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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2009

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 001-34112

**Energy Recovery, Inc.**

(Exact name of registrant as specified in its charter)

Delaware  
(State of Incorporation)

1908 Doolittle Drive  
San Leandro, CA 94577  
(Address of Principal Executive Offices)

01-0616867  
(IRS Employer Identification No.)

94577  
(Zip Code)

(510) 483-7370  
(Telephone No.)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if a smaller reporting company)

Smaller reporting company

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

As of July 31, 2009, there were 50,156,444 shares of the registrant's common stock outstanding.

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ENERGY RECOVERY, INC.  
QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED JUNE 30, 2009  
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## PART I — FINANCIAL INFORMATION

## Item 1. Financial Statements (unaudited)

## ENERGY RECOVERY, INC.

**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share data)  
(unaudited)

	June 30, 2009	December 31, 2008
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 79,631	\$ 79,287
Restricted cash	2,284	246
Accounts receivable, net of allowance for doubtful accounts of \$295 and \$59 at June 30, 2009 and December 31, 2008, respectively	8,407	20,615
Unbilled receivables, current	4,629	4,948
Inventories	11,160	8,493
Deferred tax assets, net	1,755	1,755
Prepaid income taxes	1,065	—
Prepaid expenses and other current assets	1,306	984
<b>Total current assets</b>	<b>110,237</b>	<b>116,328</b>
Unbilled receivables, non-current	355	1,929
Restricted cash, non-current	3,461	19
Property and equipment, net	4,399	1,845
Intangible assets, net	308	321
Deferred tax assets, non-current, net	119	119
Other assets, non-current	52	51
<b>Total assets</b>	<b>\$ 118,931</b>	<b>\$ 120,612</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 1,838	\$ 2,270
Accrued expenses and other current liabilities	3,587	4,787
Income taxes payable	108	1,657
Accrued warranty reserve	295	270
Deferred revenue	2,643	4,000
Current portion of long-term debt	128	172
Current portion of capital lease obligations	39	37
<b>Total current liabilities</b>	<b>8,638</b>	<b>13,193</b>
Long-term debt	277	385
Capital lease obligations, non-current	7	27
Other non-current liabilities	5	8
<b>Total liabilities</b>	<b>8,927</b>	<b>13,613</b>
Commitments and Contingencies (Note 6)		
<b>Stockholders' equity:</b>		
Preferred stock, \$0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding	—	—
Common stock, \$0.001 par value; 200,000,000 shares authorized; 50,153,944 and 50,015,718 shares issued and outstanding at June 30, 2009 and December 31, 2008, respectively	50	50
Additional paid-in capital	99,841	98,527
Notes receivable from stockholders	(88)	(296)
Accumulated other comprehensive loss	(44)	(44)
Retained earnings	10,245	8,762
<b>Total stockholders' equity</b>	<b>110,004</b>	<b>106,999</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 118,931</b>	<b>\$ 120,612</b>

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

## ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(in thousands, except per share data)  
(unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2009	2008	2009	2008
Net revenue	\$ 9,089	\$ 11,961	\$ 21,735	\$ 21,081
Cost of revenue	3,291	3,951	7,864	7,625
Gross profit	5,798	8,010	13,871	13,456
Operating expenses:				
General and administrative	3,508	2,854	6,662	5,515
Sales and marketing	1,651	1,453	3,161	2,796
Research and development	826	536	1,630	1,045
Total operating expenses	5,985	4,843	11,453	9,356
Income (loss) from operations	(187)	3,167	2,418	4,100
Other income (expense):				
Interest expense	(10)	(24)	(24)	(45)
Interest and other income (expense), net	117	(23)	29	624
Income (loss) before provision for income taxes	(80)	3,120	2,423	4,679
Provision for income taxes	(9)	1,291	940	1,903
Net income (loss)	\$ (71)	\$ 1,829	\$ 1,483	\$ 2,776
Earnings (loss) per share:				
Basic	\$ (0.00)	\$ 0.05	\$ 0.03	\$ 0.07
Diluted	\$ (0.00)	\$ 0.04	\$ 0.03	\$ 0.07
Number of shares used in per share calculations:				
Basic	50,146	39,827	50,099	39,816
Diluted	50,146	42,284	52,629	42,240

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(in thousands)  
(unaudited)

	Six Months Ended June 30,	
	2009	2008
<b>Cash Flows From Operating Activities</b>		
Net income	\$ 1,483	\$ 2,776
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	392	238
Interest accrued on notes receivables from stockholders	(3)	(9)
Stock-based compensation	911	320
Net gain on foreign currency transactions	(466)	(586)
Provision for doubtful accounts	260	1
Provision for (reversal of) warranty claims	37	(550)
Provision for excess or obsolete inventory	86	53
Changes in operating assets and liabilities:		
Accounts receivable	12,402	416
Unbilled receivables	1,878	(1,047)
Inventories	(2,753)	(2,322)
Prepaid and other assets	(1,388)	(3,409)
Accounts payable	(432)	137
Accrued expenses and other liabilities	(1,179)	3,427
Income taxes payable	(1,433)	(699)
Deferred revenue	(1,357)	939
<b>Net cash provided by (used in) operating activities</b>	<u>8,438</u>	<u>(315)</u>
<b>Cash Flows From Investing Activities</b>		
Capital expenditures	(2,935)	(286)
Restricted cash	(5,480)	1,587
Other	—	(1)
<b>Net cash (used in) provided by investing activities</b>	<u>(8,415)</u>	<u>1,300</u>
<b>Cash Flows From Financing Activities</b>		
Repayment of long-term debt	(152)	(86)
Repayment of capital lease obligation	(18)	(18)
Net proceeds from issuance of common stock	280	35
Repayment of notes receivables from stockholders	211	518
Other short term financing activities	—	(6)
<b>Net cash provided by financing activities</b>	<u>321</u>	<u>443</u>
<b>Effect of exchange rate differences on cash and cash equivalents</b>	<u>—</u>	<u>(13)</u>
<b>Net change in cash and cash equivalents</b>	344	1,415
<b>Cash and cash equivalents, beginning of period</b>	79,287	240
<b>Cash and cash equivalents, end of period</b>	<u>\$ 79,631</u>	<u>\$ 1,655</u>
<b>Supplemental disclosure of cash flow information</b>		
Cash paid for interest	\$ 24	\$ 45
Cash paid for income taxes	<u>\$ 3,440</u>	<u>\$ 2,603</u>
<b>Supplemental disclosure of non-cash transactions</b>		
Issuance of common stock in exchange for notes receivable from stockholders	<u>\$ —</u>	<u>\$ 14</u>

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(unaudited)

**Note 1 — The Company and Summary of Significant Accounting Policies**

***The Company***

Energy Recovery, Inc. (“the Company” or “ERI”) develops, manufactures and sells high-efficiency energy recovery devices for use in seawater desalination. Our products are sold under the trademarks ERI®, PX®, Pressure Exchanger® and PX Pressure Exchanger®. They make desalination affordable by recycling up to 98% of the otherwise lost pressure energy from the reject stream of the desalination process. Our products are developed and manufactured in the United States of America (“U.S.”) at ERI’s headquarters located in San Leandro, California. The Company has direct sales offices and technical support centers in Madrid, Dubai, Shanghai and Fort Lauderdale.

The Company was incorporated in Virginia in April 1992 and reincorporated in Delaware in March 2001. The Company has three subsidiaries: Osmotic Power, Inc., Energy Recovery, Inc. International, and Energy Recovery Iberia, S.L. They were incorporated in September 2005, July 2006 and September 2006, respectively. ERI became a public company in July 2008.

***Use of Estimates***

The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles (“U.S. GAAP”) requires management to make judgments, estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. 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. Actual results could materially differ from those estimates.

***Basis of Presentation***

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

The accompanying Condensed Consolidated Financial Statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to such rules and regulations. The December 31, 2008 Condensed Consolidated Balance Sheet was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP; however, the Company believes that the disclosures are adequate to make the information presented not misleading. Certain prior period amounts have been reclassified to conform to the current period presentation. These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the audited Consolidated Financial Statements and the notes thereto for the fiscal year ended December 31, 2008 included in the Company’s Annual Report on Form 10-K filed with the SEC on March 27, 2009.

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

***Recent Accounting Pronouncements***

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (“SFAS 157”) which defines fair value, establishes a framework for measuring fair value, and enhances fair value measurement disclosure. SFAS No. 157 was effective January 1, 2008 for financial assets and liabilities and January 1, 2009 for non-financial assets and liabilities. The adoption of SFAS No. 157 did not have an effect on the Company’s financial position or results of operations.

