect any security interest which Bank is granted hereunder, Bank may, in its sole discretion, discharge any lien or encumbrance or bond the same, pay any insurance, maintain guards, warehousemen, or any personnel to protect the Collateral, pay any service bureau, or, obtain any records, and all costs for the same shall be added to the Indebtedness and shall be payable on demand.

4.8 Borrower agrees that Bank may provide information relating to this Agreement or relating to Borrower to Bank's parent, affiliates, subsidiaries and service providers.

4.9 Borrower, for itself and its Subsidiaries, agrees that it will not and that it will not permit its Subsidiaries to pledge or otherwise grant a security interest in the Intellectual Property to any Person, other than the Bank, or enter into or be subject to any agreement with any other Person pursuant to which Borrower agrees for the benefit of such other Person that Borrower will not pledge or grant a security interest in the Intellectual Property, all without the Bank's prior written consent.

4.10 All Warranty Letters of Credit shall be secured by cash collateral in the aggregate face amount of all issued and outstanding Warranty Letters of Credit, which cash collateral shall be held and retained by Bank as cash collateral for the repayment of such Letter of Credit Obligation, together with any and all other Indebtedness of Borrower to Bank remaining unpaid, and Borrower pledges to Bank and grants to Bank a continuing first priority security interest in such cash collateral so delivered to Bank.

5. CONDITIONS PRECEDENT.

5.1 As conditions precedent to the making of the loans and the extension of the financial accommodations hereunder, Borrower shall execute, or cause to be executed, and deliver to Bank, in form and substance satisfactory to Bank and its counsel, the following:

a. This Agreement and other documents, instruments and agreements required by Bank;

b. If Borrower is a corporation, limited liability company, limited partnership or other such entity, certified copies of all actions taken by Borrower, any grantor of a security interest to Bank to secure the Indebtedness, and any guarantor of the Indebtedness, authorizing the execution, delivery and performance of this Agreement and any other documents, instruments or agreements entered into in connection herewith, and authorizing specific officers to execute and deliver any such documents, instruments and agreements;

c. If Borrower is a corporation, limited liability company, limited partnership or other such entity, then a certificate of good standing showing that Borrower is in good standing under the laws of the state of its incorporation or formation and certificates indicating that Borrower is qualified to transact business and is in good standing in any other state in which it conducts business;

d. If Borrower is a partnership, then a copy of Borrower's partnership agreement certified by each general partner of Borrower;

e. UCC searches and financing statements, tax lien and litigation searches, fictitious business statement filings, insurance certificates, notices or other similar documents which Bank may require and in such form as Bank may require, in order to reflect, perfect or protect Bank's first priority security interest in the Collateral and in order to fully consummate all of the transactions contemplated under this Agreement;

f. Evidence that Borrower has obtained insurance and acceptable endorsements;

g. Such control agreements from each Person as Bank may require;

h. Duly executed certificates of title with respect to that portion of the Collateral that is subject to certificates of title:

i. Such collateral access agreements from each lesser, warehouseman, bailee, and other Person as Bank may require, duly executed by each such Person; and

j. Warranties and representations of officers.

6. WARRANTIES, REPRESENTATIONS AND COVENANTS.

6.1 If so requested by Bank, Borrower shall, at such intervals designated by Bank, during the term hereof execute and deliver a Report of Accounts Receivable or similar report, in form customarily used by Bank.

6.2 Bank shall retain its security interest in all Accounts, until all Indebtedness has been fully paid and satisfied. Returns and allowances, if any, as between Borrower and its customers, will be on the same basis and in accordance with the usual customary practices of Borrower, as they exist at this time. Any merchandise which is returned by an account debtor or otherwise recovered shall be set aside, marked with Bank's name, and Bank shall retain a security interest therein. Borrower shall promptly notify Bank of all disputes and claims and settle or adjust them on terms approved by Bank. After default by Borrower hereunder, no discount, credit on allowance shall be granted to any account debtor by Borrower and no return of merchandise shall be accepted by Borrower without Bank's consent. Bank may, after default by Borrower, settle or adjust disputes and claims directly with account debtors for amounts and upon terms which Bank considers advisable, and in such cases Bank will credit Borrower's loan account with only the net amounts received by Bank in payment of the Accounts, after deducting all Bank Expenses in connection therewith.

6.3 Borrower warrants, represents, covenants and agrees that:

a. Borrower has good and marketable title to the Collateral. Bank has and shall continue to have a first priority perfected security interest in and to the Collateral, subject to Permitted Liens. The Collateral shall at all times remain free and clear of all liens, encumbrances and security interests, except for Permitted Liens;

b. All Accounts are and will, at all times pertinent hereto, be bona fide existing obligations created by the sale and delivery of merchandise or the rendition of services to account debtors in the ordinary course of business, free of liens claims, encumbrances and security interests, except for Permitted Liens, and are unconditionally owed to Borrower without defenses, disputes, offsets counterclaims, rights of return or cancellation, and Borrower shall have received no notice of actual or imminent bankruptcy or insolvency of any account debtor at the time an Account due from such account debtor is assigned to Bank; and

c. At the time each Account is assigned to Bank, all property giving rise to such Account shall have been delivered to the account debtor or to the agent for the account debtor for immediate shipment to, and unconditional acceptance by, the account debtor. Borrower shall deliver to Bank, as Bank may from time to time require, delivery receipts customer's purchase orders, shipping instructions, bills of lading and any other evidence of shipping arrangements. (ILLEGIBLE) such a request by Bank, copies of all such documentation shall be held by Borrower as custodian for Bank.

6.4 Borrower shall keep the Inventory only at the following locations: 1908 Doolittle Drive, San Leandro, California (ILLEGIBLE) and the owner or mortgagees of such location is 2101 Williams Associates, LLC.

a. Borrower, immediately upon demand by Bank therefor, shall now and from time to time hereafter, at such intervals as are reasonably requested by Bank, deliver to Bank, designations of Inventory specifying Borrower's cost (ILLEGIBLE) Inventory, the wholesale market value thereof and such other matters and information relating to the Inventory as Bank may request;

b. Borrower's Inventory, valued at the lower of Borrower's cost or the wholesale market value thereof, at all times pertinent hereto shall not be less than N/A Dollars ($ N/A) of which no less than N/A Dollars ($ N/A shall be in raw materials and finished goods;

c. All of the Inventory is and shall remain free from all purchase money or other security interests, liens (ILLEGIBLE) encumbrances, except for Permitted Liens;

d. Borrower does now keep and hereafter at all times shall keep correct and accurate records itemizing and describing the kind, type, quality and quantity of the Inventory, its cost therefor and selling price thereof, and the daily withdrawals therefrom and additions thereto, all of which records shall be available upon demand to any of Bank's officers agents and employees for inspection and copying;

e. All Inventory, now and hereafter at all times, shall be new Inventory of good and merchantable quality free from material defects;

f. Inventory is not now and shall not at any time or times hereafter be located or stored with a (ILLEGIBLE) warehouseman or other third party without Bank's prior written consent, and, in such event, Borrower will concurrently therewith cause any such bailee, warehouseman or other third party to issue and deliver to Bank, warehouse receipts (ILLEGIBLE) Bank's name evidencing the storage of Inventory and/or an acknowledgment by such bailee of Bank's prior rights in the Inventory, in each case in form and substance acceptable to Bank. In any event, Borrower shall instruct any third party to hold all such Inventory for Bank's account subject to Bank's security interests and its instructions; and

g. Bank shall have the right upon demand now and/or at all times hereafter, during Borrower's usual business hours, after reasonable notice, to inspect and examine the Inventory and to check and test the same as to quality, quantity value and condition and Borrower agrees to reimburse Bank for Bank's reasonable costs and expenses in so doing.

6.6 Borrower represents, warrants and covenants with Bank that Borrower will not, without Bank's prior written consent:

a. Grant a security interest in or permit a lien, claim or encumbrance upon any of the Collateral (including the Intellectual Property) to any person, association, firm, corporation, entity or governmental agency or instrumentality, except Borrower may pledge a temporary license or other rights to use any of the Copyrights, Patents or Trademarks to any of its customers so long as Borrower provides prior written notice to Bank of the material terms of any such license agreements with a description of its likely impact on Borrower's business or financial condition;

b. Permit any levy, attachment or restraint to be made affecting any of Borrower's assets;

c. Permit any Judicial Officer or Assignee to be appointed or to take possession of any or all of Borrower's assets;

d. Other than sales of Inventory in the ordinary course of Borrower's business, to sell, lease, or otherwise dispose of, move, or transfer, whether by sale or otherwise, any of Borrower's assets;

e. Change its name, the location of its sole place of business, chief executive office or residence, business structure, corporate identity or structure, form of organization or the state in which it has been formed or organized; add any new fictitious names, dissolve, liquidate, merge or consolidate with or into any other corporation, entity, or other business organization, or permit another corporation, entity or other business organization to merge into it;

f. Move or relocate any Collateral;

g. Acquire any other business organization;

h. Enter into any transaction not in the usual course of Borrower's business;

i. Make any change in Borrower's financial structure or in any of its business objectives, purposes or operations which would materially adversely affect the ability of Borrower to repay Borrower's Indebtedness;

j. Incur any debts outside the ordinary course of Borrower's business except renewals or extensions of existing debts and interest thereon;

k. Make loans, advances or extensions of credit to any Person, except in the ordinary course of business;

l. Guarantee or otherwise, directly or indirectly, in any way be or become responsible for obligations of any other Person, whether by agreement to purchase the indebtedness of any other Person, agreement for the furnishing of funds to any other Person through the furnishing of goods, supplies or services, by way of stock purchase, capital contribution, advance or loan, for the purpose of paying or discharging (or causing the payment or discharge of) the indebtedness of any other Person, or otherwise, except for the endorsement of negotiable instruments by Borrower in the ordinary course of business for deposit or collection;

m. Make any payment on account of any Subordinated Debt except for regularly scheduled payments of interest and principal in accordance with the provisions of any Subordination Agreement executed by Bank and the subordinated debt holder, or amend any provision contained in any documentation relating to any such Subordinated Debt without Bank's prior written consent;

n. Sell, lease, transfer or otherwise dispose of properties and assets having an aggregate book value of more than Fifty Thousand Dollars ($50,000) (whether in one transaction or in a series of transactions) except as to the sale of inventory in the ordinary course of business; (b) change its name, consolidate with or merge into any other corporation, permit another corporation to merge into it, acquire all or substantially all the properties or assets of any other Person, enter into any reorganization or recapitalization or reclassify its capital stock, or (c) enter into any sale-leaseback transaction;

o. Purchase or hold beneficially any stock or other securities of, or make any investment or acquire any securities or other interest whatsoever in, any other Person, except for the common stock of the Subsidiaries owned by Borrower on the date of this Agreement and except for certificates of deposit with maturities of one year or less of United States commercial banks with capital, surplus and undivided profits in excess of One Hundred Million Dollars ($100,000,000.00) and the securities or other direct obligations of the United States Government maturing within one year from the date of acquisition thereof;

p. Allow any fact, condition or event to occur or exist with respect to any employee pension or profit sharing plans established or maintained by it which might constitute grounds for termination of any such plan or for the court appointment of a trustee to administer any such plan;

q. Use any loan or other extension of credit under this Agreement or any other document, instrument or agreement entered into by Borrower with or in favor of Bank in connection with this Agreement for any purpose other than to provide working capital for its operations, for the issuance of Letters of Credit and for other general business purposes. In no event shall the funds from any such loan or other extension of credit be used directly or indirectly by any Person for personal, family, household or agricultural purposes or for the purpose, whether immediate, incidental or ultimate, of purchasing, acquiring or carrying any "margin stock" or any "margin securities" (as such terms are defined respectively in Regulation U and Regulation G promulgated by the Board of Governors of the Federal Reserve System) or to extend credit to others directly or indirectly for the purpose of purchasing or carrying any such margin stock or margin securities. Borrower hereby represents and warrants that Borrower is not engaged principally, or as one of Borrower's important activities, in the business of extending credit to others for the purpose of purchasing or carrying such margin stock or margin securities; and

r. Borrower shall not without Bank's prior written consent acquire or expend for or commit itself to acquire or expend for fixed assets by lease, purchase or otherwise in an aggregate amount that exceeds Fifty Thousand Dollars ($50,000) in any fiscal year.

6.7 Borrower shall permit representatives of Bank to conduct audits of Borrower's Books relating to the Accounts and other Collateral and make extracts therefrom, with results satisfactory to Bank, provided that Bank shall use its best efforts to not interfere with the conduct of Borrower's business, and to the extent possible to arrange for verification of the Accounts directly with the account debtors obligated thereon or otherwise, all under reasonable procedures acceptable to Bank and at Borrower's sole expense; provided, however, that, prior to an Event of Default, Borrower shall not be responsible for more than one (1) such audit in each calendar year.

6.8 Borrower represents, warrants, covenants and agrees that:

a. Borrower's true and correct legal name is that set forth on the signature page to this Agreement. Except as disclosed in writing to Bank on or before the date of this Agreement, Borrower has not done business under any name other than that set forth on the signature page to this Agreement;

b. If Borrower is an individual, the location (as determined pursuant to the Uniform Commercial Code) of Borrower's principal residence is that set forth following Borrower's name on the signature page to this Agreement;

c. If Borrower is a registered organization that is organized under the laws of any one of the states comprising the United States (e.g. corporation, limited partnership, registered limited liability partnership or limited liability company), and is located (as determined pursuant to the Uniform Commercial Code) in the state under the laws of which it was organized, Borrower's form of organization and the state in which it has been organized are those set forth immediately following Borrower's name on the signature page to this Agreement;

d. If Borrower is a registered organization organized under the laws of the United States, and Borrower is located in the state that United States law designates as its location or, if United States law authorizes Borrower to designate the state for its location, the state designated by Borrower, or if neither of the foregoing are applicable, at the District of Columbia (in each case as determined in accordance with the Uniform Commercial Code), Borrower's form of organization and the state or district in which it is located are those set forth immediately following Borrower's name on the signature page to this Agreement;

e. If Borrower is a domestic organization that is not a registered organization under the laws of the United States or any state thereof (e.g. general partnership, joint venture, trust, estate or association), and Borrower is located (as determined pursuant to the Uniform Commercial Code) at its sole place of business or, if it has more than one place of business, at its chief executive office, Borrower's form of organization and the address of that location are those set forth on the signature page to this Agreement; and

f. If Borrower is a foreign individual or foreign organization or a branch or agency of a bank that is not organized under the laws of the United States or a state thereof, Borrower is located (as determined pursuant to the Uniform Commercial Code) at the address set forth following Borrower's name on the signature page to this Agreement.

6.9 If Borrower is a corporation, Borrower represents, warrants and covenants as follows:

a. Borrower will not make any distribution or declare or pay any dividend (in stock or in cash) to any shareholder or on any of its capital stock, of any class, whether now or hereafter outstanding, or purchase, acquire,

repurchase, or redeem or retire any such capital stock other than distributions or dividends made at such times when no Default or Event of Default is existing or would arise after giving effect thereto;

b. Borrower is and shall at all times hereafter be a corporation duly organized and existing in good standing under the laws of the state of its incorporation and qualified and licensed to do business in California or any other state in which it conducts its business;

c. Borrower has the right and power and is duly authorized to enter into this Agreement; and

d. The execution by Borrower of this Agreement shall not constitute a breach of any provision contained in Borrower's articles of incorporation or by-laws.

6.10 The execution of and performance by Borrower of all of the terms and provisions contained in this Agreement shall not result in a breach of or constitute an event of default under any agreement to which Borrower is now or hereafter becomes a party.

6.11 Borrower shall promptly notify Bank in writing of its acquisition by purchase, lease or otherwise of any after acquired property of the type included in the Collateral, with the exception of purchases of Inventory in the ordinary course of business.

6.12 All assessments and taxes, whether real, personal or otherwise, due or payable by, or imposed, levied or assessed against, Borrower or any of its property have been paid, and shall hereafter be paid in full, before delinquency. Borrower shall make due and timely payment or deposit of all federal, state and local taxes, assessments or contributions required of it by law, and will execute and deliver to Bank, on demand, appropriate certificates attesting to the payment or deposit thereof. Borrower will make timely payment or deposit of all F.I.C.A. payments and withholding taxes required of it by applicable laws, and will upon request furnish Bank with proof satisfactory to it that Borrower has made such payments or deposit. If Borrower fails to pay any such assessment, tax, contribution, or make such deposit, or furnish the required proof, Bank may, in its sole and absolute discretion and without notice to Borrower, (i) make payment of the same or any part thereof, or (ii) set up such reserves in Borrower's loan account as Bank deems necessary to satisfy the liability therefor, or both. Bank may conclusively rely on the usual statements of the amount owing or other official statements issued by the appropriate governmental agency. Each amount so paid or deposited by Bank shall constitute a Bank Expense and an additional advance to Borrower.

6.13 There are no actions or proceedings pending by or against Borrower or any guarantor of Borrower before any court or administrative agency and Borrower has no knowledge of any pending, threatened or imminent litigation, governmental investigations or claims, complaints, actions or prosecutions involving Borrower or any guarantor of Borrower, except as heretofore specifically disclosed in writing to Bank. If any of the foregoing arise during the term of the Agreement, Borrower shall immediately notify Bank in writing.

6.14 Insurance.

a. Borrower, at its expense, shall keep and maintain its assets insured against loss or damage by fire, theft, explosion, sprinklers and all other hazards and risks ordinarily insured against by other owners who use such properties in similar businesses for the full insurable value thereof. Borrower shall also keep and maintain business interruption insurance and public liability and property damage insurance relating to Borrower's ownership and use of the Collateral and its other assets. All such policies of insurance shall be in such form, with such companies, and in such amounts as may be satisfactory to Bank. Borrower shall deliver to Bank certified copies of such policies of insurance and evidence of the payments of all premiums therefor. All such policies of insurance (except those of public liability and property damage) shall contain an endorsement in a form satisfactory to Bank showing Bank as a loss payee thereof, with a waiver of warranties satisfactory to Bank, and all proceeds payable thereunder shall be payable to Bank and, upon receipt by Bank, shall be applied on account of the Indebtedness owing to Bank. To secure the payment of the Indebtedness, Borrower grants Bank a security interest in and to all such policies of insurance (except those of public liability and property damage) and the proceeds thereof, and Borrower shall direct all insurers under such policies of insurance to pay all proceeds thereof directly to Bank.

b. Borrower hereby irrevocably appoints Bank (and any of Bank's officers, employees or agents designated by Bank) as Borrower's attorney for the purpose of making, selling and adjusting claims under such policies of insurance, endorsing the name of Borrower on any check, draft, instrument or other item of payment for the proceeds of such policies of insurance and for making all determinations and decisions with respect to such policies of insurance. Borrower will not cancel any of such policies without Bank's prior written consent. Each such insurer shall agree by endorsement upon the policy or policies of insurance issued by it to Borrower as required above, or by independent instruments furnished to Bank, that it will give Bank at least ten (10) days written notice before any such policy or policies of insurance shall be altered or canceled, and that no act or default of Borrower, or any other person, shall affect the right of Bank to recover under such policy or policies

of insurance required above or to pay any premium in whole or in part relating thereto. Bank, without waiving or releasing any Indebtedness or any Event of Default, may, but shall have no obligation to do so, obtain and maintain such policies of insurance and pay such premiums and take any other action with respect to such policies which Bank deems advisable. All sums so disbursed by Bank, as well as reasonable attorneys' fees incurred by Bank, whether in-house or outside counsel is used, court costs, expenses and other charges relating thereto, shall constitute Bank Expenses and are payable on demand.

6.15 All financial statements and information relating to Borrower which have been or may hereafter be delivered by Borrower to Bank are true and correct and have been prepared in accordance with GAAP consistently applied and there has been no material adverse change in the financial condition of Borrower since the submission of such financial information to Bank.

6.16 Financial Reporting.

a. Borrower at all times hereafter shall maintain a standard and modern system of accounting in accordance with GAAP consistently applied with ledger and account cards and/or computer tapes and computer disks, computer printouts and computer records pertaining to the Collateral which contain information as may from time to time be requested by Bank, not modify or change its method of accounting or enter into, modify or terminate any agreement presently existing, or at any time hereafter entered into with any third party accounting firm and/or service bureau for the preparation and/or storage of Borrower's accounting records without the written consent of Bank first obtained and without said accounting firm and/or service bureau agreeing to provide information regarding the Accounts and Inventory and Borrower's financial condition to Bank; permit Bank and any of its employees, officers or agents, upon demand, during Borrower's usual business hours, or the usual business hours of third persons having control thereof, to have access to and examine all of Borrower's Books relating to the Collateral, Borrower's Indebtedness to Bank, Borrower's financial condition and the results of Borrower's operations and in connection therewith, permit Bank or any of its agents, employees or officers to copy and make extracts therefrom.

b. Borrower shall deliver to Bank within thirty (30) days after the end of each month, company prepared balance sheets, statements of cash flow, and profit and loss statements covering Borrower's operations; deliver to Bank as soon as available and in any event no later than 30 days before the beginning of the next fiscal year of Borrower, a annual financial projections of the Borrower that includes balance sheets, income statements, cash flow statements, a statement of underlying assumptions for the upcoming fiscal year, which projections shall be in form and content approved by Borrower's board of directors; deliver to Bank within one hundred eighty (180) days after the end of each of Borrower's fiscal years annual statements of the financial condition of Borrower for each such fiscal year, including but not limited to, a balance sheet, statements of cash flow, and profit and loss statement audited by independent certified public accountants acceptable to Bank in accordance with generally accepted accounting principles consistently applied (which such statements shall not be qualified as to the scope of review or as to the status of Borrower as a going concern, and shall state that such financial statements fairly present, in all material respects, the financial position of Borrower as at the dates indicated and the results of its operations and its cash flows for the periods indicated); and together with each delivery of the annual and monthly financial statements required by this Section 6.16 b., furnish to Bank a certificate of its chief executive officer or financial officer setting forth Borrower's compliance with the financial covenants set forth in Section 6.17 of this Agreement; and any other report requested by Bank relating to the Collateral and the financial condition of Borrower, and a certificate signed by an authorized employee of Borrower to the effect that all reports, statements, computer disk or tape files, computer printouts, computer runs, or other computer prepared information of any kind or nature relating to the foregoing or documents delivered or caused to be delivered to Bank under this subparagraph are complete, correct and thoroughly present the financial condition of Borrower and that there exists on the date of delivery to Bank no condition or event which constitutes a breach or Event of Default under this Agreement.

c. In addition to the financial statements requested above, Borrower agrees to provide Bank within fifteen (15) days after the end of each month, unless otherwise provided below (in form and content satisfactory to Bank) the following schedules:

(1) Accounts Receivable Agings

(2) Accounts Payable Agings

(3) Inventory Reports

6.17 Borrower shall maintain the following financial ratios and covenants on a consolidated and non-consolidated basis, which shall be monitored on a monthly basis, except as noted below:

a. an Adjusted Quick Ratio of not less than .85 to 1.00

b. a Debt-to-Tangible Effective Net Worth of not more than 1.25 to 1.00.

c. a minimum quarterly Net Income before taxes as determined for the four fiscal quarters then ended of at least:

i. $5,000,000 for the quarters ending March 31, 2008, June 30, 2008 and September 30, 2008, and

ii. $7,000,000 for the quarter ending December 31, 2008 and at all times thereafter.

All financial covenants shall be computed in accordance with GAAP consistently applied except as otherwise specifically set forth in this Agreement. All monies due from affiliates (including officers, directors and shareholders) shall be excluded from Borrower's assets for all purposes hereunder.

6.18 Borrower shall promptly supply Bank (and cause any guarantor to supply Bank) with such other information (including tax returns) concerning its financial affairs (or that of any guarantor) as Bank may request from time to time hereafter, and shall promptly notify Bank of any material adverse change in Borrower's financial condition and of any condition or event which constitutes a breach of or an event which constitutes an Event of Default under this Agreement.

6.19 Borrower is now and shall be at all times hereafter solvent and able to pay its debts (including trade debts) as they mature.

6.20 Borrower shall immediately and without demand reimburse Bank for all sums expended by Bank in connection with any action brought by Bank to correct any default or enforce any provision of this Agreement, including all Bank Expenses; Borrower authorizes and approves all advances and payments by Bank for items described in this Agreement as Bank Expenses.

6.21 Each warranty, representation and agreement contained in this Agreement shall automatically be deemed repeated with each advance and shall conclusively be presumed to have been relied on by Bank regardless of any investigation made or information possessed by Bank. The warranties, representations and agreements set forth herein shall be cumulative and in addition to any and all other warranties, representations and agreements which Borrower shall give, or cause to be given, to Bank, either now or hereafter.

6.22 Borrower shall keep all of its principal bank accounts with Bank and shall notify Bank immediately in writing of the existence of any other bank account, deposit account, or any other account into which money can be deposited.

6.23 Borrower shall furnish to Bank: (a) as soon as possible, but in no event later than thirty (30) days after Borrower knows or has reason to know that any reportable event with respect to any deferred compensation plan has occurred, a statement of the chief financial officer of Borrower setting forth the details concerning such reportable event and the action which Borrower proposes to take with respect thereto, together with a copy of the notice of such reportable event given to the Pension Benefit Guaranty Corporation, if a copy of such notice is available to Borrower; (b) promptly after the filing thereof with the United States Secretary of Labor or the Pension Benefit Guaranty Corporation, copies of each annual report with respect to each deferred compensation plan; (c) promptly after receipt thereof, a copy of any notice Borrower may receive from the Pension Benefit Guaranty Corporation or the Internal Revenue Service with respect to any deferred compensation plan; provided, however, this subparagraph shall not apply to notice of general application issued by the Pension Benefit Guaranty Corporation or the Internal Revenue Service; and (d) when the same is made available to participants in the deferred compensation plan, all notices and other forms of information from time to time disseminated to the participants by the administrator of the deferred compensation plan.

6.24 Borrower is now and shall at all times hereafter remain in compliance with all federal, state and municipal laws, regulations and ordinances relating to the handling, treatment and disposal of toxic substances, wastes and hazardous material and shall maintain all necessary authorizations and permits.

7. EVENTS OF DEFAULT.

Any one or more of the following events shall constitute an Event of Default by Borrower under this Agreement:

a. If Borrower fails or neglects to perform, keep or observe any term, provision, condition, covenant, agreement, warranty or representation contained in this Agreement, or any other present or future document, instrument or agreement between Borrower and Bank:

b. If any representation, statement, report or certificate made or delivered by Borrower, or any of its officers, employees or agents to Bank is not true and correct;

c. If Borrower fails to pay when due and payable or declared due and payable, all or any portion of Borrower's Indebtedness (whether of principal, interest, taxes, reimbursement of Bank Expenses, or otherwise);

d. If there is a material impairment of the prospect of repayment of all or any portion of Borrower’s Indebtedness or a material impairment of the value or priority of Bank’s security interest in the Collateral;

e. If all or any of Borrower’s assets are attached, seized, subject to a writ or distress warrant, or are levied upon, or come into the possession of any Judicial Officer or Assignee and the same are not released, discharged or bonded against within ten (10) days thereafter;

f. If any Insolvency Proceeding is filed or commenced by or against Borrower without being dismissed within ten (10) days thereafter;

g. If any proceeding is filed or commenced by or against Borrower for its dissolution or liquidation;

h. If Borrower is enjoined, restrained or in any way prevented by court order from continuing to conduct all (ILLEGIBLE) any material part of its business affairs;

i. If a notice of lien, levy or assessment is filed of record with respect to any or all of Borrower’s assets by the United States Government, or any department, agency or instrumentality thereof, or by any state, county, municipal or other government agency, or if any taxes or debts owing at any time hereafter to any one or more of such entities becomes a lien whether inchoate or otherwise, upon any or all of Borrower’s assets and the same is not paid on the payment date thereof;

j. If a judgment or other claim becomes a lien or encumbrance upon any or all of Borrower’s assets and the same is not satisfied, dismissed or bonded against within ten (10) days thereafter;

k. If Borrower’s records are prepared and kept by an outside computer service bureau at the time this Agreement is entered into or during the term of this Agreement such an agreement with an outside service bureau is entered into, and at any time thereafter, without first obtaining the written consent of Bank, Borrower terminates, modifies, amends (ILLEGIBLE) changes its contractual relationship with said computer service bureau or said computer service bureau fails to provide Bank with any requested information or financial data pertaining to Bank’s Collateral, Borrower’s financial condition or the results (ILLEGIBLE) Borrower’s operations;

l. If Borrower permits a default in any material agreement to which Borrower is a party with third parties so as to result in an acceleration of the maturity of Borrower’s indebtedness to others, whether under any indenture, agreement (ILLEGIBLE) otherwise;

m. If Borrower makes any payment on account of indebtedness which has been subordinated to Borrower’s Indebtedness to Bank except as otherwise permitted under the terms of this Agreement;

n. If any misrepresentation exists now or thereafter in any warranty or representation made to Bank by any officer or director of Borrower, or if any such warranty or representation is withdrawn by any officer or director;

o. If any party subordinating its claims to that of Bank’s or any guarantor of Borrower’s Indebtedness dies, terminates its subordination or guaranty, violates the terms of the subordination or guaranty, becomes insolvent, or an Insolvency Proceeding is commenced by or against any such subordinating party or guarantor;

p. If Borrower is an individual and Borrower dies;

q. If there is a change of ownership or control of twenty percent (20%) or more of the issued and outstanding stock of Borrower; or

r. If any reportable event, which Bank determines constitutes grounds for the termination of any deferred compensation plan by the Pension Benefit Guaranty Corporation or for the appointment by the appropriate United States District Court of a trustee to administer any such plan, shall have occurred and be continuing thirty (30) days after written notice of such determination shall have been given to Borrower by Bank, or any such Plan shall be terminated within the meaning of Title IV of the Employment Retirement Income Security Act (“ERISA”), or a trustee shall be appointed by the appropriate United States District Court to administer any such plan, or the Pension Benefit Guaranty Corporation shall institute proceedings to terminate any plan and in case of any event described in this Section 7, the aggregate amount of Borrower’s liability to the Pension Benefit Guaranty Corporation under Sections 4062,4063 or 4064 of ERISA shall exceed five percent (5%) of Borrower’s Tangible Effective Net Worth.

Notwithstanding anything contained in Section 7 to the contrary, Bank shall refrain from exercising its rights and remedies and Event of Default shall thereafter not be deemed to have occurred by reason of the occurrence of any of the events set forth in Sections 7.e, 7.f or 7.j of this Agreement if, within ten (10) days from the date thereof, the same is released, discharged,

dismissed, bonded against or satisfied; provided, however, if the event is the institution of Insolvency Proceedings against Borrower, Bank shall not be obligated to make advances to Borrower during such cure period.

8. BANK'S RIGHTS AND REMEDIES.

8.1 Upon the occurrence of an Event of Default by Borrower under this Agreement, Bank may, at its election, without notice of its election and without demand, do any one or more of the following, all of which are authorized by Borrower:

a. Declare Borrower's Indebtedness, whether evidenced by this Agreement, installment notes, demand notes or otherwise, immediately due and payable to Bank;

b. Cease advancing money or extending credit to or for the benefit of Borrower under this Agreement, or any other agreement between Borrower and Bank;

c. Terminate this Agreement as to any future liability or obligation of Bank, but without affecting Bank's rights and security interests in the Collateral, and the Indebtedness of Borrower to Bank;

d. Without notice to or demand upon Borrower or any guarantor, make such payments and do such acts as Bank considers necessary or reasonable to protect its security interest in the Collateral. Borrower agrees to assemble the Collateral if Bank so requires and to make the Collateral available to Bank as Bank may designate. Borrower authorizes Bank to enter the premises where the Collateral is located, take and maintain possession of the Collateral and the premises (at no charge to Bank), or any part thereof, and to pay, purchase, contest or compromise any encumbrance, charge or lien which in the opinion of Bank appears to be prior or superior to its security interest and to pay all expenses incurred in connection therewith;

e. Intentionally Omitted;

f. Ship, reclaim, recover, store, finish, maintain, repair, prepare for sale, advertise for sales and sell (in the manner provided for herein) the Inventory;

g. Sell or dispose the Collateral at either a public or private sale, or both, by way of one or more contracts or transactions, for cash or on terms, in such manner and at such places (including Borrower's premises) as is commercially reasonable in the opinion of Bank. It is not necessary that the Collateral be present at any such sale. At any sale or other disposition of the Collateral pursuant to this Section, Bank disclaims all warranties which would otherwise be given under the Uniform Commercial Code, including without limitation a disclaimer of any warranty relating to title, possession, quiet enjoyment or the like, and Bank may communicate these disclaimers to a purchaser at such disposition. This disclaimer of warranties will not render the sale commercially unreasonable;

h. Bank shall give notice of the disposition of the Collateral as follows:

(1) Bank shall give Borrower and each holder of a security interest in the Collateral who has filed with Bank a written request for notice, a notice in writing of the time and place of public sale, or, if the sale is a private sale or some disposition other than a public sale is to be made of the Collateral, the time on or after which the private sale or other disposition is to be made;

(2) The notice shall be personally delivered or mailed, postage prepaid, to Borrower's address appearing in this Agreement, at least ten (10) calendar days before the date fixed for the sale, or at least ten (10) calendar days before the date on or after which the private sale or other disposition is to be made, unless the Collateral is perishable or threatens to decline speedily in value. Notice to persons other than Borrower claiming an interest in the Collateral shall be sent to such addresses as have been furnished to Bank or as otherwise determined in accordance with Section 961 1 of the Uniform Commercial Code; and

(3) If the sale is to be a public sale, Bank shall also give notice of the time and place by publishing a notice one time at least ten (10) calendar days before the date of the sale in a newspaper of general circulation in the county in which the sale is to be held; and

(4) Bank may credit bid and purchase at any public sale.

i. Borrower shall pay all Bank Expenses incurred in connection with Bank's enforcement and exercise of any of its rights and remedies as herein provided, whether or not suit is commenced by Bank;

j. Any deficiency which exists after disposition of the Collateral as provided above will be paid immediately by Borrower. Any excess will be returned, without interest and subject to the rights of third parties, to Borrower by Bank, or, in Bank's discretion, to any party who Bank believes, in good faith, is entitled to the excess;

k. Without constituting a retention of Collateral in satisfaction of an obligation within the meaning of 9620 of the Uniform Commercial Code or an action under California Code of Civil Procedure 726, apply any and all amounts maintained by Borrower as deposit accounts (as that term is defined under 9102 of the Uniform Commercial Code) or other accounts that Borrower maintains with Bank against the Indebtedness;

l. The proceeds of any sale or other disposition of Collateral authorized by this Agreement shall be applied by Bank first upon all expenses authorized by the Uniform Commercial Code and all reasonable attorney fees and legal expenses incurred by Bank, whether in-house or outside counsel is used, the balance of the proceeds of the sale or other disposition shall be applied in the payment of the Indebtedness, first to interest, then to principal, then to remaining Indebtedness and the surplus, if any, shall be paid over to Borrower or to such other person(s) as may be entitled to it under applicable law. Borrower shall remain liable for any deficiency, which it shall pay to Bank immediately upon demand. Borrower agrees that Bank shall be under no obligation to accept any noncash proceeds in connection with any sale or disposition of Collateral unless failure to do so would be commercially unreasonable. If Bank agrees in its sole discretion to accept noncash proceeds (unless the failure to do so would be commercially unreasonable), Bank may ascribe any commercially reasonable value to such proceeds. Without limiting the foregoing, Bank may apply any discount factor in determining the present value of proceeds to be received in the future or may elect to apply proceeds to be received in the future only as and when such proceeds are actually received in cash by Bank; and

m. The following shall be the basis for any finder of fact's determination of the value of any Collateral which is the subject matter of a disposition giving rise to a calculation of any surplus or deficiency under Section 9615(f) of the Uniform Commercial Code: (i)The Collateral which is the subject matter of the disposition shall be valued in an "as is" condition as of the date of the disposition, without any assumption or expectation that such Collateral will be repaired or improved in any manner; (ii) the valuation shall be based upon an assumption that the transferee of such Collateral desires a resale of the Collateral for cash promptly (but no later than 30 days) following the disposition; (iii) all reasonable closing costs customarily borne by the seller in commercial sales transactions relating to property similar to such Collateral shall be deducted including, without limitation, brokerage commissions, tax prorations, attorney's fees, whether in-house or outside counsel is used, and marketing costs; (iv) the value of the Collateral which is the subject matter of the disposition shall be further discounted to account for any estimated holding costs associated with maintaining such Collateral pending sale (to the extent not accounted for in (iii) above), and other maintenance, operational and ownership expenses; and (v) any expert opinion testimony given or considered in connection with a determination of the value of such Collateral must be given by persons having at least 5 years experience in appraising property similar to the Collateral and who have conducted and prepared a complete written appraisal of such Collateral taking into consideration the factors set forth above. The "value" of any such Collateral shall be a factor in determining the amount of proceeds which would have been realized in a disposition to a transferee other than a secured party, a person related to a secured party or a secondary obligor under Section 9615(f) of the Uniform Commercial Code.