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As of June 30, 2009, the Company's financial assets measured at fair value on a consistent basis consist of cash, cash equivalents, and restricted cash, which are valued using market prices in active markets (level 1). Level 1 instrument valuations are obtained from real-time quotes for transactions in active exchange markets involving identical assets.

Effective this quarter, the Company implemented Statement of Financial Accounting Standards No. 165, *Subsequent Events* ("SFAS 165"). This standard establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The adoption of SFAS 165 did not impact the Company's financial position or results of operations. All events or transactions that occurred after June 30, 2009 up through August 7, 2009, the date that these financial statements were available for issuance, have been evaluated. During this period, there were no material recognizable or unrecognizable subsequent events.

No other new accounting pronouncement issued or effective during the period had or is expected to have a material impact on the consolidated financial statements.

### Note 2 — Earnings (Loss) 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):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
<b>Numerator:</b>				
Net income (loss)	\$ (71)	\$ 1,829	\$ 1,483	\$ 2,776
<b>Denominator:</b>				
Weighted average common shares outstanding	50,146	39,827	50,099	39,816
<b>Effect of dilutive securities:</b>				
Nonvested shares	—	18	—	10
Stock options	—	561	610	545
Warrants	—	1,878	1,920	1,869
Total shares for purpose of calculating diluted net income (loss) per share	<u>50,146</u>	<u>42,284</u>	<u>52,629</u>	<u>42,240</u>
<b>Earnings (loss) per share:</b>				
Basic	<u>\$ (0.00)</u>	<u>\$ 0.05</u>	<u>\$ 0.03</u>	<u>\$ 0.07</u>
Diluted	<u>\$ (0.00)</u>	<u>\$ 0.04</u>	<u>\$ 0.03</u>	<u>\$ 0.07</u>

The following potential common shares were excluded from the computation of diluted net income per share because their effect would have been anti-dilutive (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Stock options	3,519	252	1,855	233
Warrants	2,074	—	—	—

### Note 3 — Balance Sheet Details

#### Restricted Cash

The Company has irrevocable standby letters of credit with two financial institutions securing performance and warranty commitments under contracts with customers and lessors and an outstanding equipment promissory note. The standby letters of credit are collateralized by either a line of credit (see Note 4) or restricted cash. At June 30, 2009 and December 31, 2008, the amount of irrevocable standby letters of credit collateralized by restricted cash was \$5.3 million and \$265,000, respectively. At June 30, 2009, restricted cash of \$0.4 million secured the promissory note. The Company has deposited a corresponding amount into non-interest bearing accounts.

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### *Inventories*

Inventories consisted of the following (in thousands):

	<u>June 30, 2009</u>	<u>December 31, 2008</u>
Raw materials	\$ 4,038	\$ 2,894
Work in process	380	139
Finished goods	6,742	5,460
	<u>\$ 11,160</u>	<u>\$ 8,493</u>

### *Property and Equipment*

Property and equipment consisted of the following (in thousands):

	<u>June 30, 2009</u>	<u>December 31, 2008</u>
Machinery and equipment	\$ 2,746	\$ 2,434
Office equipment, furniture, and fixtures	1,115	772
Automobiles	22	22
Software	293	208
Leasehold improvements	466	466
Construction in progress	1,940	—
	6,582	3,902
Less: accumulated depreciation and amortization	(2,183)	(2,057)
	<u>\$ 4,399</u>	<u>\$ 1,845</u>

Construction in progress costs at June 30, 2009 primarily relate to the construction and installation of specialized manufacturing equipment. The Company estimates the costs to complete this construction in progress to be approximately \$1.5 million as of June 30, 2009 and expects to complete construction within the next twelve months.

### *Accrued Expenses and Other Current Liabilities*

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

	<u>June 30, 2009</u>	<u>December 31, 2008</u>
Accrued payroll and commission expenses	\$ 2,544	\$ 2,929
Professional fees	303	193
Inventory in transit	162	251
Collaboration fees	91	916
Other accrued expenses and current liabilities	487	498
	<u>\$ 3,587</u>	<u>\$ 4,787</u>

## **Note 4 — Long-Term Debt**

### *Promissory Notes*

In February 2009, the Company paid the outstanding balance of a fixed promissory note for a total of \$83,000, including accrued interest.



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As of June 30, 2009, long term debt consisted of one equipment promissory note payable. Future minimum principal payments due under this long-term debt arrangement consists of the following (in thousands):

	<u>June 30,</u> <u>2009</u>
2009 (remaining six months)	\$ 64
2010	128
2011	128
2012	85
	<u>\$ 405</u>

### *Credit Agreements*

In February 2009, the Company terminated a March 2008 credit agreement with a financial institution. As a result, during the first quarter of 2009, the Company transferred \$9.1 million in cash to a restricted cash account as collateral for outstanding irrevocable standby letters of credit that were collateralized by the credit agreement as of the date of its termination and as collateral for an outstanding equipment promissory note. During the six months ended June 30, 2009, \$3.4 million of the restricted cash was released.

Upon the termination of the credit agreement, a new loan and security agreement with another financial institution became effective. The new agreement provides a total available credit line of \$15.0 million. Under the new agreement, the Company is allowed to draw advances up to \$10.0 million on a revolving line of credit or utilize up to \$14.8 million as collateral for irrevocable standby letters of credit, provided that the aggregate of the advances and the collateral do not exceed \$15.0 million. Advances under the revolving line of credit incur interest based on either a prime rate index or LIBOR plus 1.375%. The new agreement expires on December 31, 2009 and is collateralized by substantially all of the Company's assets. The Company is subject to certain financial and administrative covenants under this new agreement. As of June 30, 2009, the Company was in compliance with these covenants.

During the periods presented, the Company provided certain customers with irrevocable standby letters of credit to secure its obligations for the delivery of products, performance guarantees and warranty commitments in accordance with sales arrangements. These letters of credit were issued under the Company's credit line and generally terminate within 12 to 36 months from issuance. At June 30, 2009 and December 31, 2008, the amounts outstanding on the letters of credit collateralized by the Company's credit line totaled approximately \$3.8 million and \$8.4 million, respectively.

### **Note 5 — Income Taxes**

The Company's effective tax rate for the six months ended June 30, 2009 and 2008 was 38.8% and 40.7%, respectively. These effective tax rates differ from the U.S. statutory rate principally due to the effect of state income taxes and non-deductible stock based compensation, offset in part by deductions and credits related to manufacturing and research and development, respectively.

There have been no material changes to the Company's income tax position during the six months ended June 30, 2009.

### **Note 6 — Commitments and Contingencies**

#### *Lease Obligations*

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

	<u>June 30,</u> <u>2009</u>
2009 (remaining six months)	\$ 847
2010	1,586
2011	1,405
2012	1,379
2013	1,413
Thereafter	8,560
	<u>\$ 15,190</u>

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### ***Product Warranty***

The Company sells products with a limited warranty for a period ranging from one to five years. 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 following table summarizes the activity related to the product warranty liability during the six months ended June 30, 2009 (in thousands):

	<b>Six Months Ended June 30,</b>	
	<b>2009</b>	<b>2008</b>
Balance at beginning of period	\$ 270	\$ 868
Warranty costs charged to cost of revenue	37	138
Utilization of warranty	(12)	(68)
Reduction of extended warranty reserve	—	(688)
Balance at end of period	<u>\$ 295</u>	<u>\$ 250</u>

### ***Purchase Obligations***

In 2008, the Company entered into a supply agreement with a vendor. Under this agreement, the Company is obligated to pay a fee of up to \$250,000 if the Company does not meet minimum purchase requirements by 2012.

As of June 30, 2009, the Company had entered into purchase commitments with several vendors for the purchase of ceramics manufacturing equipment. If the orders are canceled, the Company is generally obligated to pay up to 30% of the original purchase order or the total costs incurred by the vendor through the date of cancellation, whichever is greater. As of June 30, 2009, the Company had approximately \$1.5 million of these open purchase commitments.

In addition, the Company had purchase order arrangements related to various key raw materials and components parts with several vendors for which it had not received the related goods or services as of June 30, 2009. 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. As of June 30, 2009, the Company had approximately \$5.6 million of these 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 the Company's 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 June 30, 2009 and December 31, 2008.

In certain cases, the Company issues warranty and product performance guarantees to its customers for amounts ranging from 10% to 30% of the total sales agreement to endorse the execution of product delivery and the warranty of design work, fabrication and operating performance of the PX device. These guarantees are issued under the Company's credit facility (see Note 4) or collateralized by restricted cash (see Note 3). These guarantees typically remain in place for periods ranging from 12 to 36 months and, in some cases, up to 65 months, which generally relate to the corresponding underlying product warranty period.

### ***Employee Agreements***

The Company has an agreement with its chief executive officer governing the terms of his employment. The agreement expires in December 2009.

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**Litigation**

The Company is not currently a 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.