8.2 In addition to any and all other rights and remedies available to Bank under or pursuant to this Agreement or any other documents, instrument or agreement contemplated hereby, Borrower acknowledges and agrees that (i) at any time following the occurrence and during the continuance of any Event of Default, and/or (ii) termination of Bank's commitment or obligation to make loans or advances or otherwise extent credit to or in favor of Borrower hereunder, in the event that and to the extent that there are any Letter of Credit Obligations outstanding at such time, upon demand of Bank, Borrower shall deliver to Bank, or cause to be delivered to Bank, cash collateral in an amount not less than such Letter of Credit Obligations, which cash collateral shall be held and retained by Bank as cash collateral for the repayment of such Letter of Credit Obligations, together with any and all other Indebtedness of Borrower to Bank remaining unpaid, and Borrower pledges to Bank and grants to Bank a continuing first priority security interest in such cash collateral so delivered to Bank. Alternatively, Borrower shall cause to be delivered to Bank an irrevocable standby letter of credit issued in favor of Bank by a bank acceptable to Bank, in its sole discretion, in an amount not less than such Letter of Credit Obligations, and upon terms acceptable to Bank, in its sole discretion.

8.3 Bank's rights and remedies under this Agreement and all other agreements shall be cumulative. Bank shall have all other rights and remedies not inconsistent herewith as provided by law or in equity. No exercise by Bank of one right or remedy shall be deemed an election, and no waiver by Bank of any default on Borrower's part shall be deemed a continuing waiver. No delay by Bank shall constitute a waiver, election or acquiescence by Bank.

9. TAXES AND EXPENSES REGARDING BORROWER'S PROPERTY. If Borrower fails to pay promptly when due to another person or entity, monies which Borrower is required to pay by reason of any provision in this Agreement, Bank may, but need not, pay the same and charge Borrower's loan account therefor, and Borrower shall promptly reimburse Bank. All such sums shall become additional Indebtedness owing to Bank, shall bear interest at the rate hereinabove provided, and shall be secured by all Collateral. Any payments made by Bank shall not constitute (i) an agreement by it to make similar payments in the future, or (ii) a waiver by Bank of any default under this Agreement. Bank need not inquire as to, or contest the validity of, any such expense, tax, security interest,

encumbrance or lien and the receipt of the usual official notice of the payment thereof shall be conclusive evidence that the same was validly due and owing. Such payments shall constitute Bank Expenses and additional advances to Borrower.

10. WAIVERS.

10.1 Borrower agrees that checks and other instruments received by Bank in payment or on account of Borrower's Indebtedness constitute only conditional payment until such items are actually paid to Bank and Borrower waives the right to direct the application of any and all payments at any time or times hereafter received by Bank on account of Borrower's indebtedness and Borrower agrees that Bank shall have the continuing exclusive right to apply and reapply such payments in any manner as Bank may deem advisable, notwithstanding any entry by Bank upon its books.

10.2 Borrower waives demand, protest, notice of protest, notice of default or dishonor, notice of payment and nonpayment, notice of any default, nonpayment at maturity, release, compromise, settlement, extension or renewal of any or all commercial paper, accounts, documents, instruments, chattel paper, and guarantees at any time held by Bank on which Borrower may in any way be liable.

10.3 Bank shall not in any way or manner be liable or responsible for (a) the safekeeping of the Inventory; (b) any loss or damage thereto occurring or arising in any manner or fashion from any cause; (c) any diminution in the value thereof; or (d) any act or default of any carrier, warehouseman, bailee, forwarding agency or other person whomsoever. All risk of loss, damage or destruction of Inventory shall be borne by Borrower.

10.4 Borrower waives the right and the right to assert a confidential relationship, if any, it may have with any accountant, accounting firm and/or service bureau or consultant in connection with any information requested by Bank pursuant to or in accordance with this Agreement, and agrees that a Bank may contact directly any such accountants, accounting firm and/or service bureau or consultant in order to obtain such information.

10.5 Co-Borrowers. Each Borrower agrees as follows:

a. Each Borrower agrees that it is jointly and severally, directly, and primarily liable to Bank for payment in full of the indebtedness and that such liability is independent of the duties, obligations and liabilities of the other Borrower. The Agreement and each other document, instrument and agreement entered into by any one or more of the Borrowers in connection therewith (collectively, hereinafter, the "Loan Documents") are a primary and original obligation of each Borrower, are not the creation of a surety relationship, and are an absolute, unconditional, and continuing promise of payment and performance which shall remain in full force and effect without respect to future changes in conditions, including any change of law or any invalidity or irregularity with respect to the Loan Documents. Each Borrower acknowledges that the obligations of such Borrower undertaken herein might be construed to consist, at least in part, of the guaranty of obligations of persons or entities other than such Borrower (including any other Borrower party hereto) and, in full recognition of that fact, each Borrower consents and agrees that Bank may, at any time and from time to time, without notice or demand, whether before or after any actual or purported termination, repudiation, or revocation of the Agreement and the other Loan Documents by any one or more Borrowers, and without affecting the enforceability or continuing effectiveness hereof as to each Borrower: (a) supplement, restate, modify, amend, increase, decrease, extend, renew, accelerate, or otherwise change the time for payment or the terms of the indebtedness or any part thereof, including any increase or decrease of the rate(s) of interest thereon; (b) supplement, restate, modify, amend, increase, decrease or waive, or enter into or give any agreement, approval, or consent with respect to, the indebtedness or any part thereof, or any of the Loan Documents or any additional security or guaranties, or any condition, covenant, default, remedy, right, representation or term thereof or thereunder; (c) accept new or additional instruments, documents or agreements in exchange for or relative to any of the Loan Documents or the indebtedness or any part thereof; (d) accept partial payments on the Indebtedness; (e) receive and hold additional security or guaranties for the indebtedness or any part thereof; (f) release, reconvey, terminate, waive, abandon, fail to perfect, subordinate, exchange, substitute, transfer, or enforce any security or guaranties, and apply any security and direct the order or manner of sale thereof as Bank in its sole and absolute discretion may determine; (g) release any Person from any personal liability with respect to the indebtedness or any part thereof; (h) settle, release on terms satisfactory to Bank or by operation of applicable laws, or otherwise liquidate or enforce any indebtedness and any security therefor or guaranty thereof in any manner, consent to the transfer of any security and bid and purchase at any sale; or (i) consent to the merger, change, or any other restructuring or termination of the corporate or partnership existence of any Borrower or any other Person, and correspondingly restructure the Indebtedness, and any such merger, change, restructuring, or termination shall not affect the liability of any Borrower or the continuing effectiveness hereof, or the enforceability hereof with respect to all or any part of the Indebtedness.

b. Upon the occurrence and during the continuance of any Event of Default, Bank may enforce the Agreement and the other Loan Documents independently as to each Borrower and independently of any other remedy or security Bank at any time may have or hold in connection with the Indebtedness, and it shall not be necessary for Bank to marshal assets in favor of any Borrower or any other Person or to proceed upon or against or exhaust any security or remedy before proceeding to enforce the Agreement and the other Loan Documents. Each Borrower expressly waives any right to require Bank to marshal assets in favor of any Borrower or any other Person or to proceed against any other Borrower or any Collateral

provided by any Person, and agrees that Bank may proceed against Borrowers or any Collateral in such order as it (ILLEGIBLE) determine in its sole and absolute discretion.

c. Bank may file a separate action or actions against any Borrower, whether action is brought or prosecuted with respect to any security or against any other person, or whether any other person is joined in any such action or actions Each Borrower agrees that Bank and any Borrower and any affiliate of any Borrower may deal with each other in connection with the indebtedness or otherwise, or alter any contracts or agreements now or hereafter existing between any of them, (ILLEGIBLE) any manner whatsoever, all without in any way altering or affecting the continuing efficacy of the Agreement or the other Loan Documents.

d. Bank's rights under the Loan Documents shall be reinstated and revived, and the enforceability of the Agreement and the other Loan Documents shall continue, with respect to any amount at any time paid on account of the indebtedness which thereafter shall be required to be restored or returned by Bank, all as though such amount had not been paid. The rights of Bank created or granted herein and the enforceability of the Agreement and the other Loan Documents (ILLEGIBLE) all times shall remain effective to cover the full amount of all the indebtedness even though the Indebtedness, including any part thereof or any other security or guaranty therefor, may be or hereafter may become invalid or otherwise unenforceable (ILLEGIBLE) against any Borrower and whether or not any other Borrower shall have any personal liability with respect thereto.

e. To the maximum extent permitted by applicable law and to the extent that a Borrower is deemed guarantor, each Borrower expressly waives any and all defenses now or hereafter arising or asserted by reason of (a) an! disability or other defense of any other Borrower with respect to the Indebtedness, (b) the unenforceability or invalidity of any security or guaranty for the indebtedness or lack of perfection or continuing perfection or failure of priority of any security for the Indebtedness, (c) the cessation for any cause whatsoever of the liability of any other Borrower (other than by reason of the full payment and performance of all Indebtedness), (d) any failure of the Bank to marshal assets in favor of Bank or an] Borrower or any other person, (e) any failure of Bank to give notice of sale or other disposition of collateral to any Borrower (ILLEGIBLE) any other Person or any defect in any notice that may be given in connection with any sale or disposition of collateral, (f) any failure of Bank to comply with applicable law in connection with the sale or other disposition of any collateral or other security for any Obligation, including any failure of Bank to conduct a commercially reasonable sale or other disposition of any collateral or other security for any Obligation, (g) any act or omission of Bank or others that directly or indirectly results in (ILLEGIBLE) aids the discharge or release of any Borrower or the indebtedness or any security or guaranty therefor by operation of law (ILLEGIBLE) otherwise, (h) any law which provides that the obligation of a surety or guarantor must neither be larger in amount nor in (ILLEGIBLE) respects more burdensome than that of the principal or which reduces a surety's or guarantor's obligation in proportion to the principal obligation, (i) any failure of Bank to file or enforce a claim in any bankruptcy or other proceeding with respect to any Person, (j) the election by Bank of the application or non-application of Section 1111(b)(2) of the United States Bankruptcy Code, (k) any extension of credit or the grant of any lien under Section 364 of the United States Bankruptcy Code, (1) any use of cash collateral under Section 363 of the United States Bankruptcy Code, (m) any agreement or stipulation with respect to the provision of adequate protection in any bankruptcy proceeding of any Person, (n) the avoidance of any lien in favor (ILLEGIBLE) Bank for any reason, or (o) any action taken by Bank that is authorized by the Agreement or any other provision of any Loan Document. Until such time as all of the indebtedness have been fully, finally, and indefeasibly paid in full in cash: (i) each Borrower hereby waives and postpones any right of subrogation it has or may have as against any other Borrower respect to the Indebtedness; and (ii) in addition, each Borrower also hereby waives and postpones any right to proceed or to seek recourse against or with respect to any property or asset of any other Borrower. Each Borrower expressly waives all (ILLEGIBLE) and counterclaims and all presentments, demands for payment or performance, notices of nonpayment or nonperformance protests, notices of protest, notices of dishonor and all other notices or demands of any kind or nature whatsoever with respect to the Indebtedness, and all notices of acceptance of the Agreement or the other Loan Documents or of the existence, creation or incurring of new or additional Indebtedness.

f. In the event that all or any part of the Indebtedness at any time are secured by any one or more deeds (ILLEGIBLE) trust or mortgages or other instruments creating or granting liens on any interests in real property, each Borrower authorizes Bank, upon the occurrence of and during the continuance of any Event of Default, at its sole option, without notice or demand and without affecting the obligations of any Borrower, the enforceability of the Agreement and the other Loan Documents, (ILLEGIBLE) the validity or enforceability of any liens of Bank, to foreclose any or all of such deeds of trust or mortgages or other instruments by judicial or nonjudicial sale.

g. Without limiting the generality of any other waiver or other provision set forth in this Agreement, each Borrower waives all rights and defenses that such Borrower may have because the Indebtedness is secured by real property This means, among other things:

(1) Bank may collect from any Borrower without first foreclosing on any real or personal property pledged as Collateral by any other Borrower to secure the Indebtedness.

(2) If Bank forecloses on any real property pledged as Collateral by any Borrower:

(a) the amount of the debt may be reduced only by the price for which that Collateral is sold at the foreclosure sale, even if the collateral is worth more than the sale price.

(b) Bank may collect from any Borrower even if Bank, by foreclosing on the real property pledged as Collateral, has destroyed any right that Borrower may have to collect from any other Borrower.

This is an unconditional and irrevocable waiver of any rights and defenses each Borrower may have because the Indebtedness is secured by Real Property. These rights and defenses include, but are not limited to, any rights or defenses based upon Section 580a, 580b, 580d, or 726 of the California Code of Civil Procedure.

h. To the fullest extent permitted by applicable law, to the extent that a Borrower is deemed a guarantor, each Borrower expressly waives any defenses to the enforcement of the Agreement and the other Loan Documents or any rights of Bank created or granted hereby or to the recovery by Bank against any Borrower or any other Person liable therefor of any deficiency after a judicial or nonjudicial foreclosure or sale, even though such a foreclosure or sale may impair the subrogation rights of Borrowers and may preclude Borrowers from obtaining reimbursement or contribution from other Borrowers. To the fullest extent permitted by applicable law, each Borrower expressly waives any suretyship defenses or benefits that it otherwise might or would have under applicable law. WITHOUT LIMITING THE GENERALITY OF ANY OTHER WAIVER OR OTHER PROVISION SET FORTH IN THIS AGREEMENT, TO THE FULLEST EXTENT PERMITTED BY APPLICABLE LAW, EACH BORROWER WAIVES ALL RIGHTS AND DEFENSES ARISING OUT OF AN ELECTION OF REMEDIES BY BANK, EVEN THOUGH THAT ELECTION OF REMEDIES, SUCH AS A NONJUDICIAL FORECLOSURE WITH RESPECT TO SECURITY FOR THE INDEBTEDNESS, HAS DESTROYED SUCH BORROWER'S RIGHTS OF SUBROGATION AND REIMBURSEMENT AGAINST THE OTHER BORROWERS BY OPERATION OF LAW, INCLUDING BUT NOT LIMITED TO SECTION 580d OF THE CALIFORNIA CODE OF CIVIL PROCEDURE, OR OTHERWISE.

10.6 THE UNDERSIGNED ACKNOWLEDGE THAT THE RIGHT TO TRIAL BY JURY IS A CONSTITUTIONAL ONE, BUT THAT IT MAY BE WAIVED UNDER CERTAIN CIRCUMSTANCES. TO THE EXTENT PERMITTED BY LAW, EACH PARTY, AFTER CONSULTING (OR HAVING HAD THE OPPORTUNITY TO CONSULT) WITH COUNSEL OF ITS, HIS OR HER CHOICE, KNOWINGLY AND VOLUNTARILY, AND FOR THE MUTUAL BENEFIT OF ALL PARTIES, WAIVES ANY RIGHT TO TRIAL BY JURY IN THE EVENT OF LITIGATION ARISING OUT OF OR RELATED TO THIS AGREEMENT, THE INDEBTEDNESS OR ANY OTHER DOCUMENT, INSTRUMENT OR AGREEMENT BETWEEN THE UNDERSIGNED PARTIES.

10.7 Reference Provision.

(a) In the event the Jury Trial Waiver set forth above is not enforceable, the parties elect to proceed under this Judicial Reference Provision.

(b) With the exception of the items specified in clause (c), below, any controversy, dispute or claim (each, a "Claim") between the parties arising out of or relating to this Agreement or any other document, instrument or agreement between the undersigned parties (collectively in this Section, the "Comerica Documents"), will be resolved by a reference proceeding in California in accordance with the provisions of Sections 638 et seq. of the California Code of Civil Procedure ("CCP"), or their successor sections, which shall constitute the exclusive remedy for the resolution of any Claim, including whether the Claim is subject to the reference proceeding. Except as otherwise provided in the Comerica Documents, venue for the reference proceeding will be in the state or federal court in the county or district where the real property involved in the action, if any, is located or in the state or federal court in the county or district where venue is otherwise appropriate under applicable law (the "Court").

(c) The matters that shall not be subject to a reference are the following: (i) nonjudicial foreclosure of any security interests in real or personal property, (ii) exercise of self-help remedies (including, without limitation, set-off), (iii) appointment of a receiver and (iv) temporary, provisional or ancillary remedies (including, without limitation, writs of attachment, writs of possession, temporary restraining orders or preliminary injunctions). This reference provision does not limit the right of any party to exercise or oppose any of the rights and remedies described in clauses (i) and (ii) or to seek or oppose from a court of competent jurisdiction any of the items described in clauses (iii) and (iv). The exercise of, or opposition to, any of those items does not waive the right of any party to a reference pursuant to this reference provision as provided herein.

(d) The referee shall be a retired judge or justice selected by mutual written agreement of the parties. If the parties do not agree within ten (10) days of a written request to do so by any party, then, upon request of any party, the referee shall be selected by the Presiding Judge of the Court (or his or her representative). A request for appointment of a referee may be heard on an ex parte or expedited basis, and the parties agree that irreparable harm would result if ex parte relief is not granted. Pursuant to CCP § 170.6, each party shall have one peremptory challenge to the referee selected by the Presiding Judge of the Court (or his or her representative).

(e) The parties agree that time is of the essence in conducting the reference proceedings. Accordingly, the referee shall be requested, subject to change in the time periods specified herein for good cause shown, to (i) set the matter for a status and trial-setting conference within fifteen (15) days after the date of selection of the referee, (ii) if practicable, try all issues of law or fact within one hundred twenty (120) days after the date of the conference and (iii) report a statement of decision within twenty (20) days after the matter has been submitted for decision.

(f) The referee will have power to expand or limit the amount and duration of discovery. The referee may set or extend discovery deadlines or cutoffs for good cause, including a party's failure to provide requested discovery for any reason whatsoever. Unless otherwise ordered based upon good cause shown, no party shall be entitled to "priority" in conducting discovery, depositions may be taken by either party upon seven (7) days written notice, and all other discovery shall be responded to within fifteen (15) days after service. All disputes relating to discovery which cannot be resolved by the parties shall be submitted to the referee whose decision shall be final and binding.

(g) Except as expressly set forth herein, the referee shall determine the manner in which the reference proceeding is conducted including the time and place of hearings, the order of presentation of evidence, and all other questions that arise with respect to the course of the reference proceeding. All proceedings and hearings conducted before the referee, except for trial, shall be conducted without a court reporter, except that when any party so requests, a court reporter will be used at any hearing conducted before the referee, and the referee will be provided a courtesy copy of the transcript. The party making such a request shall have the obligation to arrange for and pay the court reporter. Subject to the referee's power to award costs to the prevailing party, the parties will equally share the cost of the referee and the court reporter at trial.

(h) The referee shall be required to determine all issues in accordance with existing case law and the statutory laws of the State of California. The rules of evidence applicable to proceedings at law in the State of California will be applicable to the reference proceeding. The referee shall be empowered to enter equitable as well as legal relief, enter equitable orders that will be binding on the parties and rule on any motion which would be authorized in a court proceeding, including without limitation motions for summary judgment or summary adjudication. The referee shall issue a decision at the close of the reference proceeding which disposes of all claims of the parties that are the subject of the reference. Pursuant to CCP § 644, such decision shall be entered by the Court as a judgment or an order in the same manner as if the action had been tried by the Court and any such decision will be final, binding and conclusive. The parties reserve the right to appeal from the final judgment or order or from any appealable decision or order entered by the referee. The parties reserve the right to findings of fact, conclusions of laws, a written statement of decision, and the right to move for a new trial or a different judgment, which new trial, if granted, is also to be a reference proceeding under this provision.

(i) If the enabling legislation which provides for appointment of a referee is repealed (and no successor statute is enacted), any dispute between the parties that would otherwise be determined by reference procedure will be resolved and determined by arbitration. The arbitration will be conducted by a retired judge or justice, in accordance with the California Arbitration Act §1280 through §1294.2 of the CCP as amended from time to time. The limitations with respect to discovery set forth above shall apply to any such arbitration proceeding.

(j) THE PARTIES RECOGNIZE AND AGREE THAT ALL CONTROVERSIES, DISPUTES AND CLAIMS RESOLVED UNDER THIS REFERENCE PROVISION WILL BE DECIDED BY A REFEREE AND NOT BY A JURY. AFTER CONSULTING (OR HAVING HAD THE OPPORTUNITY TO CONSULT) WITH COUNSEL OF ITS, HIS OR HER OWN CHOICE, EACH PARTY KNOWINGLY AND VOLUNTARILY, AND FOR THE MUTUAL BENEFIT OF ALL PARTIES, AGREES THAT THIS REFERENCE PROVISION WILL APPLY TO ANY CONTROVERSY, DISPUTE OR CLAIM BETWEEN OR AMONG THEM ARISING OUT OF OR IN ANY WAY RELATED TO, THIS AGREEMENT, THE INDEBTEDNESS OR THE OTHER COMERICA DOCUMENTS.

10.8 In the event that Bank elects to waive any rights or remedies hereunder, or compliance with any of the terms hereof, or delays or fails to pursue or enforce any term, such waiver, delay or failure to pursue or enforce shall only be effective with respect to that single act and shall not be construed to affect any subsequent transactions or Bank's right to later pursue such rights and remedies.

11. <u>ONE CONTINUING LOAN TRANSACTION</u>. All loans and advances heretofore, now or at any time or times hereafter made by Bank to Borrower under this Agreement or any other agreement between Bank and Borrower, shall constitute one loan secured by Bank's security interests in the Collateral and by all other security interests, liens, encumbrances heretofore, now or from time to time hereafter granted by Borrower to Bank.

Notwithstanding the above, (i) to the extent that any portion of the Indebtedness is a consumer loan, that portion shall not be secured by any deed of trust or mortgage on or other security interest in Borrower's principal dwelling which is not a purchase money security interest as to that portion, unless expressly provided to the contrary in another place, or (ii) if Borrower (or any of them) has (have) given or give(s) Bank a deed of trust or mortgage covering real property, that deed of trust or mortgage shall not secure the loan and any other Indebtedness of Borrower (or any of them), unless expressly provided to the contrary in another place.

12. NOTICES. Unless otherwise provided in this Agreement, all notices or demands by either party on the other relating to this Agreement shall be in writing and sent by regular United States mail, postage prepaid, properly addressed to Borrower or to Bank at the addresses stated in this Agreement, or to such other addresses as Borrower or Bank may from time to time specify to the other in writing. Requests for information made to Borrower by Bank from time to time hereunder may be made orally or in writing, at Bank's discretion.

13. AUTHORIZATION TO DISBURSE. Bank is hereby authorized to make loans and advances hereunder upon telephonic or other instructions received from anyone purporting to be an officer, employee, or representative of Borrower, or at the discretion of Bank if said loans and advances are necessary to meet any Indebtedness of Borrower to Bank. Bank shall have no duty to make inquiry or verify the authority of any such party, and Borrower shall hold Bank harmless from any damage, claims or liability by reason of Bank's honor of, or failure to honor, any such instructions.

14. PAYMENTS. Borrower hereby authorizes Bank to deduct the full amount of any interest, fees, costs, or Bank Expenses due under this Agreement and not paid or collected when due in accordance with the terms and conditions hereof from any account maintained by Borrower with Bank. Should there be insufficient funds in any such account to pay all such sums when due, the full amount of such deficiency shall be immediately due and payable by Borrower; provided, however, that Bank shall not be obligated to advance funds to cover any such payment.

15. DESTRUCTION OF BORROWER'S DOCUMENTS. Any documents, schedules, invoices or other papers delivered to Bank, may be destroyed or otherwise disposed of by Bank six (6) months after they are delivered to or received by Bank, unless Borrower requests, in writing, the return of the said documents, schedules, invoices or other papers and makes arrangements, at Borrower's expense, for their return.

16. CHOICE OF LAW. The validity of this Agreement, its construction, interpretation and enforcement, and the rights of the parties hereunder and concerning the Collateral, shall be determined according to the laws of the State of California. The parties agree that all actions or proceedings arising in connection with this Agreement shall be tried and litigated only in the state and federal courts in California.

17. GENERAL PROVISIONS.

17.1 This Agreement shall be binding and deemed effective when executed by Borrower and accepted and executed by Bank at its headquarters office.

17.2 This Agreement shall bind and inure to the benefit of the respective successors and assigns of each of the parties; provided, however, that Borrower may not assign this Agreement or any rights hereunder without Bank's prior written consent and any prohibited assignment shall be absolutely void. No consent to an assignment by Bank shall release Borrower or any guarantor from their obligations to Bank. Bank may assign this Agreement and its rights and duties hereunder. Bank reserves the right to sell, assign, transfer, negotiate or grant participations in all or any part of, or any interest in Bank's rights and benefits hereunder. In connection therewith, Bank may disclose all documents and information which Bank now or hereafter may have relating to Borrower or Borrower's business.

17.3 Paragraph headings and paragraph numbers have been set forth herein for convenience only; unless the contrary is compelled by the context, everything contained in each paragraph applies equally to this entire Agreement. Unless the context of this Agreement clearly requires otherwise, references to the plural include the singular, references to the singular include the plural, and the term "including" is not limiting. The words "hereof", "herein", "hereby", "hereunder", and similar terms in this Agreement refer to this Agreement as a whole and not to any particular provision of this Agreement.

17.4 Neither this Agreement nor any uncertainty or ambiguity herein shall be construed or resolved against Bank or Borrower, whether under any rule of construction or otherwise; on the contrary, this Agreement has been reviewed by all parties and shall be construed and interpreted according to the ordinary meaning of the words used so as to fairly accomplish the purposes and intentions of all parties hereto.

17.5 Each provision of this Agreement shall be severable from every other provision of this Agreement for the purpose of determining the legal enforceability of any specific provision.

17.6 This Agreement cannot be changed or terminated orally. This Agreement contains the entire agreement of the parties hereto and supersedes all prior agreements, understandings, representations, warranties and negotiations, if any, related to the subject matter hereof, and none of the parties shall be bound by anything not expressed in writing.

17.7 The parties intend and agree that their respective rights, duties, powers, liabilities, obligations and discretions shall be performed, carried out, discharged and exercised reasonably and in good faith.

17.8 In addition, if this Agreement is secured by a deed of trust or mortgage covering real property, then the trustor or mortgagor shall not mortgage or pledge the mortgaged premises as security for any other indebtedness or obligations. This Agreement, together with all other indebtedness secured by said deed of trust or mortgage, shall become due and payable immediately, without notice, at the option of Bank, (a) if said trustor or mortgagor shall mortgage or pledge the mortgaged premises for any other indebtedness or obligations or shall convey, assign or transfer the mortgaged premises by deed, installment sale contract (ILLEGIBLE) other instrument; (b) if the title to the mortgaged premises shall become vested in any other person or party in any manner whatsoever, or (c) if there is any disposition (through one or more transactions) of legal or beneficial title to a controlling interest of said trustor (ILLEGIBLE) mortgagor.

17.9 Each undersigned Borrower hereby agrees that it is jointly and severally, directly, and primarily liable to Bank for payment and performance in full of all duties, obligations and liabilities under this Agreement and each other document, instrument and agreement entered into by Borrower with or in favor of Bank in connection herewith, and that such liability is independent of the duties, obligations and liabilities of any other Borrower or any other guarantor of the Indebtedness, as applicable. Each reference herein to Borrower shall mean each and every Borrower party hereto, individually and collectively, jointly and severally.

17.10 This Agreement may be executed by the parties hereto in several counterparts, each of which shall be deemed to be an original and all of which shall constitute together but one and the same agreement. This Agreement, together with each other document, instrument and agreement entered into with or in favor of Bank in connection herewith constitute the entire understanding among the parties hereto with respect to the subject matter hereof and, as applicable amends and restates in full any other agreement, written or oral, with respect thereto.

IN WITNESS WHEREOF, the parties hereto have caused this Loan and Security Agreement (Accounts and Inventory) to be executed as of the date first hereinabove written.

BORROWER:
ENERGY RECOVERY, INC.,
a Delaware corporation

By: /s/ Tom Willardson
Name: TOM WILLARDSON
Title: CFO

By: ______________________
Name: ______________________
Title: ______________________

Address for Notices:

1908 Doolittle Drive
San Leandro, California 94577
Attention: Thomas Willardson, CFO
Fax Number: (510) 483-7371

Accepted and effective as of: March 27, 2008
at Bank's Western Market Headquarters Office

COMERICA BANK,
a Texas banking association

By: /s/ Darren Santos
Name: Darren Santos
Title: Corporate Banking Officer — Western Market

Address for Notices:

75 East Trimble Road
San Jose, California 95131
Attn: Credit Manager
Fax Number: (408) 556-5097

SCHEDULE OF PERMITTED LIENS

Attach Delaware and California UCC Lien Search Results

LIBOR Addendum To Loan and Security Agreement

This Addendum to Loan and Security Agreement (this “Addendum”) is entered into as of March 27, 2008, by and between Comerica Bank (the “Bank”) and Energy Recovery, Inc. (the “Borrower”). This Addendum supplements the terms of the Loan and Security Agreement (Accounts and Inventory) dated March 27, 2008 (the “Note”).

1. Definitions. As used in this Addendum, the following terms shall have the following meanings. Initially capitalized terms used and not defined in this Addendum shall have the meanings ascribed thereto in the Note.

a. “Advance” means a borrowing requested by Borrower and made by Bank under the Note, including any refunding of an outstanding Advance as the same type of Advance or the conversion of any such outstanding Advance to another type of Advance, and shall include a LIBOR-based Rate Advance and/or a Prime-based Rate Advance.

b. “Applicable Interest Rate” means the LIBOR-based Rate or the Prime-based Rate, as selected by Borrower from time to time or as otherwise determined in accordance with the terms and conditions of the Note.

c. “Business Day” means any day, other than a Saturday, Sunday or any other day designated as a holiday under Federal or applicable State statute or regulation, on which Bank is open for all or substantially all of its domestic and international business (including dealings in foreign exchange) in Detroit, Michigan and San Jose, California, and, in respect of notices and determinations relating to LIBOR-based Rate Advances, the LIBOR-based Rate and LIBOR Periods, also a day on which dealings in dollar deposits are also carried on in the London interbank market and on which banks are open for business in London, England.

d. “LIBOR-based Rate” means a per annum interest rate which is equal to the sum of two and three quarters percent (2.75%), plus the quotient of the following:

(i) the LIBOR Rate;

divided by

(ii) a percentage (expressed as a decimal) equal to 1.00 minus the maximum rate during such Eurodollar Period at which Bank is required to maintain reserves on “Euro-currency Liabilities” as defined in and pursuant to Regulation D of the Board of Governors of the Federal Reserve System or, if such regulation or definition is modified, and as long as Bank is required to maintain reserves against a category of liabilities which includes eurodollar deposits or includes a category of assets which includes eurodollar loans, the rate at which such reserves are required to be maintained on such category.

e. “LIBOR Lending Office” means Bank’s office located in the Cayman Islands, British West Indies, or such other branch of Bank, domestic or foreign, as it may hereafter designate as its LIBOR Lending Office by notice to Borrower.

f. “LIBOR Rate” means, with respect to any Indebtedness outstanding under the Note at the LIBOR-based Rate, the per annum rate of interest determined on the basis of the rate for deposits in United States Dollars for a period equal to the relevant LIBOR Period for such Indebtedness, commencing on the first day of such LIBOR Period, appearing on Page BBAM of the Bloomberg Financial Markets Information Service as of 8:00 a.m. (California time) (or soon thereafter as practical), two (2) Business Days prior to the first day of such LIBOR Period. In the event that such rate does not appear on Page BBAM of the Bloomberg Financial Markets Information Service (or otherwise on such Service), the “LIBOR Rate” shall be determined by reference to such other publicly available service for displaying eurodollar rates as may be agreed upon by Bank and Borrower, or, in the absence of such agreement, the “LIBOR Rate” shall, instead, be the per annum rate equal to the average (rounded upward, if necessary, to the nearest one-sixteenth of one percent (1/16%)) of the rate at which Bank is offered United States Dollar deposits at or about 8:00 a.m. (California time) (or soon thereafter as practical), two (2) Business Days prior to the first day of such LIBOR Period in the interbank eurodollar market in an amount comparable to the principal amount of the respective Indebtedness which is to bear interest at such LIBOR Rate and for a period equal to the relevant LIBOR Period.

g. “LIBOR Period” means, with respect to a LIBOR-based Rate Advance, a period of one (1) month, two (2) months, three (3) months, four (4) months, five (5) months, or six (6) months as selected by Borrower (and which period is acceptable to Bank in its sole discretion), or as otherwise determined pursuant to and in accordance with the terms of the Note, commencing on the day a LIBOR-based Rate Advance is made or the day an Advance is converted to a LIBOR-based Rate Advance or the day an outstanding LIBOR-based Rate Advance is refunded or continued as another LIBOR-based Rate Advance for an applicable LIBOR Period, provided that any LIBOR Period which would otherwise end on a day which is not a Business Day shall be extended to the next succeeding Business Day, except that if the next succeeding Business Day falls in another calendar month, the LIBOR Period shall end on the next preceding Business Day, and when an LIBOR Period begins on a day which has no numerically corresponding day in the calendar month during which such LIBOR Period is to end, it shall end on the last Business Day of such calendar month. In the event that any LIBOR-based Rate Advance is at any time refunded or continued as another LIBOR-based Rate Advance for an additional LIBOR Period, such LIBOR Period shall commence on the last day of the preceding LIBOR Period then ending.

h. “Prime-based Rate” means a per annum interest rate which is equal to the greater of (i) the Prime Rate plus zero percent (0%) per annum; or (ii) the rate of interest equal to the sum of (a) one percent (1%) and (b) the rate of interest equal to the

average of the rates on overnight Federal funds transactions with members of the Federal Reserve System arranged by Federal funds brokers (the "Overnight Rates"), as published by the Federal Reserve Bank of New York, or, if the Overnight Rates are not so published for any day, the average of the quotations for the Overnight Rates received by Bank from three (3) Federal funds brokers of recognized standing selected by Bank, as the same may be changed from time to time.

i. "Request for Advance" means a Request for Advance issued by Borrower in the form of Exhibit "A" attached hereto and incorporated herein by this reference.