**Note 7 — Stockholders' Equity**

**Equity Incentive Plans**

The following table summarizes the stock option activity under the Company's equity incentive plans for the six months ended June 30, 2009:

	Shares Available for Issuance	Options Outstanding			
		Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in thousands)(2)
Balance at December 31, 2008	146,449	2,531,986	\$ 5.48	8.6	\$ 6,593
Shares authorized for issuance	2,500,000	—	—		
Options granted	(1,246,300)	1,246,300	7.32		
Options exercised	—	(138,226)	2.02		
Options forfeited (1)	52,187	(121,188)	5.97		
Balance at June 30, 2009	<u>1,452,336</u>	<u>3,518,872</u>	6.25	8.8	\$ 4,994
Vested and exercisable as of June 30, 2009	<u>—</u>	<u>715,197</u>	\$ 2.15	7.0	\$ 3,523

- Pursuant to Section 3.3 of the Company's 2008 Equity Incentive Plan ("2008 Plan"), options under the 2008 Plan that are forfeited or terminated shall become available for issuance again under the plan. Due to the cancellation of all prior stock option plans, options that are forfeited or terminated under any other stock option plan cannot be reissued.
- The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying options and the fair market value of the Company's stock as of June 30, 2009 of \$7.08 per share. The aggregate intrinsic value excludes the effect of stock options that have a zero or negative intrinsic value.

In July 2009, the Company issued 120,000 stock options and 84,000 restricted stock units to certain executives under the 2008 Plan.

**Stock-based Compensation Expense**

For the three and six months ended June 30, 2009 and 2008, the Company recognized share-based compensation expense related to employees and consultants as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008 (1)	2009	2008 (1)
Cost of revenue	\$ 44	\$ 8	\$ 68	\$ 31
General and administrative	461	49	553	142
Sales and marketing	150	29	210	102
Research and development	61	13	80	45
	<u>\$ 716</u>	<u>\$ 99</u>	<u>\$ 911</u>	<u>\$ 320</u>

- Share-based compensation expense for the three and six months ended June 30, 2008 included \$7,000 and \$142,000, respectively, related to employee share-based compensation arrangements accounted for in accordance with the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB 25").

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As of June 30, 2009, total unrecognized compensation cost related to non-vested options, net of forfeitures, was \$7.7 million, which is expected to be recognized as expense over a weighted-average period of approximately 3.3 years.

### **Note 8 — 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 disaggregated 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 the Company to deliver the Company's products to a location that differs from the known ultimate location of use. In such cases, the ultimate location of use, rather than the delivery location, is reflected in the table below (in thousands, except percentages):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2008	2009	2008
Domestic revenue	\$ 713	\$ 1,146	\$ 1,422	\$ 1,867
International revenue	8,376	10,815	20,313	19,214
Total revenue	<u>\$ 9,089</u>	<u>\$ 11,961</u>	<u>\$ 21,735</u>	<u>\$ 21,081</u>
Revenue by country:				
Algeria	57%	*%	24%	21%
Italy	15	*	6	*
United States	8	10	7	9
Spain	5	38	7	24
Israel	*	5	31	3
China	*	14	2	11
Others	15	33	23	32
Total	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

\* Less than 1%.

### **Note 9 — Concentrations**

Five customers accounted for approximately 59% of the Company's accounts receivable at June 30, 2009. As of December 31, 2008, five customers accounted for approximately 81% of accounts receivable.

Revenue from customers representing 10% or more of net revenue varies from period to period. For the three months ended June 30, 2009, PROTECNO, s.r.l. and UTE Mostaganem, a consortium of Inima (Grupo OHL) and Aqualia (Grupo FCC), accounted for approximately 13% and 57% of the Company's net revenue, respectively. For the three months ended June 30, 2008, Multiplex Degremont J.V. accounted for approximately 37% of the Company's net revenue.

For the six months ended June 30, 2009, IDE Technologies, Ltd. and UTE Mostaganem, accounted for approximately 39% and 26% of the Company's net revenue, respectively. For the six months ended June 30, 2008, Multiplex Degremont J.V. and Geida, a consortium of Befesa Agua, Cobra-Tedagua, and Sadyt S.A., each accounted for approximately 21% of the Company's net revenue.

No other customer accounted for more than 10% of the Company's net revenue during any of these periods.

### **Note 10 — Related Party Transactions**

The Company entered into a supply agreement with Piedmont Pacific Corporation, a company owned by James Medanich, a former director of the Company. Expenses incurred under this supply agreement amounted to \$11,000 and \$3,000 for the three months ending

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June 30, 2009 and 2008, respectively, and \$34,000 and \$4,000 for the six months ending June 30, 2009 and 2008, respectively. \$1,000 in payments due to this vendor were outstanding as of June 30, 2009. There were no payments outstanding to this vendor as of December 31, 2008. The Company believes that the transactions under the supply agreement were conducted as if consummated on an arm's-length basis between two independent parties.

The Company entered into a consulting agreement with Darby Engineering, LLC (invoiced as Think Mechanical, LLC), a firm owned by Peter Darby, a former director of the Company. Expenses incurred under this consulting agreement amounted to \$7,000 and \$31,000 for the three months ending June 30, 2009 and 2008, respectively, and \$38,000 and \$59,000 for the six months ending June 30, 2009 and 2008, respectively. \$7,000 and \$27,000 in payments due to this vendor were outstanding as of June 30, 2009 and December 31, 2008, respectively. The Company believes that the transactions under the consulting agreement were conducted as if consummated on an arm's-length basis between two independent parties.

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

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

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

*Forward-looking statements in this report include, without limitation, statements about the following:*

- our expectation that our expenditures for research and development will increase;*
- our expectation that we will continue to rely on sales of our PX devices for a substantial portion of our revenue;*
- our expectation that a significant portion of our annual sales will continue to occur during the fourth quarter;*
- our expectation that sales outside of the United States will remain a significant portion of our revenue;*
- our expectation that future sales and marketing expense will increase; and*
- our belief that our existing cash balances and cash generated from our operations will be sufficient to meet our anticipated capital requirements for at least the next 12 months*

*All forward-looking statements included in this document are subject to additional risks and uncertainties further discussed under "Part II, Item 1A: Risk Factors" and are based on information available to us as of August 7, 2009. We assume no obligation to update any such forward-looking statements. It is important to note that our actual results could differ materially from the results set forth or implied by our forward-looking statements. The factors that could cause our actual results to differ from those included in such forward-looking statements are set forth under the heading "Part II, Item 1A: Risk Factors," and our results disclosed from time to time in our reports on Forms 10-K, 10-Q and 8-K and our Annual Reports to Stockholders.*

*The following should be read in conjunction with the condensed financial statements and related notes included in "Part I, Item 1: Financial Statements" of this quarterly report and the consolidated financial statements and related notes included in our Annual Report on Form 10-K as filed on March 27, 2009.*

### Overview

We are in the business of designing, developing and manufacturing energy recovery devices for sea water reverse osmosis desalination. Our company was founded in 1992 and we introduced the initial version of our energy recovery device, the PX<sup>®</sup>, in early 1997. As of June 30, 2009, we had shipped approximately 6,800 PX devices to desalination plants worldwide.

A majority of our net revenue has been generated by sales to large engineering and construction firms, which are involved with the design and construction of larger desalination plants. Sales to these firms often involve a long sales cycle, which can range from six to 16 months. A single large 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 a large engineering and construction firm for a particular plant may represent significant revenue, we often experience significant fluctuations in net revenue from quarter to quarter. In addition, our engineering

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and construction firm 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.

A limited number of our customers accounts for a substantial portion of our net revenue and accounts receivables. Revenue from customers representing 10% or more of total revenue varies from period to period.

For the three months ended June 30, 2009, two customers accounted for approximately 70% of the Company's net revenue. For the three months ended June 30, 2008, one customer accounted for approximately 37% of the Company's net revenue.

For the six months ended June 30, 2009, two customers accounted for approximately 65% of the Company's net revenue. For the six months ended June 30, 2008, two customers accounted for approximately 42% of the Company's net revenue.

As of June 30, 2009, five customers accounted for approximately 59% of our accounts receivable.

During the three and six months ended June 30, 2009 and 2008, 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 high pressure circulation pumps, which we manufacture or purchase 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.

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.