2. Interest Rate Options. Borrower shall have the following options regarding the interest rate to be paid by Borrower on Advances under the Note:

a. A rate equal to two and three quarters percent (2.75%) above the LIBOR-based Rate, which LIBOR-based Rate shall be in effect during the relevant LIBOR Period; or

b. A rate equal to zero percent (0%) above the Prime-based Rate as referenced in the Note and quoted from time to time by Bank as such rate may change from time to time.

3. LIBOR-based Rate Advance. The minimum LIBOR-based Rate Advance will not be less Five Hundred Thousand and No/100 Dollars ($500,000.00) for any LIBOR-based Rate Advance.

4. Payment of Interest on LIBOR-based Rate Advances. Interest on each LIBOR-based Rate Advance shall be payable pursuant to the terms of the Note. Interest on such LIBOR-based Rate Advance shall be computed on the basis of a 360-day year and shall be assessed for the actual number of days elapsed from the first day of the LIBOR Period applicable thereto but not including the last day thereof.

5. Bank's Records Re: LIBOR-based Rate Advances. With respect to each LIBOR-based Rate Advance, Bank is hereby authorized to note the date, principal amount, interest rate and LIBOR Period applicable thereto and any payments made thereon on Bank's books and records (either manually or by electronic entry) and/or on any schedule attached to the Note, which notations shall be prima facie evidence of the accuracy of the information noted. For any LIBOR-based Rate Advance, if Bank shall designate a LIBOR Lending Office which maintains books separate from those of the rest of Bank, Bank shall have the option of maintaining and carrying such Advance on the books of such LIBOR Lending Office.

6. Selection/Conversion of Interest Rate Options. Borrower may request an Advance hereunder, including the refunding of an outstanding Advance as the same type of Advance or the conversion of an outstanding Advance to another type of Advance, upon the delivery to Bank of a Request for Advance executed by Borrower, subject to the following: (a) Bank shall not have made demand for payment hereunder and no Event of Default, or any condition or event which, with the giving of notice or the running of time, or both, would constitute an Event of Default, shall have occurred and be continuing or exist under the Note; (b) each such Request for Advance shall set forth the information required on the Request for Advance form attached hereto as Exhibit A; (c) each such Request for Advance shall be delivered to Bank by 10:00 a.m. (California time) on the proposed date of the requested Advance; (d) the principal amount of each LIBOR-based Rate Advance shall be at least Five Hundred Thousand Dollars ($500,000); (e) the proposed date of any refunding of any outstanding LIBOR-based Rate Advance as another LIBOR-based Rate Advance or the conversion of any outstanding LIBOR-based Rate Advance to a Prime-based Rate Advance shall only be on the last day of the LIBOR Period applicable to such outstanding LIBOR-based Rate Advance; and (f) a Request for Advance, once delivered to Bank, shall not be revocable by Borrower.

Advances hereunder may be requested in Borrower's discretion by telephonic notice to Bank. Any Advance requested by telephonic notice shall be confirmed by Borrower that same day by submission to Bank, either by first class mail, facsimile or other means of delivery acceptable to Bank, of the written Request for Advance aforementioned. Borrower acknowledges that if Bank makes an Advance based on a telephonic request, it shall be for Borrower's convenience and all risks involved in the use of such procedure shall be borne by Borrower, and Borrower expressly agrees to indemnify and hold Bank harmless therefor. Bank shall have no duty to confirm the authority of anyone requesting an Advance by telephone.

If, as to any outstanding LIBOR-based Rate Advance, Bank shall not receive a timely Request for Advance, or telephonic notice, in accordance with the foregoing requesting the refunding or continuation of such Advance as another LIBOR-based Rate Advance for a specified LIBOR Period or the conversion of such Advance to a Prime-based Rate Advance, effective as of the last day of the LIBOR Period applicable to such outstanding LIBOR-based Rate Advance, and as of the last day of each succeeding LIBOR Period, the principal amount of such Advance which is not then repaid shall be automatically refunded or continued as a LIBOR-based Rate Advance for successive LIBOR Periods of one (1) month each, unless Borrower is not entitled to request LIBOR-based Rate Advances hereunder or otherwise elect the LIBOR-based Rate as the Applicable Interest Rate for the principal Indebtedness outstanding hereunder in accordance with the terms of the Note or the LIBOR-based Rate is not otherwise available to Borrower as the Applicable Interest Rate hereunder for the principal Indebtedness outstanding hereunder in accordance with the terms of the Note, in which case, the Prime-based Rate shall be the Applicable Interest Rate hereunder in respect of such Indebtedness for such period, subject in all respects to the terms and conditions of the Note. The foregoing shall not in any way whatsoever limit or otherwise affect Bank's right to make demand for payment of all or any part of the Indebtedness hereunder at any time in Bank's sole and absolute discretion or any of Bank's rights or remedies under the Note upon the occurrence of any Event of Default thereunder, or any condition or event which, with the giving of notice or the running of time, or both, would constitute an Event of Default.

7. Default Interest Rate. Upon the occurrence of an Event of Default under the Note, the outstanding principal balance of the Note shall bear interest at the default rate set forth in the Note.

8. Prepayment. In the event that the LIBOR-based Rate is the Applicable Interest Rate for all or any part of the outstanding principal balance of the Note, and any payment or prepayment of any such outstanding principal balance of the Note shall occur on any day other than the last day of the applicable LIBOR Period (whether voluntarily, by acceleration, required payment, or otherwise), or if Borrower elects the LIBOR-based Rate as the Applicable Interest Rate for all or any part of the outstanding principal balance of the Note in accordance with the terms and conditions hereof, and, subsequent to such election, but prior to the commencement of the applicable LIBOR Period, Borrower revokes such election for any reason whatsoever, or if the Applicable Interest Rate in respect of any outstanding principal balance of the Note hereunder shall be changed, for any reason whatsoever, from the LIBOR-based Rate to the Prime-based Rate prior to the last day of the applicable LIBOR Period, or if Borrower shall fail to make any payment of principal or interest hereunder at any time that the LIBOR-based Rate is the Applicable Interest Rate hereunder in respect of such outstanding principal balance of the Note, Borrower shall reimburse Bank, on demand, for any resulting loss, cost or expense incurred by Bank as a result thereof, including, without limitation, any such loss, cost or expense incurred in obtaining, liquidating, employing or redeploying deposits from third parties. Such amount payable by Borrower to Bank may include, without limitation, an amount equal to the excess, if any, of (a) the amount of interest which would have accrued on the amount so prepaid, or not so borrowed, refunded or converted, for the period from the date of such prepayment or of such failure to borrow, refund or convert, through the last day of the relevant LIBOR Period, at the applicable rate of interest for such outstanding principal balance of the Note, as provided under the Note, over (b) the amount of interest (as reasonably determined by Bank) which would have accrued to Bank on such amount by placing such amount on deposit for a comparable period with leading banks in the interbank LIBOR market. Calculation of any amounts payable to Bank under this paragraph shall be made as though Bank shall have actually funded or committed to fund the relevant outstanding principal balance of the Note hereunder through the purchase of an underlying deposit in an amount equal to the amount of such outstanding principal balance of the Note and having a maturity comparable to the relevant LIBOR Period; provided, however, that Bank may fund the outstanding principal balance of the Note hereunder in any manner it deems fit and the foregoing assumptions shall be utilized only for the purpose of the calculation of amounts payable under this paragraph. Upon the written request of Borrower, Bank shall deliver to Borrower a certificate setting forth the basis for determining such losses, costs and expenses, which certificate shall be conclusively presumed correct, absent manifest error. Any prepayment hereunder shall also be accompanied by the payment of all accrued and unpaid interest on the amount so prepaid. Any outstanding principal balance of the Note which is bearing interest at such time at the Prime-based Rate may be prepaid without premium or penalty. Borrower hereby acknowledges and agrees that the foregoing shall not, in any way whatsoever, limit, restrict, or otherwise affect Bank's right to make demand for payment of all or any part of the Indebtedness under the Note due on a demand basis in Bank's sole and absolute discretion, whether such Indebtedness is bearing interest at the LIBOR-based Rate or the Prime-based Rate at such time.

BY INITIALING BELOW, BORROWER ACKNOWLEDGE(S) AND AGREE(S) THAT: (A) THERE IS NO RIGHT TO PREPAY ANY LIBOR-BASED RATE ADVANCE, IN WHOLE OR IN PART, WITHOUT PAYING THE PREPAYMENT AMOUNT SET FORTH HEREIN ("PREPAYMENT AMOUNT'), EXCEPT AS OTHERWISE REQUIRED UNDER APPLICABLE LAW; (B) BORROWER SHALL BE LIABLE FOR PAYMENT OF THE PREPAYMENT AMOUNT IF BANK EXERCISES ITS RIGHT TO ACCELERATE PAYMENT OF ANY LIBOR-BASED RATE ADVANCE AS PART OR ALL OF THE OBLIGATIONS OWING UNDER THE NOTE, INCLUDING WITHOUT LIMITATION, ACCELERATION UNDER A DUE-ON-SALE PROVISION; (C) BORROWER WAIVES ANY RIGHTS UNDER SECTION 2954.10 OF THE CALIFORNIA CIVIL CODE OR ANY SUCCESSOR STATUTE; AND (D) BANK HAS MADE EACH LIBOR-BASED RATE ADVANCE PURSUANT TO THE NOTE IN RELIANCE ON THESE AGREEMENTS.

/s/ TW
BORROWER'S INITIALS

9. Hold Harmless and Indemnification. Borrower agrees to indemnify Bank and to hold Bank harmless from, and to reimburse Bank on demand for, all losses and expenses which Bank sustains or incurs as a result of (i) any payment of a LIBOR-based Rate Advance prior to the last day of the applicable LIBOR Period for any reason, including, without limitation, termination of the Note, whether pursuant to this Addendum or the occurrence of an Event of Default; (ii) any termination of a LIBOR Period prior to the date it would otherwise end in accordance with this Addendum; or (iii) any failure by Borrower, for any reason, to borrow any portion of a LIBOR-based Rate Advance.

10. Regulatory Developments or Other Circumstances Relating to LIBOR Rate.

a. If, with respect to any LIBOR Period, Bank determines that, (a) by reason of circumstances affecting the foreign exchange and interbank markets generally, deposits in eurodollars in the applicable amounts or for the relative maturities are not being offered to Bank for such LIBOR Period, or (b) the LIBOR-based Rate will not accurately or fairly cover or reflect the cost to Bank of maintaining any of the Indebtedness under the Note at the LIBOR-based Rate for such LIBOR Period, then Bank shall forthwith give notice thereof to Borrower. Thereafter, until Bank notifies Borrower that such conditions or circumstances no longer exist, the right of Borrower to request a LIBOR-based Rate Advance and to convert an Advance to or refund an Advance as a LIBOR-based Rate Advance shall be suspended.

b. If, after the date hereof, the introduction of, or any change in, any applicable law, rule or regulation or in the interpretation or administration thereof by any governmental authority charged with the interpretation or administration thereof, or compliance by Bank (or its LIBOR Lending Office) with any request or directive (whether or not having the force of law) of any such authority, shall make it unlawful or impossible for the Bank (or its LIBOR Lending Office) to make or maintain any Advance with interest at the LIBOR-based Rate, Bank shall forthwith give notice thereof to Borrower. Thereafter, (a) until Bank notifies Borrower that such

conditions or circumstances no longer exist, the right of Borrower to request a LIBOR-based Rate Advance and to convert an Advance to or refund an Advance as a LIBOR-based Rate Advance shall be suspended, and thereafter, Borrower may select only the Prime-based Rate as the Applicable Interest Rate hereunder, and (b) if Bank may not lawfully continue to maintain an outstanding Advance to the end of the then current LIBOR Period applicable thereto, the Prime-based Rate shall be the Applicable Interest Rate for the remainder of such LIBOR Period with respect to such outstanding Advance.

c. If the adoption after the date hereof, or any change after the date hereof in, any applicable law, rule or regulation (whether domestic or foreign) of any governmental authority, central bank or comparable agency charged with the interpretation or administration thereof, or compliance by Bank (or its LIBOR Lending Office) with any request or directive (whether or not having the force of law) made by any such authority, central bank or comparable agency after the date hereof: (a) shall subject Bank (or its LIBOR Lending Office) to any tax, duty or other charge with respect to the Note or any Indebtedness hereunder, or shall change the basis of taxation of payments to Bank (or its LIBOR Lending Office) of the principal of or interest under the Note or any other amounts due under the Note in respect thereof (except for changes in the rate of tax on the overall net income of Bank or its LIBOR Lending Office imposed by the jurisdiction in which Bank's principal executive office or LIBOR Lending Office is located); or (b) shall impose, modify or deem applicable any reserve (including, without limitation, any imposed by the Board of Governors of the Federal Reserve System), special deposit or similar requirement against assets of, deposits with or for the account of, or credit extended by Bank (or its LIBOR Lending Office), or shall impose on Bank (or its LIBOR Lending Office) or the foreign exchange and interbank markets any other condition affecting the Note or the Indebtedness hereunder; and the result of any of the foregoing is to increase the cost to Bank of maintaining any part of the Indebtedness hereunder or to reduce the amount of any sum received or receivable by Bank under the Note by an amount deemed by the Bank to be material, then Borrower shall pay to Bank, within fifteen (15) days of Borrower's receipt of written notice from Bank demanding such compensation, such additional amount or amounts as will compensate Bank for such increased cost or reduction. A certificate of Bank, prepared in good faith and in reasonable detail by Bank and submitted by Bank to Borrower, setting forth the basis for determining such additional amount or amounts necessary to compensate Bank shall be conclusive and binding for all purposes, absent manifest error.

d. In the event that any applicable law, treaty, rule or regulation (whether domestic or foreign) now or hereafter in effect and whether or not presently applicable to Bank, or any interpretation or administration thereof by any governmental authority charged with the interpretation or administration thereof, or compliance by Bank with any guideline, request or directive of any such authority (whether or not having the force of law), including any risk-based capital guidelines, affects or would affect the amount of capital required or expected to be maintained by Bank (or any corporation controlling Bank), and Bank determines that the amount of such capital is increased by or based upon the existence of any obligations of Bank hereunder or the maintaining of any Indebtedness hereunder, and such increase has the effect of reducing the rate of return on Bank's (or such controlling corporation's) capital as a consequence of such obligations or the maintaining of such Indebtedness hereunder to a level below that which Bank (or such controlling corporation) could have achieved but for such circumstances (taking into consideration its policies with respect to capital adequacy), then Borrower shall pay to Bank, within fifteen (15) days of Borrower's receipt of written notice from Bank demanding such compensation, additional amounts as are sufficient to compensate Bank (or such controlling corporation) for any increase in the amount of capital and reduced rate of return which Bank reasonably determines to be allocable to the existence of any obligations of the Bank hereunder or to maintaining any Indebtedness hereunder. A certificate of Bank as to the amount of such compensation, prepared in good faith and in reasonable detail by the Bank and submitted by Bank to Borrower, shall be conclusive and binding for all purposes absent manifest error.

11. Legal Effect. Except as specifically modified hereby, all of the terms and conditions of the Note remain in full force and effect.

IN WITNESS WHEREOF, the parties have agreed to the foregoing as of the date first set forth above.

COMERICA BANK

By: /s/ Darren Santos
Its: Corporate Banking Officer — Western Market

ENERGY RECOVERY, INC.

By: /s/ Tom Willardson
Its: CFO

EXHIBIT A
REQUEST FOR ADVANCE

Borrower hereby requests COMERICA BANK ("Bank") to make a ________________________________ [LIBOR-based Rate or Prime-based Rate] Advance to Borrower on ____________________, in the amount of ____________________ Dollars ($____________________) under the Loan and Security Agreement (Accounts and Inventory) dated March 27, 2008, entered into between Borrower and Bank (the "Note"). Initially capitalized terms used and not defined in this Addendum shall have the meanings ascribed thereto in the Note. The Eurodollar Period for the requested Advance, if applicable, shall be ______________________________. In the event that any part of the Advance requested hereby constitutes the refunding or conversion of an outstanding Advance, the amount to be refunded or converted is _____ ________________ Dollars ($____________________), and the last day of the Eurodollar Period for the amounts being converted or refunded hereunder, if applicable, is ____________________.

Borrower represents, warrants and certifies that no Event of Default, or any condition or event which, with the giving of notice or the running of time, or both, would constitute an Event of Default, has occurred and is continuing under the Note, and none will exist upon the making of the Advance requested hereunder. Borrower further certifies that upon advancing the sum requested hereunder the aggregate principal amount outstanding under the Note will not exceed the face amount thereof. If the amount advanced to Borrower under the Note shall at any time exceed the face amount thereof, Borrower will immediately pay such excess amount, without any necessity of notice or demand.

Borrower hereby authorizes Bank to disburse the proceeds of the Advance being requested by this Request for Advance by crediting the account of Borrower with Bank separately designated by Borrower or as Borrower may otherwise direct, unless this Request for Advance is being submitted for a conversion or refunding of all or any part of any outstanding Advance(s), in which (ILLEGIBLE) such proceeds shall be deemed to be utilized, to the extent necessary, to refund or convert that portion stated above of the existing outstandings under such Advance(s).

Capitalized terms used but not otherwise defined herein shall have the respective meanings given to them in the Note.

Dated this __________ day of ____________________.

ENERGY RECOVERY, INC.

By: ____

Its: ____

EQUIPMENT RIDER

Borrower(s):
Energy Recovery, Inc.

Borrower has entered into a certain Loan and Security Agreement (Accounts and Inventory) (hereinafter referred to as “Agreement”), dated March 27, 2008 with Bank (Secured Party). This EQUIPMENT RIDER (hereinafter referred to as this “Rider”) dated March 27, 2008 is hereby made a part of and incorporated into that Agreement.

1. Borrower grants to Bank a security interest in the following wherever located (hereinafter referred to as “Equipment”):

(a) all of Borrower’s present machinery, equipment, fixtures, vehicles, office equipment, furniture, furnishings, tools, dies, jigs and attachments, wherever located, (including but not limited to, the items listed and described on the Schedule of Equipment attached hereto and marked Exhibit “A” and by this reference made a part hereof as though fully set forth herein);

(b) all of Borrower’s additional equipment, wherever located, of like or unlike nature, to be acquired hereafter, and all replacements, substitutes, accessions, additions and improvements to any of the foregoing; and

(c) all of Borrower’s general intangibles, including without limitation, computer programs, computer disks, computer tapes, literature, reports, catalogs, drawings, blueprints and other proprietary items.

2. Bank’s security interest in the Equipment as set forth above shall secure each, any and all of Borrower’s Indebtedness to Bank, as the term “Indebtedness” is defined in the Agreement.

3. Bank may, in its sole discretion, from time to time hereafter, make loans to Borrower. Loans made by Bank to Borrower pursuant to this Rider shall be included as part of the Indebtedness of Borrower to Bank and at Bank’s option, may be evidenced by promissory note(s), in form satisfactory to Bank. Such loans shall bear interest at the rate and be payable in the manner specified in said promissory note(s) in the event Bank exercises the aforementioned option, and in the event Bank does not, such loans shall bear interest at the rate and be payable in the manner specified in the Agreement.

4. Borrower represents and warrants to Bank that:

(a) it has good and indefeasible title to the Equipment;

(b) the Equipment is and will be free and clear of all liens, security interests, encumbrances and claims, except as held by Bank;

(c) the Equipment shall be kept only at the following locations: 1908 Doolittle Drive, San Leandro, California 94577;

(d) the owners or mortgagees of the respective locations are: 2101 Williams Associates, LLC; and

(e) Bank shall have the right upon demand now and/or at all times hereafter, during Borrower’s usual business hours to inspect and examine the Equipment and Borrower agrees to reimburse Bank for its reasonable costs and expenses in so doing.

5. Borrower shall keep and maintain the Equipment in good operating condition and repair, make all necessary replacements thereto so that the value and operating efficiency thereof shall at all times be maintained and preserved. Borrower shall not permit any items of Equipment to become a fixture to real estate or accession to other property, and the Equipment is now and shall at all times remain and be personal property.

6. Borrower, at its expense, shall keep and maintain: the Equipment insured against loss or damage by fire, theft, explosion, sprinklers and all other hazards and risks ordinarily insured against by other owners who use such properties and interest in properties in similar businesses for the full insurable value thereof; and business interruption insurance and public liability and property damage insurance relating to Borrower’s ownership and use of its assets. All such policies of insurance shall be in such form, with such companies and in such amounts as may be satisfactory to Bank. Borrower shall deliver to Bank certified copies of such policies of insurance and evidence of the payment of all premiums thereof. All such policies of insurance (except those of public liability and property damage) shall contain an endorsement in a form satisfactory to Bank showing loss payable to Bank and all proceeds payable thereunder shall be payable to Bank and upon receipt by Bank shall be applied on the account of Borrower’s Indebtedness. To secure the payment of Borrower’s Indebtedness, Borrower grants Bank a security interest in and to all such policies of insurance (except those of public liability and property damage) and the proceeds thereof and directs all insurers under such policies of insurance to pay all proceeds thereof directly to Bank. Borrower hereby irrevocably appoints Bank (and any of Bank’s officers, employees or agents designated by Bank) as Borrower’s attorney-in-fact for the purpose of making, settling and adjusting claims under such policies of insurance and for making all determinations and decisions with respect to such policies of insurance. Each such insurer shall agree by endorsement upon the policy or policies of insurance issued by it to Borrower as required above, or by independent instruments furnished to Bank that it will give Bank at least ten (10) days written notice before any such policy or policies of insurance shall be altered or canceled, and that no act or default of Borrower, or any other person, shall affect the right of Bank to recover under such policy or policies of insurance required above or to pay any premium in whole or in part relating thereto. Bank, without waiving or releasing any obligations or defaults by Borrower hereunder, may at any time or times hereafter, but shall have no obligation to do so, obtain and maintain such policies of insurance and pay such premiums and take any other action with respect to such policies which Bank deems advisable. All sums so disbursed by Bank, including reasonable attorneys’ fees, court costs, expenses and other charges relating thereto, shall be a part of Borrower’s Indebtedness and payable on demand.

7. Until default by Borrower under the Agreement or this Rider, Borrower may, subject to the provisions of the Agreement and this Rider and consistent therewith, remain in possession thereof and use the Equipment referred to herein in the ordinary course of business at the location or locations hereinabove designated.

8. All of the terms, conditions, warranties, covenants, agreements and representations of the Agreement are incorporated herein and reaffirmed.

9. Upon a default by Borrower under the Agreement or this Rider, Borrower upon request of Bank to do so, agrees to assemble and make the Equipment or any part thereof available to Bank at a place designated by Bank.

10. Borrower shall upon demand by Bank immediately deliver to Bank and properly endorse, any and all evidences of ownership, certificates of title or applications for title to any of the aforesaid items of Equipment.

11. Bank shall not in any way or manner be liable or responsible for (a) the safekeeping of the Equipment; (b) any loss or damage thereto occurring or arising in any manner or fashion from any cause; (c) any diminution in the value thereof or (d) any act or default by any person whomsoever. All risk of loss, damage or destruction of the Equipment shall be borne by Borrower.

Borrower: **ENERGY RECOVERY, INC.**

By: /s/ Tom Willardson
Its: CFO

By: ______________________
Its: ______________________

Accepted this 27th day of March, 2008 at Bank's place of business in Walnut Creek, CA

COMERICA BANK

By: /s/ Darren Santos
Its: Corporate Banking Officer-Western Market

ENVIRONMENTAL RIDER

Comerica Bank
NAME OF OFFICE

333 West Santa Clara Street, San Jose, CA 95113
ADDRESS

This ENVIRONMENTAL RIDER (this "Rider") dated this 27th day of March, 2008 is hereby made a part of and incorporated into that certain Loan and Security Agreement (the "Agreement") dated March 27, 2008 between Comerica Bank ("Bank") and Energy Recovery, Inc. ("Debtor").

1. Debtor hereby represents, warrants and covenants that none of the collateral or real property occupied and/or owned by Debtor has ever been used by Debtor or any other previous owner and/or operator in connection with the disposal of or to refine, generate, manufacture, produce, store, handle, treat, transfer, release, process or transport any hazardous substance, as defined in 42 U.S.C. 9601 (14) ("Hazardous Substance"), and Debtor will not at any time use the collateral or such real property for the disposal of, refining of, generating, manufacturing, producing, storing, handling, treating, transferring, releasing, processing, or transporting any such Hazardous Substances and/or any other hazardous waste.

2. None of the collateral or real property used and/or occupied by Debtor has been designated, listed or identified in any manner by the United States Environmental Protection Agency (the "EPA") or under and pursuant to the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended, set forth at 42 U.S.C. 9601 et seq. ("CERCLA") or the Resource Conservation and Recovery Act of 1986, as amended, set forth at 42 U.S.C. 9601 et seq. ("RCRA") or any other environmental protection statute as a Hazardous Substance, or any other hazardous waste, disposal or removal site, superfund or cleanup site or candidate for removal of closure pursuant to RCRA, CERCLA or any other environmental protection statute.

3. Debtor has not received a summons, citation, notice, directive, letter or other communication, written or oral, from the EPA or any other federal or state governmental agency or instrumentality, authorized pursuant to an environmental protection statute, concerning any intentional or unintentional action or omission by Debtor resulting in the releasing, spilling, leaking, pumping, pouring, emitting, emptying, dumping or otherwise disposing of a Hazardous Substance or other hazardous waste into the environment resulting in damage thereto or to the fish, shellfish, wildlife, biota or other natural resources.

4. Debtor shall not cause or permit to exist, as a result of an intentional or unintentional action or omission on its part, or on the part of any third party, on property owned and/or occupied by Debtor, any disposal, releasing, spilling, leaking, pumping, omitting, pouring, emptying or dumping of a Hazardous Substance or any other hazardous waste into the environment where damage may result to the environment, fish, shellfish, wildlife, biota or other natural resources unless such disposal, release, spill, leak, pumping, emission, pouring, emptying or dumping is pursuant to and in compliance with the conditions of a permit issued by the appropriate federal or state governmental authority.

5. Debtor shall furnish to Bank:

(a) Promptly and in any event within thirty (30) days after receipt thereof, a copy of any notice, summons, citation, directive, letter or other communications from the EPA or any other governmental agency or instrumentality concerning any intentional or unintentional action or omission on Debtor's part in connection with the handling, transporting, transferring, disposal or in the releasing, spilling, leaking, pumping, pouring, emitting, emptying or dumping of Hazardous Substances or any other hazardous waste into the environment resulting in damage to the environment, fish, shellfish, wildlife, biota and any other natural resource;

(b) Promptly and in any event within thirty (30) days after the receipt thereof, a copy of any notice of or other communication concerning the filing of a lien upon, against or in connection with Debtor, the collateral or Debtor's real property by the EPA or any other governmental agency or instrumentality authorized to file such a lien pursuant to an environmental protection statute in connection with a fund to pay for damages and/or cleanup and/or removal costs arising from the intentional or unintentional action or omission of Debtor resulting from the disposal or in the releasing, spilling, leaking, pumping, pouring, emitting, emptying or dumping of Hazardous Substances or any other hazardous waste into the environment;

(c) Promptly and in any event within thirty (30) days after the receipt thereof, a copy of any notice, directive, letter or other communication from the EPA or any other governmental agency or instrumentality acting under the authority of an environmental protection statute indicating that all or any portion of the Debtor's property or assets have been listed and/or borrowers deemed by such agency to be the owner and operator of the facility that has failed to furnish to the EPA or other authorized governmental agency or instrumentality, all the information required by the RCRA, CERCLA or other applicable environmental protection statutes;

(d) Promptly and in no event more than thirty (30) days after the filing thereof with the EPA or other governmental agency or instrumentality authorized as such pursuant to an environmental protection statute, copies of any and all information reports filed with such agency or instrumentality in connection with Debtor's compliance with RCRA, CERCLA or other applicable environmental protection statutes.

6. Any one or more of the following events which occur with respect to Debtor shall constitute an event of default:

(a) The breach by Debtor of any covenant or condition, representation or warranty contained in this Rider;

(b) The failure by Debtor to comply with each, every and all of the requirements of RCRA, CERCLA or any other environmental protection statute applicable to the collateral or the real property occupied and/or owned by Debtor;

(c) The receipt by Debtor of a notice from the EPA or any other governmental agency or instrumentality acting under the authority of any environmental protection statute, indicating that a lien has been filed against any of the collateral, or any of Debtor's other property by the EPA or any other governmental agency or instrumentality in connection with a fund as a result of damage arising from an intentional or unintentional action or omission by Debtor resulting from the disposal, releasing, spilling, leaking, pumping, pouring, emitting, emptying or dumping of Hazardous Substances or any other hazardous waste into the environment; and

(d) Any other event or condition exists which might, in the opinion of Bank, under applicable environmental protection statutes, have a material adverse effect on the financial or operational condition of Debtor or the value of all or any material part of the collateral or other property of Debtor.

In witness whereof, the Debtor has agreed as of the date first set forth above.

ENERGY RECOVERY, INC.

By: /s/ Tom Willardson
Its: CFO
By: ____________________
Its: ____________________

Automatic Loan Payment Authorization

Date: March 27, 2008

Obligor Name (Typed or Printed): Energy Recovery, Inc.

Obligor Number: ______________________ Lender's Cost Center #: ______________________

Address: 1908 Doolittle Drive, San Leandro, California 94577

STREET ADDRESS CITY STATE COUNTRY ZIP CODE

The undersigned hereby authorizes Comerica Bank ("Bank") to charge the account designated below for the payments due on the loan(s) as designated below and all renewals, extensions, modifications and/or substitutions thereof. This authorization will remain in effect unless the undersigned requests a modification that is agreed to by the Bank in writing. The undersigned remains fully responsible for all amounts outstanding to Bank if the designated account is insufficient for repayment.

☐ Automatic Payment Authorization for all payments on all current and future borrowings, as and when such payments come due (which payments include, without limitation, principal, interest, fees, costs, and expenses).

☐ Automatic Payment Authorization for all payments on only the specific borrowing identified below, as and when such payments come due (which payments include, without limitation, principal, interest, fees, costs, and expenses).

Specific Obligation Number: ______________________

☐ Automatic Payment Authorization for less than all payments on only the specific borrowing identified below, as and when such payments come due.

Specific Obligation Number: ______________________

- ☐ Principal and Interest payments only
- ☐ Principal payments only
- ☐ Interest payments only
- ☐ SPECIAL INSTRUCTIONS/IRREGULAR PAYMENT INSTRUCTIONS

Payment Due Date: Your loan payments will be charged to your account as indicated above on the dates such payments become due (or on a date thereafter when there are available funds) unless that day is a Saturday, Sunday, or Bank holiday in which case such payments will be charged on the following business day, with interest to accrue during this extension as provided under the loan documents.

Account to be Charged:

☑ Checking 1892962802 Comerica Account No. ____________________

☐ Savings ____________________ Comerica Account No. ____________________

Number of lead days to issue billing 15

(Charges to account are withdrawals pursuant to account resolution)

ENERGY RECOVERY, INC.

By: /s/ Tom Willardson
SIGNATURE OF

Its: CFO
TITLE

Borrower's Authorization

To: Comerica Bank ("Bank")

Re: Loan from the Bank evidenced by a note/agreement dated as of March 27, 2008 in the current amount of Nine Million Dollars ($9,000,000) ("Loan") executed by Energy Recovery, Inc. ("Borrower")

Borrower hereby authorizes and directs Bank to:

1. Disburse the proceeds of the Loan as follows:

   a. Wire Transfer to ____________________ the sum of $__________.

   b. Deposit to Account No. __________ in the name of __________ at Bank the sum of $__________.

   c. Credit to Loan No. __________ at Bank the sum of $__________ effective as of __________.

   d. Pay to Bank the sum of $__________ for payment of the Loan Fee.

   e. Pay to Bank the sum of $__________ for reimbursement of its costs and expenses for legal fees, appraisal fees, title fees, flood certification, tax service contract, etc. (Not Applicable for CALREAL product)

   f. Other: Obligor #8718005157, Note 59; Obligor #8718015909, Note 59

ENERGY RECOVERY, INC.

By: /s/ Tom Willardson
SIGNATURE OF

Its: CFO
TITLE

STATEMENT

Date: March 27, 2008

Energy Recovery, Inc.
1908 Doolittle Drive
San Leandro, California 94577
Attention: Thomas Willardson, CFO
Fax Number: (510) 483-7371

Comerica Bank
P.O. Box 49032
San Jose, CA 95161-9032

RE: Fee on $9,000,000 Note, dated March 27, 2008, and maturing September 30, 2008 Officer Darren Santos.

Commitment Fee	$9,000.00
TOTAL	**$9,000.00**

☐ Customer Check Attached

☐ Charge DDA No. ______________________________

Acknowledged by: /s/ Tom Willardson

FIRST MODIFICATION TO LOAN AND SECURITY AGREEMENT

This First Modification to Loan and Security Agreement (this "Modification") is entered into by and between**ENERGY RECOVERY, INC**. ("Borrower") and **COMERICA BANK** ("Bank") as of March 27, 2008, at San Jose, California.

RECITALS

This Modification is entered into upon the basis of the following facts and understandings of the parties, which facts and understandings are acknowledged by the parties to be true and accurate:

Bank and Borrower previously entered into a Loan and Security Agreement (Accounts and Inventory) dated March 27, 2008. The Loan and Security Agreement shall be referred to herein as the "Agreement."

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties agree as set forth below.

AGREEMENT

1. Incorporation by Reference. The Recitals and the documents referred to therein are incorporated herein by this reference. Except as otherwise noted, the terms not defined herein shall have the meaning set forth in the Agreement.

2. Modification to the Agreement. Subject to the satisfaction of the conditions precedent as set forth in Section 3 hereof, the Agreement is hereby modified as set forth below.

(a) Section 1.36 of the Agreement is hereby deleted in its entirety and replaced with the following:

"1.36 'Warranty Letter of Credit' shall mean a standby letter of credit which is issued or caused to be issued by Bank to support the obligations of Borrower with respect to a Warranty or a standby letter of credit which by its terms becomes a Warranty Letter of Credit."

(b) Section 4.10 of the Agreement is hereby deleted in its entirety and replaced with the following:

"4.10 Intentionally Deleted."

(c) The first sentence of Section 6.4 of the Agreement is hereby deleted in its entirety and replaced with the following:

"6.4 Borrower shall keep the Inventory only at the following locations: See

Schedule 6.4 attached hereto."

(d) Clause r. of Section 6.6 of the Agreement is hereby deleted in its entirety and replaced with the following:

“r. Borrower shall not without Bank’s prior written consent acquire or expend for or commit itself to acquire or expend for fixed assets by lease, purchase or otherwise in an aggregate amount that exceeds Seven Hundred Fifty Thousand Dollars ($750,000) in any fiscal year.”