### *Second Quarter of 2009 Compared to Second Quarter of 2008*

#### **Results of Operations**

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

	Three Months Ended June 30,					
	2009		2008		Change Increase / (Decrease)	
<b>Results of Operations:*</b>						
Net revenue	\$ 9,089	100.0%	\$ 11,961	100.0%	\$ (2,872)	(24)%
Cost of revenue	<u>3,291</u>	36.2%	<u>3,951</u>	33.0%	(660)	(17)%
Gross profit	5,798	63.8%	8,010	67.0%	(2,212)	(28)%
Operating expenses:						
General and administrative	3,508	38.6%	2,854	23.9%	654	23%
Sales and marketing	1,651	18.2%	1,453	12.1%	198	14%
Research and development	<u>826</u>	9.1%	<u>536</u>	4.5%	290	54%
Total operating expenses	<u>5,985</u>	65.8%	<u>4,843</u>	40.5%	1,142	24%
Income (loss) from operations	(187)	(2.1)%	3,167	26.5%	(3,354)	(106)%
Other income (expense):						
Interest expense	(10)	(0.1)%	(24)	(0.2)%	(14)	(58)%
Interest income and other income (expense)	<u>117</u>	1.3%	<u>(23)</u>	(0.2)%	140	609%
Income (loss) before provision for income taxes	(80)	(0.9)%	3,120	26.1%	(3,200)	(103)%
Provision for income taxes	<u>(9)</u>	(0.1)%	<u>1,291</u>	10.8%	(1,300)	(101)%
Net income (loss)	<u>\$ (71)</u>	(0.8)%	<u>\$ 1,829</u>	15.3%	\$ (1,900)	(104)%

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

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Our net revenue decreased by \$2.9 million, or 24%, to \$9.1 million for the three months ended June 30, 2009 from \$12.0 million for the three months ended June 30, 2008. The decrease in net revenue is primarily due to a decrease in shipments to OEM customers during the second quarter of 2009 compared to the same quarter last year due to project delays related to the global economic downturn and financial market crisis.

For the three months ended June 30, 2009, the sales of PX devices accounted for approximately 88% of our revenue, pump sales accounted for approximately 7% and spare parts and service accounted for 5%. For the three months ended June 30, 2008, the sales of PX devices accounted for approximately 94% of revenue, pump sales accounted for approximately 4%, and spare parts and service accounted for 2%.

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. The amounts below are in thousands, except percentage data.

	Three Months Ended	
	June 30,	
	2009	2008
Domestic revenue	\$ 713	\$ 1,146
International revenue	8,376	10,815
Total revenue	<u>\$ 9,089</u>	<u>\$ 11,961</u>
Revenue by country:		
Algeria	57%	*%
Italy	15	*
United States	8	10
Spain	5	38
Israel	*	5
China	*	14
Others	15	33
Total	<u>100%</u>	<u>100%</u>

\* 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, primarily ceramic materials, which we obtain from multiple suppliers. For the three months ended June 30, 2009, gross profit as a percentage of net revenue was 63.8%. For the three months ended June 30, 2008, gross profit as a percentage of net revenue was 61.2%, excluding the reversal of a warranty provision in the amount of \$688,000, or 5.8%, related to the cancellation of an extended product warranty contract. The increase in gross margin as a percentage of net revenue, when adjusted for the one time warranty provision reversal in 2008, was largely due to a higher average selling price during the second quarter of 2009 as compared to the second quarter of 2008.

Stock compensation expense included in cost of revenue was \$44,000 and \$8,000 for the three months ended June 30, 2009 and June 30, 2008, respectively.



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Future gross profit as a percentage of net revenue is highly dependent on the product and customer mix of our future sales. Accordingly, we are not able to predict our future gross profit percentages with certainty.

### *General and Administrative Expense*

General and administrative expense increased by \$654,000, or 23%, to \$3.5 million for the three months ended June 30, 2009 from \$2.9 million for the three months ended June 30, 2008. As a percentage of net revenue, general and administrative expense was 39% for the three months ended June 30, 2009 and 24% for the three months ended June 30, 2008. The increase of general and administrative expense was attributable primarily to the increase in general and administrative headcount to support our growth in operations and to support the requirements for operating as a public company. General and administrative employees increased to 35 at June 30, 2009 from 25 at June 30, 2008.

Of the \$654,000 increase in general and administrative expense, increases of \$876,000 related to compensation and employee-related benefits and \$275,000 related to bad debt expense and other administrative costs were partially offset by decreases of \$451,000 related to professional services and \$46,000 related to Value Added Taxes (VAT). Stock-based compensation expense included in general and administrative expense was \$461,000 for the three months ended June 30, 2009 and \$49,000 for the three months ended June 30, 2008.

### *Sales and Marketing Expense*

Sales and marketing expense increased by \$198,000, or 14%, to \$1.7 million for the three months ended June 30, 2009 from \$1.5 million for the three months ended June 30, 2008. This increase was primarily related to growth in our sales force that resulted in higher headcount with sales and marketing employees increasing to 21 at June 30, 2009 from 18 at June 30, 2008.

As a percentage of our net revenue, sales and marketing expense increased to 18% for the three months ended June 30, 2009 from 12% for the three months ended June 30, 2008. The increase in 2009 was attributable primarily to a decrease in our net revenue for that period, while our sales and marketing expense increased.

Of the \$198,000 net increase in sales and marketing expense for the three months ended June 30, 2009, \$197,000 related to compensation, employee-related benefits and commissions to outside sales representatives and \$13,000 related to occupancy and other administrative costs. The increases were slightly offset by a decrease of \$12,000 related to other sales and marketing costs. Stock-based compensation expense included in sales and marketing expense was \$150,000 for the three months ended June 30, 2009 and \$29,000 for the three months ended June 30, 2008.

We expect that our future sales and marketing expense will increase in absolute dollars as we continue to develop our sales and marketing operations.

### *Research and Development Expense*

Research and development expense increased by \$290,000, or 54%, to \$826,000 for the three months ended June 30, 2009 from \$536,000 for the three months ended June 30, 2008. This increase was primarily attributable to recent efforts to develop and strengthen our expertise in ceramics material science.

Of the \$290,000 increase, compensation and employee-related benefits accounted for \$123,000, consulting and professional service fees accounted for \$99,000, research and development direct project costs accounted for \$61,000, and occupancy and other miscellaneous costs accounted for \$7,000.

Headcount in our research and development department increased to 11 at June 30, 2009 from seven at June 30, 2008. Stock-based compensation expense included in research and development expense was \$61,000 for three months ended June 30, 2009 and \$13,000 for the three months ended June 30, 2008.

We anticipate that our research and development expenditures will increase in the future as we expand and diversify our product offerings and further our expertise in advanced ceramics.

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### Other Income (Expense), Net

Other net income (expense) changed favorably by \$154,000 to \$107,000 net income for the three months ended June 30, 2009 from (\$47,000) net expense for the three months ended June 30, 2008. The change was primarily due to a reduction in foreign currency denominated contracts and favorable changes in foreign currency rates, resulting in net foreign currency transaction gains of \$92,000 for the three months ended June 30, 2009 compared to net foreign currency transaction losses of (\$33,000) for the three months ended June 30, 2008. Additionally, interest and other income increased \$15,000 resulting from IPO net proceeds of \$76.7 million received in July 2008 and interest expense decreased \$14,000 resulting from a reduction of debt in the first quarter of 2009.

### Six Months Ended June 30, 2009 Compared to Six Months Ended June 30, 2008

#### Results of Operations

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

	Six Months Ended June 30,					
	2009		2008		Change Increase / (Decrease)	
<b>Results of Operations:*</b>						
Net revenue	\$ 21,735	100.0%	\$ 21,081	100.0%	\$ 654	3%
Cost of revenue	<u>7,864</u>	36.2%	<u>7,625</u>	36.2%	239	3%
Gross profit	13,871	63.8%	13,456	63.8%	415	3%
Operating expenses:						
General and administrative	6,662	30.7%	5,515	26.2%	1,147	21%
Sales and marketing	3,161	14.5%	2,796	13.3%	365	13%
Research and development	<u>1,630</u>	7.5%	<u>1,045</u>	5.0%	585	56%
Total operating expenses	<u>11,453</u>	52.7%	<u>9,356</u>	44.4%	2,097	22%
Income (loss) from operations	2,418	11.1%	4,100	19.4%	(1,682)	(41)%
Other income (expense):						
Interest expense	(24)	(0.1)%	(45)	(0.2)%	(21)	(47)%
Interest income and other income (expense)	<u>29</u>	0.1%	<u>624</u>	3.0%	(595)	(95)%
Income (loss) before provision for income taxes	2,423	11.1%	4,679	22.2%	(2,256)	(48)%
Provision for income taxes	<u>940</u>	4.3%	<u>1,903</u>	9.0%	(963)	(51)%
Net income (loss)	<u>\$ 1,483</u>	6.8%	<u>\$ 2,776</u>	13.2%	\$ (1,293)	(47)%

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

Our net revenue increased by \$654,000, or 3%, to \$21.7 million for the six months ended June 30, 2009 from \$21.1 million for the six months ended June 30, 2008. The increase in net revenue was partially due to an increase in the average unit selling price in the first six months of 2009 compared to the first six months of 2008 and partially due to an increase in parts and service revenue. These factors were partially offset by a decrease in shipments to OEM customers during the second quarter of 2009 compared to the same quarter last year due to project delays related to the global economic downturn and financial market crisis.

For the six months ended June 30, 2009, the sales of PX devices accounted for approximately 91% of our revenue, pump sales accounted for approximately 5% and spare parts and service accounted for 4%. For the six months ended June 30, 2008, the sales of PX devices accounted for approximately 92% of revenue, pump sales accounted for approximately 5%, and spare parts and service accounted for 3%.

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. The amounts below are in thousands, except percentage data.

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	Six Months Ended	
	June 30,	
	2009	2008
Domestic revenue	\$ 1,422	\$ 1,867
International revenue	20,313	19,214
Total revenue	<u>\$ 21,735</u>	<u>\$ 21,081</u>
Revenue by country:		
Israel	31%	3%
Algeria	24	21
Spain	7	24
China	2	11
Others (1)	36	41
Total	<u>100%</u>	<u>100%</u>

(1) Includes countries that individually represent less than 10% of net revenue

### *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, primarily ceramic materials, which we obtain from multiple suppliers. For the six months ended June 30, 2009, gross profit as a percentage of net revenue was 63.8%, as compared to 60.6% for the six months ended June 30, 2008, excluding the reversal of a warranty provision in the amount of \$688,000, or 3.2%, related to the cancellation of an extended product warranty contract. The increase in gross margin as a percentage of net revenue, when adjusted for the one time warranty provision reversal in 2008, was largely due to a higher average selling price during the first six months of 2009 as compared to the first six months of 2008.

Stock compensation expense included in cost of revenue was \$68,000 and \$31,000 for the six months ended June 30, 2009 and June 30, 2008, respectively.

Future gross profit as a percentage of net revenue is highly dependent on the product and customer mix of our future sales. Accordingly, we are not able to predict our future gross profit percentages with certainty.

### *General and Administrative Expense*

General and administrative expense increased by \$1.1 million, or 21%, to \$6.7 million for the six months ended June 30, 2009 from \$5.5 million for the six months ended June 30, 2008. As a percentage of net revenue, general and administrative expense was 31% for the six months ended June 30, 2009 and 26% for the six months ended June 30, 2008. The increase of general and administrative expense was attributable primarily to the increase in general and administrative headcount to support our growth in operations and to support the requirements for operating as a public company. General and administrative employees increased to 35 at June 30, 2009 from 25 at June 30, 2008.

Of the \$1.1 million increase in general and administrative expense, increases of \$1.7 million in compensation and employee-related benefits and \$272,000 in bad debt expense and other administrative costs were partially offset by decreases of \$735,000 in professional services and \$162,000 in Value Added Taxes (VAT). Stock-based compensation expense included in general and administrative expense was \$553,000 for the six months ended June 30, 2009 and \$142,000 for the six months ended June 30, 2008.

### *Sales and Marketing Expense*

Sales and marketing expense increased by \$365,000, or 13%, to \$3.2 million for the six months ended June 30, 2009 from \$2.8 million for the six months ended June 30, 2008. This increase was primarily related to growth in our sales force that resulted in higher headcount with sales and marketing employees increasing to 21 at June 30, 2009 from 18 at June 30, 2008. In addition, our sales team is compensated in part by commissions, resulting in increased sales expense as our sales increase.

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As a percentage of our net revenue, sales and marketing expense increased to 15% for the six months ended June 30, 2009 from 13% for the six months ended June 30, 2008. The increase in 2009 was attributable primarily to our net revenue growing at a lesser rate than our sales and marketing expense during the first six months of 2009.

Of the net increase in sales and marketing expense for the six months ended June 30, 2009, \$469,000 related to compensation, employee-related benefits and commissions to outside sales representatives and \$45,000 related to occupancy and other administrative costs. These increases were partially offset by a decrease of \$149,000 related to other sales and marketing costs. Stock-based compensation expense included in sales and marketing expense was \$210,000 for the six months ended June 30, 2009 and \$102,000 for the six months ended June 30, 2008.

We expect that our future sales and marketing expense will increase in absolute dollars as we continue to develop our sales and marketing operations.

### *Research and Development Expense*

Research and development expense increased by \$585,000, or 56%, to \$1.6 million for the six months ended June 30, 2009 from \$1.0 million for the six months ended June 30, 2008. This increase was primarily attributable to recent efforts to develop and strengthen our expertise in ceramics material science.

Of the \$585,000 increase, compensation and employee-related benefits accounted for \$248,000, research and development direct project costs accounted for \$178,000, consulting and professional service fees accounted for \$133,000, and occupancy and other miscellaneous costs accounted for \$26,000.

Headcount in our research and development department increased to 11 at June 30, 2009 from eight at June 30, 2008. Stock-based compensation expense included in research and development expense was \$80,000 for the six months ended June 30, 2009 and \$45,000 for the six months ended June 30, 2008.

We anticipate that our research and development expenditures will increase in the future as we expand and diversify our product offerings and further our expertise in advanced ceramics.

### *Other Income (Expense), Net*

Other net income (expense) changed unfavorably by (\$574,000) to \$5,000 for the six months ended June 30, 2009 from \$579,000 for the six months ended June 30, 2008. The change was primarily due to a reduction in foreign currency denominated contracts and unfavorable changes in foreign currency rates, resulting in net foreign currency transaction losses of (\$43,000) for the six months ended June 30, 2009 compared to net foreign currency transaction gains of \$586,000 for the six months ended June 30, 2008. The unfavorable changes in other net income (expense) was slightly offset by a net increase in interest and other income of \$34,000 resulting from IPO net proceeds of \$76.7 million received in July 2008 and by a decrease in net interest expense of \$21,000 resulting from the reduction of debt during the first quarter of 2009.

## **Liquidity and Capital Resources**

### **Overview**

Our primary source of cash historically has been proceeds from the issuance of common stock, customer payments for our products and services, and borrowings under our credit facility. From January 1, 2005 through December 31, 2008, we issued common stock for aggregate net proceeds of \$83.5 million, excluding common stock issued in exchange for promissory notes. The proceeds from the sales of common stock have been used to fund our operations and capital expenditures.

As of June 30, 2009, our principal sources of liquidity consisted of cash and cash equivalents of \$79.6 million, which are invested primarily in money market funds, and accounts receivable of \$8.4 million.

In February 2009, we terminated a March 2008 credit agreement with a financial institution. As a result, we transferred \$9.1 million in cash to a restricted cash account as collateral for outstanding irrevocable standby letters of credit that were collateralized by the

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credit agreement as of the date of its termination and collateral for the outstanding equipment promissory note. During the six months ended June 30, 2009, \$3.4 million of the restricted cash was released.

Upon the termination of the credit agreement, a new loan and security agreement with another financial institution became effective. The new agreement provides a total available credit line of \$15.0 million. Under the new agreement, we are allowed to draw advances up to \$10.0 million on a revolving line of credit or utilize up to \$14.8 million as collateral for irrevocable standby letters of credit, provided that the aggregate of the advances and the collateral do not exceed \$15.0 million. Advances under the revolving line of credit incur interest based on either a prime rate index or LIBOR plus 1.375%. The new agreement expires on December 31, 2009 and is collateralized by substantially all of the company's assets. As of June 30, 2009, we were in compliance with all financial and administrative covenants under this new agreement.

During the periods presented, we provided certain customers with irrevocable standby letters of credit to secure our obligations for the delivery of products, performance guarantees and warranty commitments in accordance with sales arrangements. Some of these letters of credit were issued under the our revolving note credit facility. The letters of credit generally terminate within 12 to 36 months, and in some cases up to 65 months, from issuance. At June 30, 2009, the amounts outstanding on irrevocable letters of credit collateralized under our credit agreement totaled approximately \$3.8 million.

### ***Cash Flows from Operating Activities***

Net cash provided by (used in) operating activities was \$8.4 million and (\$315,000) for the six months ended June 30, 2009 and 2008, respectively. For the six months ended June 30, 2009 and 2008, net income of \$1.5 million and \$2.8 million, respectively, was adjusted to \$2.7 million and \$2.2 million, respectively, by non-cash items (depreciation, amortization, unrealized gains and losses on foreign exchange, stock-based compensation, provisions for doubtful accounts, warranty reserves and excess and obsolete inventory) totaling \$1.2 million and (\$533,000), respectively. The net cash inflow (outflow) effect from changes in assets and liabilities was \$5.7 million and \$(2.6) million for the six months ended June 30, 2009 and 2008, respectively. Net changes in assets and liabilities are primarily attributable to increases in inventory as a result of the growth of our business, changes in accounts receivable and unbilled receivables as a result of timing of invoices and collections for large projects, changes in prepaid expenses and accrued liabilities as a result of the timing of payments to employees, vendors and other third parties, and changes in deferred revenue as a result of timing of advance billings and product deliveries.