(e) Clauses b. and c. of Section 6.16 of the Agreement are hereby deleted in their entirety and replaced with the following:

“b. Borrower shall deliver to Bank within thirty (30) days after the end of each quarter, company prepared balance sheets, statements of cash flow, and profit and loss statements covering Borrower’s operations; deliver to Bank as soon as available and in any event no later than 30 days before the beginning of the next fiscal year of Borrower, a annual financial projections of the Borrower that includes balance sheets, income statements, cash flow statements, a statement of underlying assumptions for the upcoming fiscal year, which projections shall be in form and content approved by Borrower’s board of directors; deliver to Bank within one hundred eighty (180) days after the end of each of Borrower’s fiscal years annual statements of the financial condition of Borrower for each such fiscal year, including but not limited to, a balance sheet, statements of cash flow, and profit and loss statement audited by independent certified public accountants acceptable to Bank in accordance with generally accepted accounting principles consistently applied (which such statements shall not be qualified as to the scope of review or as to the status of Borrower as a going concern, and shall state that such financial statements fairly present, in all material respects, the financial position of Borrower as at the dates indicated and the results of its operations and its cash flows for the periods indicated); and together with each delivery of the annual and quarterly financial statements required by this Section 6.16 b., furnish to Bank a certificate of its chief executive officer or financial officer setting forth Borrower’s compliance with the financial covenants set forth in Section 6.17 of this Agreement; and any other report requested by Bank relating to the Collateral and the financial condition of Borrower, and a certificate signed by an authorized employee of Borrower to the effect that all reports, statements, computer disk or tape files, computer printouts, computer runs, or other computer prepared information of any kind or nature relating to the foregoing or documents delivered or caused to be delivered to Bank under this subparagraph are complete, correct and thoroughly present the financial condition of Borrower and that there exists on the date of delivery to Bank no condition or event which constitutes a breach or Event of Default under this Agreement.

c. In addition to the financial statements requested above, Borrower agrees to provide Bank within fifteen (15) days after the end of each month, unless otherwise provided below (in form and content satisfactory to Bank) the following schedules:

(1) Accounts Receivable Agings

(2) Accounts Payable Agings

(3) Inventory Reports, within fifteen (15) days after the end of each quarter.”

(f) Section 6.17 of the Agreement is hereby deleted in its entirety and replaced with the following:

"6.17 Borrower shall maintain the following financial ratios and covenants on a consolidated and non-consolidated basis, which shall be monitored on a quarterly basis, except as noted below:

a. an Adjusted Quick Ratio of not less than .85 to 1.00

b. a Debt-to-Tangible Effective Net Worth of not more than 1.25 to 1.00.

c. a minimum rolling four quarter pre-tax income of at least:

i. $5,000,000 for the quarters ending March 31, 2008, June 30, 2008 and September 30, 2008, and

ii. $7,000,000 for the quarter ending December 31, 2008 and at all times thereafter.

All financial covenants shall be computed in accordance with GAAP consistently applied except as otherwise specifically set forth in this Agreement. All monies due from affiliates (including officers, directors and shareholders) shall be excluded from Borrower's assets for all purposes hereunder."

(g) Clause q. of Section 7 of the Agreement is hereby deleted in its entirety and replaced with the following:

"q. if there shall occur a transaction in which any "person" or "group" (within the meaning of Section 13(d) and 14(d)(2) of the Securities Exchange Act of 1934) becomes the "beneficial owner" (as defined in Rule 13d-3 under the Securities Exchange Act of 1934), directly or indirectly, of a sufficient number of shares of all classes of stock then outstanding of Borrower ordinarily entitled to vote in the election of directors, empowering such "person" or "group" to elect a majority of the board of directors of Borrower, who did not have such power before such transaction."

(h) Schedule 6.4 attached hereto is inserted into the Agreement immediately following the existing Schedule of Permitted Liens.

(i) The Equipment Rider attached to the Agreement is hereby deleted in its entirety and replaced with the Equipment Rider attached hereto.

3. Recertification of Authority. Borrower certifies to Bank that:

(a) the Restated Certification of Incorporation and Bylaws of Borrower delivered to Bank on or about December 1, 2005 remain in full force and effect and have not been amended, rescinded or repealed in any respect;

(b) the Corporate Resolutions and Incumbency Certification of Borrower delivered to Bank dated on or as of March 7, 2008 remain in full force and effect and the officers shown on such Incumbency Certification as officers authorized to execute and deliver to Bank documents in connection with loan financings: (i) continue to hold, and be duly appointed to, the offices indicated thereon; and (ii) continue to be duly authorized to execute and deliver to Bank this Modification and any and all documents necessary to evidence indebtedness and obligations of Borrower to Bank; and

(c) Borrower is in good standing in the State of Delaware and under each jurisdiction in which it is authorized to do business, including the State of California.

4. Legal Effect. The effectiveness of this Modification is conditioned upon receipt by Bank of this Modification, and any other documents which Bank may require to carry out the terms hereof. Except as specifically set forth in this Modification, all of the terms and conditions of the Agreement remain in full force and effect.

5. Integration. This is an integrated Modification and supersedes all prior negotiations and agreements regarding the subject matter hereof. All amendments hereto must be in writing and signed by the parties.

IN WITNESS WHEREOF, the parties have agreed as of the date first set forth above.

ENERGY RECOVERY, INC.

By: /s/ Tom Willardson
Its: CFO

By: TOM WILLARDSON
Its: CHIEF FINANCIAL OFFICER

COMERICA BANK

By: /s/ Darren Santos
Its: Corporate Banking Officer-Western Market

SCHEDULE 6.4
INVENTORY LOCATIONS

ADDRESS	OWNER/MORTGAGEE
1908 Doolittle Drive, San Leandro, California 94577 2661 Avarado, San Leandro, CA 94577	2101 Williams Associates, LLC Bob Legallet 1404 Griffith, San Francisco, CA
433 Hegenberger Road, Oakland, CA	Steve Moriarty Bergman, Inc. 39560 Stevenson Place Fremont, CA
Ribera Del Loira 46 Campo De Las Naciones 28042 Madrid, Spain	Regus Puerta De Las Naciones Ribera Del Loira 46 28042 Madrid, Spain

Exhibit 23.1

Consent of Independent Registered Public Accounting Firm

Energy Recovery, Inc.
San Leandro, California

We hereby consent to the use in the Prospectus constituting a part of this Registration Statement (Amendment No 1 to Form S-1) of our report dated March 28, 2008, relating to the consolidated financial statements and schedule of Energy Recovery, Inc., which is contained in that Prospectus.

We also consent to the reference to us under the caption “Experts” in the Prospectus.

/s/ BDO Seidman, LLP
San Jose, California

May 9, 2008

Exhibit 99.2

CONSENT OF PERSON ABOUT TO BECOME DIRECTOR

The undersigned hereby consents to the use of his name and any references to him as a person who will become a director of Energy Recovery, Inc. ("ERI") after the completion of its initial public offering in ERI's Registration Statement on Form S-1, and any and all amendments thereto, to be filed with the Securities and Exchange Commission pursuant to the Securities Act of 1933, as amended.

Dated: May 9, 2008

By: /s/ Paul M. Cook
Paul M. Cook

Baker & McKenzie LLP
Two Embarcadero Center, 11th Floor
San Francisco, CA 94111

May 12, 2008

United States Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Energy Recovery, Inc.
Amendment No. 1 to the Registration Statement on Form S-1
Initially Filed April 1, 2008
File No. 333-150007

Ladies and Gentlemen:

Attached for filing on behalf of our client, Energy Recovery, Inc., a Delaware corporation (the "Company"), pursuant to the Securities Act of 1933, as amended (the "Securities Act"), is Amendment No.1 to the Registration Statement on Form S-1 (File No. 333-150007), including exhibits, for registration of the Company's common shares for sale as described therein.

The registration fee in the amount of $6,877.50 was calculated pursuant to Rule 457(o) under the Securities Act. The registration fee was remitted previously to the Securities and Exchange Commission's account at US Bank by wire transfer.

Should you have any questions pertaining to this filing, you may reach the undersigned via telephone at (650) 251-5926 and via facsimile at (650) 856-9299.

Sincerely yours,

By: /s/ Jenny C. Yeh
Jenny C. Yeh

Enclosure

Asia Pacific
Bangkok
Beijing
Hanoi
Ho Chi Minh City
Hong Kong
Jakarta
Kuala Lumpur
Manila
Melbourne
Shanghai
Singapore
Sydney
Taipei
Tokyo

Europe & Middle East
Almaty
Amsterdam
Antwerp
Bahrain
Baku
Barcelona
Berlin
Bologna
Brussels
Budapest
Cairo
Düsseldorf
Frankfurt / Main
Geneva
Kyiv
London
Madrid
Milan
Moscow
Munich
Paris
Prague
Riyadh
Rome
St. Petersburg
Stockholm
Vienna
Warsaw
Zurich

North & South America
Bogotá
Brasilia
Buenos Aires
Calgary
Caracas
Chicago
Dallas
Guadalajara
Houston
Juarez
Mexico City
Miami
Monterrey
New York
Palo Alto
Porto Alegre
Rio de Janeiro
San Diego
San Francisco
Santiago
Sao Paulo
Tijuana
Toronto
Valencia
Washington, DC

[Baker & McKenzie Letterhead]

Baker & McKenzie LLP
660 Hansen Way
Palo Alto, CA 94304-1044, USA

Tel: +1 650 856 2400
Fax: +1 650 856 9299
www.bakernet.com

May 12, 2008

VIA EDGAR AND FEDERAL EXPRESS

Securities and Exchange Commission
Division of Corporation Finance
100 F Street, N.E.
Washington, DC 20549

Attention: Thomas Jones

Re: Energy Recovery, Inc.
Amendment No. 1 to the Registration Statement on Form S-1
Initially Filed April 1, 2008
File No. 333-150007

Dear Mr. Jones:

On behalf of Energy Recovery, Inc. (the “Company”), we submit this letter in response to comments from the staff (the “Staff”) of the Securities and Exchange Commission (the “SEC”) received by letter dated April 29, 2008 relating to the Company’s Registration Statement on Form S-1 (File No. 333-150007) (the “Registration Statement”).

On behalf of the Company, we are concurrently filing via EDGAR Amendment No. 1 to the Registration Statement (“Amendment No. 1”), and for the convenience of the Staff, we are providing copies of this letter and marked copies of Amendment No. 1 to Mr. Kartholy by overnight delivery.

In this letter, we have recited the comments from the Staff in italicized, bold type and have followed each comment with the Company’s response. Capitalized terms used but not defined herein shall have the meanings ascribed thereto in Amendment No. 1.

<u>Prospectus Cover Page</u>

1. Please confirm that any preliminary prospectus you circulate will include all non-Rule 430A information. This includes the price range and related information based on a bona fide estimate of the public offering price within that range, and other information that was left blank throughout the document.

The Company confirms that any preliminary prospectus it circulates will include all non-Rule 430A information.

Baker & McKenzie LLP is a member of Baker & McKenzie International, a Swiss Verein.

Prospectus Summary

2. ***Please revise so that the information in your summary is balanced and includes a more extensive and equally prominent summary of risks. We note, for example, that you provide separately captioned and explained bullets about your strengths on pages 2 and 3, but you provide only a brief reference to risks on page 3.***

The Company has revised pages 3 and 4 of Amendment No. 1 in response to the Staff's comment.

3. ***The documentation you provided to support various factual statements regarding your industry and your leadership within that industry is insufficient because it is too abbreviated or does not explain the relationship between the attachment and the disclosure. Please furnish sufficient support for those statements. Please furnish complete copies of sources upon which you rely extensively, such as the Global Water Intelligence article "Desalination Markets 2007" so we can get a more comprehensive view of the industry and your purported leadership role. Please mark or highlight the information in the source materials that supports your disclosure.***

The Company is providing Mr. Jones supplementally a complete copy of "Desalination Markets 2007," and has marked the relevant information therein that supports the Company's disclosure in Amendment No. 1 regarding its industry and its leadership position within that industry.

4. ***Please reconcile the statement in item 24 of the binder that the proposed Carlsbad, California plant, which if constructed, would be the largest SWRO plant in the United States with the documentation provided in item 24 that other future proposed plants in the United States would have larger capacities, such as the proposed plants in San Francisco and San Onofre. Also, we note the current status is "looking for lower bids" in the source material. If the status is so preliminary in nature, explain why you believe it is material enough to be included in the summary. If you retain the reference, advise investors of its current status.***

The Company advises the Staff that the proposed Carlsbad, California SWRO plant is in the final stages of the permit procurement process. The Company supplementally advises the Staff that other proposed plants, such as those in San Francisco and San Onofre, are in the initial stages of obtaining permits and as such, the Carlsbad plant likely will be built first and is being monitored closely by the industry and developers of such other proposed plants in California.

The Company has revised page 2 of Amendment No. 1 in response to the Staff's comment.

[Baker & McKenzie Letterhead]

5. ***Tell us whether the "Desalination Markets 2007" was prepared by an independent third party, whether it is publicly available, whether the registrant paid for the study, and whether the entity or person who prepared the report has consented to its references in your filing.***

The Company supplementally advises the Staff that "Desalination Markets 2007" was prepared by Global Water Intelligence, a monthly journal providing analysis and strategic data on the international water market that is published by Media Analytics Ltd, a privately owned publishing and information services group. "Desalination Market 2007" is available for purchase at a price of £995 per copy. The Company did not pay for the studies contained in "Desalination Market 2007" and has obtained written consent from Global Water Intelligence for the references made to Global Water Intelligence in Amendment No. 1.

Use of Proceeds, page 19

6. ***Please expand the appropriate section to provide the disclosure required by Item 505 of Regulation S-K.***

The Company has revised page 89 of Amendment No. 1 in response to the Staff's comment.

Capitalization, page 20

7. ***Cash, cash equivalents and short-term investments are not a component of capitalization for purposes of this disclosure. Please delete that item from the table.***

The Company has revised page 20 of Amendment No. 1 to remove this line item in response to the Staff's comment.

Dilution, page 22

8. ***Please expand the last paragraph to explain how the "share purchased" and "total consideration" would change in the table that precedes this paragraph, assuming all options and warrants were exercised.***

The Company has revised page 22 of Amendment No. 1 in response to the Staff's comment.

Selected Consolidated Financial Data, page 23

9. ***You state that the consolidated operations data as of December 31, 2004 and 2003 are derived from [y]our audited consolidated financial statements. Tell us why footnote 4***

to Consolidated Statement of Operations Data says that earnings per share calculations for 2004 and 2003 are not audited.

The Company supplementally advises the Staff that earnings per share calculations for 2004 and 2003 were derived from the 2004 and 2003 audited consolidated financial statements, respectively, which are not included in the prospectus. Accordingly, the Company has revised pages 23 and 24 of Amendment No. 1 to remove footnote 4 in response to the Staff's comment.

Management's Discussion and Analysis of Financial Condition and Results of Operations, page 25

Critical Accounting Policies and Estimates, page 25

Stock-Based Compensation, page 28

10. Please expand to disclose the intrinsic value of outstanding vested and unvested stock options based on the estimate offering price and the most recent balance sheet included in the filing.

The Company has revised page 28 of Amendment No. 1 in response to the Staff's comment, and will provide the missing information once the initial public offering price range has been determined.

11. It does not appear that management engaged an unrelated valuation specialist to perform contemporaneous valuations. Accordingly, we believe that MD&A should be expanded to provide the following information:

- ***A description of the significant factors, assumptions and methodologies used in determining fair value as of each grant date. In that regard, the disclosure should more specifically address how you valued common shares underlying stock options granted in December 2007 and for any subsequent issuances.***
- ***A description of each significant factor contributing to the difference between fair value as of each grant date and the estimated offering price.***

The Company has revised page 28 of Amendment No. 1 in response to the Staff's comment.

Quarterly Results of Operations, page 34

12. Please expand to clarify why EPC buying patterns lead to a higher proportion of sales in the fourth quarter.

The Company has revised pages 34 and 35 of Amendment No. 1 in response to the Staff's comment.

Liquidity and Capital Resources, page 35

13. Please file as an exhibit your new credit agreement. We note the last full sentence on page 35.

The Company has filed the Loan and Security Agreement dated March 27, 2008 and the First Modification to the Loan and Security Agreement dated March 27, 2008 as Exhibits 10.16 and 10.16.1, respectively, to Amendment No. 1.

Supplier Concentration, page 37

14. Please expand to discuss the material terms of your agreements with your material suppliers for your supply of ceramics. We note the disclosure in the second risk factor on page 10.

The Company has revised page 37 of Amendment No. 1 in response to the Staff's comment.

Our Strategy, page 46

15. Please provide us with independent support for your belief that the PX is currently the specified energy recovery device for a majority of the facilities in China.

The Company supplementally advises the Staff that its PX devices are currently installed in 28 desalination plants in China, which include the 36,000 cubic meter per day capacity desalination facility associated with the 4,000 megawatt YuHuan power plant. In addition, the Company supplementally advises the Staff that the PX is specified for the 100,000 cubic meter per day capacity SWRO project being built by Hyflux in Tianjin.

The Company has revised page 46 of Amendment No. 1 in response to the Staff's comment to reflect the foregoing and to delete the statement that the Company believes the PX is currently the specified energy recovery device for a majority of the facilities in China.

Compensation Discussion and Analysis, page 59

16. ***Please review the*** **Staff Observations in the Review of Executive Compensation Disclosure*****, dated October 9, 2007, and available on our website for specific guidance in the preparation of this discussion. In addition to the comments that follow, please consider the recommendations in this guidance, and revise your disclosure to provide a more comprehensive compensation discussion and analysis in your amended filing. We may have further comment.***

    The Company has reviewed the recommendations in the Staff Observations in the Review of Executive Compensation Disclosure and has provided a more comprehensive compensation discussion and analysis in Amendment No. 1 in response to the Staff's comment.

17. ***Please discuss how the specific compensation decisions in 2007 achieved each of the objectives mentioned in the list of bullets on page 59.***

    The Company has revised page 59 of Amendment No. 1 in response to the Staff's comment.