### ***Cash Flows from Investing Activities***

Cash flows used in 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 (used in) provided by investing activities was \$(8.4) million and \$1.3 million for six months ended June 30, 2009 and 2008, respectively. The change to net cash used in investing activities from net cash provided by investing activities was primarily attributable to a net increase in restricted cash of \$5.5 million during the first six months of 2009 compared to the release of restricted cash of \$1.6 million during the first six months of 2008. The remaining portion of the net cash used resulted from an increase in purchases of property and equipment of \$2.6 million during the first six months of 2009 compared to the first six months of 2008, primarily related to the purchase and installation of manufacturing equipment and the integration of a new manufacturing, administrative and warehouse facility during the first six months of 2009.

### ***Cash Flows from Financing Activities***

Net cash provided by financing activities decreased (\$122,000) to \$321,000 for the six months ended June 30, 2009 from \$443,000 for the six months ended June 30, 2008. The decrease in net cash flows from financing activities is primarily attributable to a decrease in the receipt of repayments of promissory notes by stockholders of (\$307,000) and an increase in the repayment of long term debt of (\$66,000) during the six months ended June 30, 2009 versus the six months ended June 30, 2008. The decreases are partially offset by a net increase in stock option exercises and other financing activities of \$251,000 during the first six months of 2009 as compared to the first six months of 2008.

### ***Liquidity and Capital Resource Requirements***

We believe that our existing cash balances 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**

We lease facilities under fixed non-cancelable operating leases that expire on various dates through 2019. The future minimum lease payments under these leases as of June 30, 2009 is \$15.2 million. For additional information, see Note 6 — “Commitments and Contingencies” to the unaudited Condensed Consolidated Financial Statements.

Recently, we entered into purchase commitments with several vendors for the purchase of ceramics manufacturing equipment. If the orders are canceled, we are obligated to pay either 30% of the original purchase order or the total costs incurred by the vendor through the date of cancelation, whichever is greater. As of June 30, 2009, purchase commitments with these vendors totaled approximately \$1.5 million.

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 and we have the right to cancel the arrangements prior to the date of delivery. As of June 30, 2009, these open purchase orders totaled approximately \$5.6 million.

We have 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 experience and information known to us as of June 30, 2009, we believe that our exposure related to these guarantees and indemnities as of June 30, 2009 was not material.

### **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**

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

### **Item 3. Quantitative and Qualitative Disclosure About Market Risk**

The information in this section should be read in connection with the information on financial market risk related to changes in non-U.S. currency exchange rates and interest rates in Part II, Item 7A, “Quantitative and Qualitative Disclosures About Market Risk,” in our Annual Report on Form 10-K for the year ended December 31, 2008. Our market risk profile has not changed significantly during the first six months of 2009.

#### ***Foreign Currency Risk***

Currently, the majority of our revenue contracts have been denominated in United States dollars. In some circumstances, we have priced certain international sales in Euros.

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As we expand our international sales, we expect that a portion of our revenue could continue to be denominated in foreign currencies. As a result, our cash and cash equivalents and operating results could be increasingly affected by changes in exchange rates. Our international sales and marketing operations incur expense that is denominated in foreign currencies. This expense could be materially affected by currency fluctuations. Our exposures are primarily 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***

At June 30, 2009, we had cash and cash equivalents totaling \$85.4 million, including restricted cash of \$5.8 million. These amounts were invested primarily in a money market fund backed by U.S. Treasury securities. The unrestricted cash and cash equivalents 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 and cash equivalents. Declines in interest rates, however, would reduce future interest income.

### ***Concentration of Credit Rate Risk***

The market risk inherent in our financial instruments and in our financial position represents the potential loss arising from disruptions caused by recent financial market conditions. Currently, our cash and cash equivalents are primarily deposited in a money market fund backed by U.S. Treasury securities; however, substantially all of our cash and cash equivalents are in excess of federally insured limits at a very limited number of financial institutions. This represents a high concentration of credit risk.

## **Item 4. Controls and Procedures.**

Under the supervision and with the participation of our management, including the President and Chief Executive Officer and the Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended June 30, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## Part II — OTHER INFORMATION

### Item 1. Legal Proceedings

We are not currently a 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. However, in the future, we may be subject to legal proceedings in the ordinary course of business.

### Item 1A. Risk Factors

***We have relied and expect to continue to rely on sales of our PX devices for almost all of our revenue; a decline in demand for desalination, reverse osmosis desalination or our PX devices will reduce demand for our products and will cause our sales and revenue to decline.***

Our primary product is the PX device, and sales of our PX device historically have accounted for a high percentage 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 developed and refined over the past 12 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 desalination, including changing weather patterns, increased precipitation, new technology for producing fresh water, new energy technology or reduced energy costs, changes in the global economy, and political changes, would reduce the demand for PX devices and would cause a significant decline in our revenue. Similarly, any other factors adversely affecting the demand for our PX devices, including new methods of desalination that reduce pressure and energy requirements, improvements in membrane technology, new energy recovery technology, increased competition, changes in customer spending priorities and industry regulations would also 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, availability of project financing, and other factors affecting the water desalination industry.***

We derive substantially all of our revenue from sales of products and services used in desalination plants for municipalities, hotels, resorts and agricultural operations in dry or drought-ridden regions of the world. The demand for our products may decrease if the construction of desalination plants declines, especially in these regions. Other factors could affect the number and capacity of desalination plants built or the timing of their completion, including the current weak global economy, the current crisis in the credit and banking systems, changes in government priorities, changes in governmental regulations, reduced capital spending for desalination and lower energy costs, which could result in cancelled orders or delays in plant construction and the installation of our products. As a result of these factors, we have experienced and may in the future experience significant variability in our revenue, on both an annual and a quarterly basis. Pronounced variability, extended delays or reductions in spending with respect to the construction of desalination plants could negatively impact our sales and revenue and make it difficult for us to accurately forecast our future sales, which could lead to increased spending by us that is not matched by equivalent or higher revenue.

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

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

***We rely on a limited number of engineering and construction firms for a large portion of our revenue. If these customers delay or 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 customers can account for a substantial portion of our net revenue. Revenue from engineering and construction firms and other customers representing 10% or more of total revenue varies from year to year. See “Note 9 — Concentrations” to the condensed consolidated financial statements regarding the impact of customer concentrations on our condensed



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consolidated financial statements. We do not have long-term contracts with our customers; instead, we sell to them on a purchase order or project basis or under individual stand-alone contracts. Orders may be postponed or delayed by our customers on short or no notice. If these customers reduce their purchases, our projected revenue may significantly decrease, which will adversely affect our financial condition and future growth. If one of our engineering and construction firm 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 are a limited number of engineering and construction firms which are involved in the desalination industry. Thus, if one of them decides not to continue to use our energy recovery devices in its future projects, we may not be able to replace such a lost customer with another such customer and our net revenue would be negatively affected.

***We face competition from a number of companies that offer competing energy recovery solutions. If any of these companies produce superior technology or offer 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 isobaric, turbine and hydraulic energy recovery devices. Our three primary competitors are Flowsolve Corporation, which recently acquired Calder AG, Fluid Equipment Development Company and Pump Engineering Incorporated. Other potential competitors may enter the market. We expect competition, especially competition on price to persist and intensify as the desalination market opportunity grows. Some of our current and potential competitors, including Flowsolve, 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 seawater reverse osmosis desalination plants in that area, has an exclusive agreement with Calder AG to use Calder's technology. In addition, our competitors 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 another one or more of our competitors were to merge or partner with another company, the change in the competitive landscape could adversely affect our ability to compete effectively which would affect our business, operating results and financial condition.

***Global economic conditions and the current crisis in the financial markets could have an adverse effect on our business and results of operations.***

Current economic conditions may continue to negatively impact our business and make forecasting future operating results more difficult and uncertain. For example, due to project delays related to the global economic downturn, we experienced a decrease in shipments to OEM customers during the second quarter of 2009. A weakening global economy may continue to cause our customers to delay or push out orders for our products or may result in the delay, postponement or canceling of planned or new desalination projects or retrofits, which would reduce our revenue. Turmoil in the financial and credit markets may also make it difficult for our customers to obtain needed project financing, resulting in lower sales. Negative economic conditions may also affect our suppliers, which could impede their ability to remain in business and supply us with parts, resulting in delays in the availability of our products. In addition, most of our cash and cash equivalents are currently invested in money market funds backed by United States Treasury securities; however, given the current weak global economy and the instability of financial institutions, we cannot be assured that we will not experience losses on our deposits, which would adversely affect our financial condition. If current economic conditions persist or worsen and negatively impact the desalination industry, our business, financial condition or results of operations could be materially and adversely 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.

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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 purchasing for seawater reverse osmosis desalination 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;
- adverse changes in the local or global financing conditions facing our customers;
- 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%, and in some instances up to 30% 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 June 30, 2009, we had approximately \$4.6 million of current unbilled receivables and approximately \$355,000 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 almost \$7 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. While new products have the potential to meet specified needs of key markets, their pricing may not meet customer expectations and they may not perform as well as our other PX devices. It is possible that potential customers may not accept new pricing structures. It is also possible that the release of new products 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 plans to manufacture a portion of our ceramic components may prove to be more costly or less reliable than outsourcing.***

We currently outsource the production of our ceramic components from a limited number of ceramic vendors. To diversify our supply of ceramics and retain more control over our intellectual property, we intend to vertically integrate by producing a portion of our ceramic component needs in house. If we are less efficient at producing our ceramic components or are unable to achieve required yields that are equal to or greater than the vendors to which we outsource, then our cost of revenue may be adversely affected. If we are unable to initiate the production of our ceramics parts on schedule, unable to manufacture these parts in-house efficiently and/or another of our ceramics suppliers goes out of business, we may be exposed to increased risk of supply chain disruption and capacity shortages.

***Our revenue and growth model depend upon the continued viability and growth of the seawater reverse osmosis desalination industry using current technology.***

If there is a downturn in the seawater reverse osmosis desalination industry, our sales would be directly and adversely impacted. Changes in seawater reverse osmosis desalination technology could also reduce the demand for our devices. For example, a reduction in the operating pressure used in seawater reverse osmosis desalination plants could reduce the need for and viability of our energy recovery devices. Membrane manufacturers are actively working on lower pressure membranes for seawater reverse osmosis desalination that could potentially be used on a large scale to desalinate seawater at a much lower pressure than is currently necessary. Engineers are also evaluating the possibility of diluting seawater prior to reverse osmosis desalination to reduce the required membrane pressure. Similarly, an increase in the recovery rate would reduce the number of energy recovery devices required and would reduce the demand for our product. A significant reduction in the cost of power may reduce demand for our product or favor a less expensive product from a competitor. Any of these changes would adversely impact our revenue and growth.

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

Our PX devices utilize ceramic components that have to date demonstrated high durability, high corrosion resistance and long life in seawater reverse osmosis desalination 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. In the event that our products are more durable than expected, our opportunity for aftermarket revenue may be deferred.

***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 time consuming and typically involves a significant product evaluation process. While the sales cycle for our OEM customers, which are involved with smaller desalination plants, averages one to three months, the average sales cycle for our international engineering and construction firm customers, which are involved with larger desalination plants, ranges from nine to 16 months and has, in some cases, extended up to 24 months. 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

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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 fourth quarter and annual revenue and operating results.***

A significant portion of our annual sales typically occurs during the fourth quarter, which we believe generally reflects engineering and construction firm 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 a limited number of 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. Two ceramics vendors provided all ceramic components purchased during the six months ended June 30, 2009. If any of our ceramic suppliers were to have financial difficulties, cancel or materially change their commitments 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 depend on single suppliers for some of our components, including stainless steel castings. If our suppliers are not able to meet our demand and/or requirements, our business could be harmed.***

We rely on single suppliers to produce all of our stainless steel castings and some other components for use in our PX products. Our reliance on single manufacturers for these parts 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 these suppliers and instead secure manufacturing availability on a purchase order basis. Our suppliers have 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 these suppliers and our suppliers 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 suppliers due to factors such as high industry demand or the inability of our vendors to consistently meet our quality or delivery requirements. If 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 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 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 warranty our products for a period of one to two years and provide a five year warranty for the ceramic components of our PX brand products. 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 have offered a five year warranty on our ceramic components for new sales agreements executed after August 7, 2007. Accordingly, we cannot quantify the error rate of the ceramic components of our products with statistical accuracy 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 our technology 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.***

Our competitive position depends on our ability to establish and maintain proprietary rights in our technology and to protect our technology from copying by others. We rely on trade secret, patent, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which may offer only limited protection. We hold five United States patents and thirteen patents outside the U.S. that are counterparts to two of the U.S. patents. The expiration terms of the U.S. patents range from 2011 to 2025, at which time we could become more vulnerable to increased competition. In addition, we have applied for four new United States patents and there are twenty-five pending foreign applications corresponding to U.S. patents and patent applications and to one international application. We do not hold issued patents in many of the countries into which we sell our PX devices, including Saudi Arabia, Algeria and China, though we do have pending applications in those and other countries where we have substantial sales activity. Accordingly, the protection of our intellectual property in some of 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. Because we generally indemnify our customers 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.

***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 require a larger manufacturing facility with greater capacity. We have entered into a 10 year lease for a 170,000 square foot facility in San Leandro, California. While this space will be available to accommodate the consolidation of our U.S. operations and the expansion of our manufacturing operations, the space is being built out and will not be available until September 2009 or later. If the build-out is delayed, our production capability could be limited, which could adversely affect our operating results.

***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. In our initial public offering in July 2008, we issued approximately 10,000,000 shares of common equity at \$8.50 per share before underwriting discount and issuing expenses. 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. 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 government entities no longer guarantee and 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 seawater reverse osmosis desalination plants which are often times constructed and maintained through government guarantees and subsidies. The rate of construction of desalination plants depends on each government's willingness and ability to allocate funds for such projects, which may be affected by the current crisis in the financial system and credit markets and the weak global economy. In addition, some desalination projects in the Middle East and North Africa have been funded by budget surpluses resulting from once high crude oil and natural gas prices. Since prices for crude oil and natural gas have fallen, governments in those countries may not have budget surpluses to fund such projects and may cancel such projects or divert funds allocated for them to other projects. As a result, 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 seawater reverse osmosis desalination 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. These countries may also be affected significantly by the current crisis in the global financial system and credit markets and the weak global economy. We have sales and technical support personnel stationed in Spain, Asia and the Middle East, among other regions, and we expect to continue to add personnel in other countries. As a result, any governmental changes or reforms or disruptions in the business, regulatory or political environments of 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.

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Sales of our products have to date been denominated principally in U.S. dollars. If the U.S. dollar strengthens against most other currencies, it will effectively 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, which the current global economic crisis may exacerbate;
- 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;
- difficulty in attracting, hiring and retaining qualified personnel; and
- increasing instability in the capital markets and banking systems worldwide, especially in developing countries, that may limit project financing availability for the construction of desalination plants.

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 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 to provide 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 are first required to report on the effectiveness of our internal control over financial reporting in our Annual Report on Form 10-K for the year ending December 31, 2009. If there are material weaknesses or deficiencies in our internal control, 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

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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 to 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.

### ***Insiders will continue to have substantial control over us and will be able to influence corporate matters.***

Our directors and executive officers and their affiliates beneficially own, in the aggregate, approximately 13% of our outstanding common stock as of June 30, 2009. 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.

### ***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 amended and restated certificate of incorporation and bylaws 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 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;



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- 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 vote 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.

### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

#### *(a) Sales of Unregistered Securities*

None.

#### *(b) Use of Proceeds from Public Offering of Common Stock*

On July 1, 2008, our registration statement (No. 333-150007) on Form S-1 was declared effective for our initial public offering, or IPO, pursuant to which we registered the offering and sale of an aggregate 16,100,000 shares of common stock, including the underwriters' over-allotment option, at a public offering price of \$8.50 per share, or aggregate offering price of \$136.9 million, of which \$86.5 million related to 10,178,566 shares sold by us and \$50.4 million related to 5,921,434 shares sold by selling stockholders. The offering closed on July 8, 2008 with respect to the primary shares and on July 11, 2008 with respect to the over-allotment shares. The managing underwriters were Citigroup Global Markets Inc. and Credit Suisse Securities (USA) LLC.

As a result of the offering, we received net proceeds of approximately \$76.7 million, after deducting underwriting discounts and commissions of \$6.1 million and additional offering-related expenses of approximately \$3.7 million. No payments for such expenses were made directly or indirectly to (i) any of our officers or directors or their associates, (ii) any persons owning 10% or more of any class of our equity securities, or (iii) any of our affiliates. During the first quarter of 2009, we pledged \$9.1 million of the net proceeds as collateral to facilitate the early termination of a credit facility with a financial institution. During the second quarter of 2009, \$3.4 million of that \$9.1 million was released, and we did not use additional net proceeds from the IPO during that quarter. We anticipate that we will use the remaining net proceeds from our IPO for working capital and other general corporate purposes, including to finance our growth, develop new products, fund capital expenditures, or to expand our existing business through acquisitions of other businesses, products or technologies. However, we do not have agreements or commitments for acquisitions at this time. Pending such uses, we have deposited a substantial amount of the net proceeds in a U.S. Treasury based money market fund as of June 30, 2009. There has been no material change in the planned use of proceeds from our IPO from that described in the final prospectus filed with the SEC pursuant to Rule 424(b).