Annual Review Process, page 59

18. ***Please [sic] how you used compensation information from "comparable companies" and how the comparison affected your compensation decisions. Identify the companies to which the registrant compared itself, as well as the compensation components it used in that comparison.***

    The Company supplementally advises the Staff that the market data it used from the three benchmark salary survey firms for comparison purposes is proprietary, and as such, the Company is not permitted to identify the names of the companies used to compile the market data.

    The Company has revised page 60 of Amendment No. 1 in response to the Staff's comment.

Base Salary, page 60

19. ***Please expand the discussion of the base salaries to describe in greater detail the factors that are taken into account in setting the base salary levels of your named executive officers.***

    The Company has revised page 60 of Amendment No. 1 in response to the Staff's comment.

Cash Bonuses, page 60

20. Please revise to provide more specific quantitative information on the "key corporate goals" and "annual performance goals" that provided the basis for your cash bonuses in 2007.

The Company advises the Staff that it used certain non-public financial and other strategic objectives as the basis for calculating its executive cash bonuses in 2007. The Company believes that the disclosure of these non-public financial and strategic objectives would cause competitive harm by revealing the Company's near-term strategy and other financial objectives and/or projections. Additionally, the Company believes that the disclosure of these non-public financial and strategic goals would increase the risk of its competitors attracting and hiring its key executives. The Company therefore respectfully requests that its specific annual performance and key corporate goals not be disclosed in the Registration Statement.

The Company has revised page 60 of Amendment No. 1 in response to the Staff's comment to the extent practicable.

21. It is not clear how the amounts in the bonus column of the summary compensation table and footnote 1 reconcile with your description in the second paragraph regarding how the bonus amounts were calculated for other than Mr. Michelet. Please revise the disclosure to explain.

The Company supplementally advises the Staff that it presented separately the holiday bonuses in the Bonus column of the summary compensation table from the annual performance bonuses in the Non-Equity Incentive Plan Compensation column to avoid possible confusion that the total bonuses exceeded the stated bonus percentage in the second paragraph of page 60 of Amendment No. 1.

The Company has revised page 64 of Amendment No. 1 to combine the two bonus columns in the summary compensation table with revised footnotes in response to the Staff's comment.

22. Please explain what factors the board considered in determining the size of the $125,000 bonus to Mr. Michelet.

The Company has revised page 61 of Amendment No. 1 in response to the Staff's comment.

Equity Based Incentives, page 60

23. Please describe with specificity how the factors considered led you to the equity based decisions made in 2007. Include a discussion of how the factors led to decisions about option grants for the different executive officers.

The Company has revised page 62 of Amendment No. 1 in response to the Staff's comment.

Certain Relationships and Related Party Transactions, page 76

24. Please provide the disclosure required by Item 404(b) of Regulation S-K.

The Company has revised page 76 of Amendment No. 1 in response to the Staff's comment.

Financial Statements, page F-1

25. Please update the financial statements when required by Rule 3-12 of Regulation S-X.

The Company will update the financial statements when required by Rule 3-12 of Regulation S-X.

Note 2. Summary of Significant Accounting Policies, page F-7

Revenue Recognition, page F-8

26. Regarding the specific product performance criteria, tell us about your contractual obligations if your products do not meet the performance criteria upon commissioning of the plant.

The Company supplementally advises the Staff that based upon the historical performance of more than 4,000 shipped PX devices over the last decade, of which approximately 2,000 have been installed, the Company establishes performance criteria primarily with respect to energy efficiency, flow rates and the mixture of brine and sea water. The Company's related contractual obligations are conditioned upon proper operation of the plant by the customer or plant operator at specific plant flow rates. Customers are required to submit routine operating data reports to verify the plant is operating in a manner that complies with the contractual operating criteria. Although the specific performance obligations vary slightly from contract to contract, in general the Company provides performance guarantees only for large projects. To date, the Company had not encountered any instance in which its PX device was unable to meet the Company's performance criteria.

If the Company's products do not perform in accordance with the specifications in a contract and the customer can document that it has operated the products in accordance with the Company's operations and maintenance manuals, the Company would be obligated to trouble-shoot the devices to correct their performance, which may involve the replacement of defective components. In some cases, there is a deadline for making such corrections, typically within 20 or 30 days from the date the Company receives notice of a problem. In the event that the Company's products fail to achieve the specified performance despite trouble-shooting efforts, then in some instances the Company would be required to pay performance penalty fees as specified in the contract.

The Company believes that the risks associated with unsatisfactory product performance are minimal due to the following factors:

- the PX device is a standard, turnkey product, and the functionality of the device is identical for all customers;
- the Company reviews the plant design and operations prior to commissioning of a plant;
- representatives of the Company are present at the plant commissioning to provide supervision and training to the plant operators and to ensure a successful launch of the PX device;
- the Company's performance guarantees are conditioned upon proper operation of the plant at specific plant flow rates;
- the Company has never paid any claim for the non-performance of its PX device, there are no such claims currently pending and the Company is not aware of any such potential claims;
- every PX device undergoes a rigorous quality assurance inspection process starting with the high quality standards for the ceramic components, testing for micro tolerances in the finishing process, wet testing under pressure for every PX device that is shipped and for most large orders, witness testing by the customer before shipment whereby the customer signs off on its review and approval of the witness testing;
- extensive beta testing in various commercial plants is undertaken under a variety of conditions before commercial launch of any new PX models; and
- sea water reverse osmosis is a proven technology over several decades and there is a high degree of commonality in plant design and operation.

Based on the foregoing, management has determined that the probability of the Company having to make performance penalty payments under its customer contracts is remote. In accordance with SFAS No. 5, *Accounting for Contingencies*, the Company has not recorded a loss contingency for the performance penalty fees. If circumstances or business practices change in the future, management will reassess the need to record a contingent liability.

27. Tell us whether your arrangements ever include customer specified performance criteria. If so, tell us how you consider those criteria in recognizing revenue.

The Company supplementally advises the Staff that other than the performance criteria discussed in its response to Comment 26 above, the Company's purchase arrangements do not involve special customized modifications or installations based on customer specified performance criteria.

28. We see the extended period from shipment to final collection of the retention. It also appears that completion of the desalination facility is primarily responsibility of other entities. In a written response, please fully explain why it is appropriate to recognize revenue on the retention portion prior to successful commissioning of the facility. Tell us how you have concluded that your practices are consistent with guidance from SAB Topic 13.

The Company supplementally advises the Staff that the retention payments and duration of the payment terms are standard contractual terms for the large plant purchase arrangements based on industry standards for the Company's EPC customers. Customers are obligated to pay 100% of the contract price with the final payment due upon product performance. The historical performance of the PX device is reasonably assured based on the technical specifications established by the Company's standard operating procedures for the device.

In accordance with the guidance from SAB Topic 13A1, Selected Revenue Recognition Issues, the Company references the statement from paragraph 2 regarding Concepts Statement 5, paragraph 83(b), which states that "an entity's revenue-earning activities involve delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues." Further, paragraph 84(a) states "the two conditions (being realized or realizable and being earned) are usually met by the time product or merchandize is delivered or services are rendered to customers, and revenues from manufacturing and selling activities...are commonly recognized at time of sale (usually meaning delivery)."

For most large orders, the customer performs witness testing at the Company's site before shipment and, upon completion of such witness testing, the customer signs-off on its review and approval of the performance of the PX device.

Based on the Company's business practices with its EPC customers, when the product is delivered the remaining undelivered elements typically are limited to supervision of customer personnel and training during the commissioning of the plant. The installation of the PX device is relatively simple, requires no customization and is performed by the customer under the supervision of Company personnel. The Company defers the fair value of the service and training component of the contract until such services and training are performed. Although the Company may agree to performance guarantees and retention payments, management concluded that the Company satisfies its contractual obligations when the product is delivered to the customer based on the following three key factors: 1) historical performance of the PX device; 2) the lack of concessions related to the final payments due to unsatisfactory performance of the PX product or other business purposes; and 3) the lack of requirement of any special customization in order for the PX device to operate in the various plants.

Although the Company deems the revenue earning process to be completed upon delivery of the product, it also evaluates the reasonable assurance of collection. As a standard procedure, management evaluates each contract and the Company's relationship with the customer to determine if revenue should be deferred for the retention payments based on any collection concerns. Some of the factors the Company considers in connection with this assessment are the length of time the Company has worked with the customer, the customer's reputation and relationship with its suppliers, and the duration and materiality of the retention payments. To date, based on the Company's evaluations, it has not recorded any deferred revenue associated with the retention payments. Please also refer to the Company's response to Comment 29 below for more details related to collection of the retention payments.

The Company advises the Staff that the period from shipment to final collection typically ranges from 12 to 24 months. In the Company's subsequent review of its contracts, it determined that there are no contracts with payment terms extending to 36 months from shipment as previously disclosed in the Registration Statement. Accordingly, the Company has amended pages 8, 9, 26, 36, 50, F-9 and F-15 of Amendment No. 1 to reflect the foregoing.

29. In light of the extended period from shipment to collection of the retention, please tell us how you determine and document that collection is reasonably assured.

The Company supplementally advises the Staff that with respect to the retention payment amounts due under customer contracts during 2005, 2006 and 2007, management assessed the reasonable assurance of collection and determined that the

collections were highly probable. As a result, management has determined that the fourth criteria for revenue recognition under Staff Accounting Bulletin — Topic 13: Revenue Recognition (i.e., collectability is reasonably assured) has been met. The assessment was based on the following factors:

- Industry standard — For the contracts related to larger plants, the Company's EPC customers require extended retention payments from all of their suppliers. The Company does not offer exceptional terms to its EPC customers.
- Performance of the PX device — Based on the history of the product consistently meeting or exceeding the performance criteria stated in the customer contracts, management believed that performance issues would be remote and that disputes over payment of the retention would not be related to the performance of the PX. The performance and related failure rates of the PX device are continuously monitored by the Company's engineering team to ascertain any adverse changes in performance. In 2007, the Company decided to increase the length of time for its warranty on the ceramic component of the PX device based on its relatively low failure rate.
- Customer satisfaction — The Company has several customers who have built and are operating more than one plant using the PX technology. For example, UTE Desaladora Skidka, Tedagua and UTE Desaladora Benisaf include mutual joint venture partners/owners to whom the Company has sold equipment in the past. Competitive products are and have been available, but the Company has not lost any major customers due to competition. In addition, some of the Company's existing customers are currently designing new plant projects that will use the PX device versus products of the Company's competitors.
- Future support and spare parts — In addition to the sale and commissioning of the plants, the Company's customers may need to procure spare parts for existing plants and new equipment for future plants. The PX is a proprietary product with no alternative source of part supply. Once the PX product is selected it would be prohibitively expensive for the PX to be removed from the plant for servicing. As such, the Company's customers understand that a strong business relationship requires them to satisfy their payment obligations in order for the Company to provide support on existing contracts and to engage in future contracts for the sale of PX devices. Management believes these aspects of the Company's business relationship, combined with customers' satisfaction with the PX product performance, contribute to an extremely low number of product returns, a limited number of sales allowances issued and a strong collection rate.
- Financial credit review — Before products are shipped, management researches the financial circumstances related to each joint venture project or individual

EPC. Management’s assessment of the financial background of the Company’s large customers includes an in-depth understanding of their current financial resources and their historical performance and relationships with their suppliers. For the most part, these customers are either directly or indirectly funded by some of the largest engineering firms in the world, including businesses such as General Electric, Acciona and Doosan Heavy Industries.

- Historical payment performance — The retention collection rate for 2005, 2006 and 2007 was 99%. As of December 31, 2007, only one customer had an unpaid balance in the amount of $134,000. This delay in payment has been resolved and a standby letter of credit has been received from the customer. This payment is due in June 2008.

30. Tell us your collection history with regards to the unbilled receivables and the nature of any significant write-offs. Please also address any significant instances where you were required to perform under the collaterized letter of credit.

As discussed in the Company’s response to Comment 29, the Company has a 99% collection history with regards to unbilled receivables, and there have been no significant write-offs. The Company’s overall history with the collection of retention payments is as follows: as of December 31, 2007, $1.8 million of retention payments were contractually owed and billed to customers out of the $6.2 million of total retentions. In other words, approximately 30% of all retention payments were contractually owed and billed to customers. Of such amount, 99% has been paid or presented under standby letters of credit. The remaining retention payments totaling $4.4 million will be invoiced in future periods and management has determined that collectability of these amounts is reasonably assured based on management’s knowledge of the business partners and other key factors outlined in the Company’s response to Comment 29.

The Company further supplementally advises the Staff that it has never had a performance issue with a PX device that required the Company to perform under a collateralized letter of credit pursuant to the performance guarantee provisions in the customer contracts.

Note 9. Stockholders’ Equity, page F-23

Stock Option Plans, page F-24

31. We see that the estimated fair value of a common share used in estimating the valuing stock options was $5 per share as of both June and December 2007. We also see the significant growth in your business in the second half of 2007. Please tell us why you believe $5 was an appropriate measure of fair value of a common share in December 2007. Describe to us the objective evidence and analysis which supports

your determination of the fair value. Please update your response for any stock options or other stock issuances subsequent to December 31, 2007.

The Company advises the Staff that a private placement of 1,000,000 shares of its common stock was consummated in May 2007 at $5 per share, and the Company relied on this private placement for purposes of determining the fair market value of its common stock. The Company supplementally advises the Staff that, in connection with the private placement, the Company issued a private placement memorandum that was produced by Poten Capital Services, the Company's independent financial advisor. The private placement memorandum projected revenue of $35.1 million for 2007, which was very close to the Company's actual revenue of $35.4 million for 2007. Because the Company only met the expectations of investors in 2007, management did not believe there was any reason to adjust the fair market value of the Company's common stock in December 2007 or the first quarter of 2008.

In March 2008, the Company retained the services of Finance Scholars Group ("FSG"), an independent valuations firm that prepared the valuation of the Company's common stock for 2007, 2006 and 2005. The Company has revised page 28 of Amendment No. 1 to include the analysis conducted by FSG in its determination of the fair market value of the Company's common stock during those years. The Company supplementally advises the Staff that pursuant to the terms of the engagement letter with FSG, the Company is not permitted to disclose FSG's name in the Registration Statement.

Furthermore, in March 2008 the Company received a written offer from a reputable private equity fund to purchase $65 million of the Company's common stock at $5 per share. While the Company did not accept this offer, it responded that it may re-evaluate the offer at a later date pending capital market conditions. Management believes that this offer corroborates its belief that the fair market value of the Company's common stock remained at $5 per share as of March 2008, which value was used in estimating the value of stock options issued by the Company in the first quarter of 2008.

32. Please tell us when discussions were initiated with your underwriter(s) about possible offering price ranges and provide us with a chronological bridge of management's fair value per share determinations to the current estimated IPO price per share.

The Company supplementally advises the Staff that it has not yet negotiated an offering price range with its underwriters. While the Company's underwriters indicated possible valuations in early 2008, such valuations were very preliminary and were discussed prior to the completion of the Company's 2007 audited financial results. The Company is expected to determine an offering price range soon based on prevailing market conditions, but in any event prior to the circulation of any preliminary prospectus. The Company further supplementally advises the Staff that the Company will not be issuing any additional stock options until its 2008 Equity Incentive Plan becomes effective, which will be immediately prior to the effectiveness of the Company's initial public offering.

33. Please note that we are deferring any final evaluation of stock compensation until the estimated offering price is specified, and we may have further comments in that regard when you file the amendment containing that information.

The Company notes the Staff's position.

Warrants, page F-26

34. We notice that you used the Black-Scholes option pricing model to value the warrants issued in July 2005 and the intrinsic value method for the warrants granted in November 2005, both apparently issued to an executive. Please clarify the disclosure to explain why you applied two different methods for warrants granted to an executive.

The Company has revised page F-26 and page II-2 of Amendment No. 1 in response to the Staff's comment.

Recent Sales of Unregistered Securities, page II-2

35. Please reconcile the issuance of warrants to purchase 550,000 shares of common stock in July and November 2005 with the disclosure on page F-26 of the issuance of 350,000 warrants in July and November 2005.

The Company has revised page II-2 of Amendment No. 1 in response to the Staff's comment.

Exhibits and Financial Statement Schedules, page II-4

36. Please include an updated accountants' consent with any amendment to the filing.

Amendment No. 1 includes a currently dated consent of BDO Seidman LLP, and the Company will request that BDO Seidman LLP provide an additional consent for future amendments.

Undertakings, page II-7

37. Please note that due, in part, to the language of Rule 430C(d), the undertakings included in Item 512(a)(5)(ii) and 512(a)(6) of Regulation S-K should be included in filings for initial public offerings. Please revise to include those undertakings.

The Company has revised page II-7 of Amendment No. 1 in response to the Staff's comment.

Back Cover Graphic

38. Please revise the graphic to more specifically explain what the dots signify with regard to your "presence" throughout the world.

The Company advises the Staff that the yellow dots indicate the locations where the PX device has been installed, and the red dots indicate the locations for the Company's offices or branches, as the case may be. The Company has revised the back cover graphic of Amendment No. 1 to include the above clarification in response to the Staff's comment.

Other Matters

Pursuant to Rule 472, Amendment No. 1 is filed herewith in response to the Staff's comments. The Company confirms that no additional material changes were made in Amendment No. 1 for reasons other than (i) in response to a specific Staff comment, (ii) as noted in this response letter and (iii) to correct certain disclosures that relate to the Company's financial results.

Please direct your questions or comments to Stephen J. Schrader of this office (415-576-3028) or me (650-251-5926). In addition, we would request that you provide a facsimile of any additional comments you may have to Mr. Schrader at 415-576-3099 and me at 650-856-9299. Thank you for your assistance.

Very truly yours,

/s/ Jenny C. Yeh

Jenny C. Yeh

cc: Thomas Willardson
Alan Denenberg, Esq.