#### *(c) Purchases of Equity Securities by the Issuer and Affiliated Purchasers*

None.

### **Item 3. Defaults Upon Senior Securities**

Not applicable.

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

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At the Company's Annual Meeting of Stockholders held on June 12, 2009, in San Leandro, CA, the following votes of security holders occurred:

### *Proposal No 1: Election of Directors*

The following persons were duly elected by the stockholders as Class I directors of the Company, each for a three (3) year term (until 2012):

<b>Name</b>	<b>Votes For</b>	<b>Votes Withheld</b>
Paul M. Cook	40,258,341	230,895
Fred Olav Johannessen	40,301,529	187,707
Marie Elisabeth Paté-Cornell	40,348,414	140,822

### *Proposal No 2: Ratification of Independent Registered Public Accountants*

The stockholders ratified the appointment of BDO Seidman, LLP as independent accountants for the Company for the fiscal year ending December 31, 2009:

For	40,453,810
Against	20,707
Abstaining	14,717

## **Item 5. Other Information**

We are providing the following information in lieu of a report under Item 5.02(e) of Form 8-K concerning compensatory arrangements of certain officers, that would otherwise be due August 10, 2009.

On August 4, 2009, the Board of Directors of Energy Recovery, Inc. ("ERI") approved and adopted the ERI Change in Control Severance Plan (the "Plan"). A copy of the Plan is attached to this report as Exhibit 10.21. The following summary of the material terms of the Plan does not describe all Plan provisions and is qualified by reference to the full text of the Plan. Definitions of capitalized terms relating to the Plan that are used below are set forth in the Plan. References to ERI below include ERI and its Affiliates.

The Plan is effective as of August 4, 2009, and will end on December 31, 2010, unless extended as provided in the Plan.

The Compensation Committee of the ERI Board of Directors is authorized by the Plan to designate any full-time employee of ERI as a Participant. Although Participants in the Plan have not been selected as of the date of this report, ERI expects that the Compensation Committee will designate a group of ERI officers and key employees as Participants.

A Participant is entitled to Severance Benefits under the Plan if ERI terminates the Participant's employment without Cause, or the Participant terminates his or her employment with Good Reason, in either case within 12 months after a Change in Control (including but not limited to an acquisition of a controlling interest in ERI by a third party).

The Severance Benefits include the following, conditioned on the Participant's signing a release in favor of ERI and complying with certain other covenants under the agreement, and less deductions required or permitted by applicable law:

- A lump sum payment equal to (i) 12 months' regular base rate of pay, plus (ii) 100% of the Participant's target annual bonus for the fiscal year in which the Change in Control occurs;
- Immediate vesting of all unvested equity compensation held by the Participant as of the date of termination (and for this purpose, all performance criteria, if any, underlying unvested awards are deemed to be satisfied at 100% of target);
- ERI's regular company share of the monthly premium under COBRA, if the Participant timely elects to continue medical, dental, and vision benefits under COBRA, for up to 12 months after employment termination (but not continuing after the Participant becomes eligible for these benefits with another employer); and
- Payment by ERI of up to \$10,000 for reasonable costs of outplacement services.

The Plan also obligates ERI to make all payments to a Participant required by applicable law upon employment termination, such as earned but unpaid salary and bonus (without regard to a release or other covenants of the Participant in the Plan, and subject to deductions required or permitted by applicable law).

The Plan further provides that all invested equity compensation held by a Participant will vest and become exercisable immediately prior to a Change in Control (whether or not the Participant's employment is terminated) if a Change of Control occurs and (i) ERI's shares are no longer publicly traded, or (ii) if a publicly traded company acquires ERI but does not replace unvested ERI awards with defined equivalent equity compensation applicable to the acquiring company's stock. For this purpose, all performance criteria, if any, underlying unvested awards are deemed to be satisfied at 100% of target.

In no event is ERI obligated to gross up any payment or benefit to a Participant to avoid the effects of the "parachute rules" of Sections 280G and 4999 of the Internal Revenue Code of 1986 as amended. However, benefits to a Participant may be reduced if the reduction would result in the Participant receiving a greater payment on an after-tax basis due to the operation of those sections of the tax law. Also, payments may be conditioned or delayed as needed to be exempt from or comply with Section 409A of that Code relating to "nonqualified deferred compensation."

**Item 6. Exhibits**

<b>Exhibit No.</b>	<b>Description</b>
10.17.1	First Amendment to Modified Industrial Gross Lease dated May 28, 2009, between the Company and Doolittle Williams, LLC.
10.17.2	Second Amendment to Modified Industrial Gross Lease dated June 26, 2009, between the Company and Doolittle Williams, LLC.
10.21	Energy Recovery, Inc. Change in Control Severance Plan
31.1	Certification of Principal Executive Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d—14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002.
31.2	Certification of Principal Financial Officer Pursuant to Exchange Act Rule 13a-14(a) or 15d—14(a), as Adopted Pursuant to Section 302 of The Sarbanes Oxley Act of 2002.
32.1	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**SIGNATURES**

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

Registrant: Energy Recovery, Inc.

By:

/s/ G. G. PIQUE

**G. G. Pique**

President and Chief Executive Officer  
(Principal Executive Officer)

August 7, 2009

/s/ THOMAS D. WILLARDSON

**Thomas D. Willardson**

Chief Financial Officer  
(Principal Financial Officer)

August 7, 2009

**Exhibit List**

<b>Exhibit No.</b>	<b>Description</b>
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32.1	Certifications of Chief Executive Officer and Chief Financial officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

**FIRST AMENDMENT TO MODIFIED INDUSTRIAL GROSS LEASE**

THIS FIRST AMENDMENT TO MODIFIED INDUSTRIAL GROSS LEASE (this "Amendment") is made as of May 28, 2009, by and between DOOLITTLE WILLIAMS, LLC, a California limited liability company ("Landlord"), and ENERGY RECOVERY, INC., a Delaware corporation ("Tenant").

**RECITALS:**

- A. Landlord and Tenant entered into that certain Modified Industrial Gross Lease dated as of November 25, 2008 (the "Lease"), relating to certain premises described in the Lease.
- B. Landlord and Tenant desire to amend the Lease as more fully set forth below.
- C. All capitalized terms used in this Amendment shall have the respective meanings given to them in the Lease unless otherwise defined herein.

**AGREEMENT:**

NOW, THEREFORE, in consideration of the premises and the mutual covenants herein contained, the parties hereby amend the Lease on the terms hereof effective as of the date hereof, notwithstanding anything to the contrary contained therein:

1. Insurance.

(a) The first sentence of Section 6.05 of the Lease is hereby deleted in its entirety and replaced with the following:

"Tenant, at Tenant's expense, shall provide and keep in force during the Term of this Lease a policy or policies of broad form or special form property insurance, in an amount not less than one hundred percent (100%) replacement value covering Tenant's merchandise, furniture, equipment, fixtures, and Tenant's improvements that Tenant owns or has installed at Tenant's sole cost and expense to the Premises."

(b) The third sentence of Section 6.07 of the Lease is hereby deleted in its entirety and replaced with the following:

"Landlord, McGrath Properties, Inc., Landlord's successors and assigns, and any ground lessor and/or holder of any fee or leasehold mortgage, shall be named as additional insureds under the commercial general liability insurance policy maintained by Tenant."

(c) The fifth sentence of Section 6.07 of the Lease is hereby deleted in its entirety and replaced with the following:

"Any deductible amounts under any insurance policies required to be carried by Tenant hereunder shall be in commercially reasonable amounts."

(d) Section 6.09 of the Lease is hereby deleted in its entirety and replaced with the following: "*Intentionally Deleted.*"

2. Parking. Section 10.06 of the Lease is hereby deleted in its entirety and replaced with the following:

*"Parking. Any monetary obligations imposed relative to parking rights with respect to the Premises shall be considered as Tax Expenses and shall be paid by Tenant under Section 5. Landlord grants Tenant the right to use all of the parking spaces located in the parking area adjacent to the Building (approximately one hundred and four (104) parking spaces), with the rules regulating the use thereof to be established, from time to time, by Landlord. Tenant shall control Tenant's employees, agents, customers, visitors, invitees, licensees, contractors, assignees and subtenants ("Tenant's Parties") to ensure compliance with such rules. Landlord may take such actions or incur such cost which it deems reasonably necessary to enforce the proper parking on the Property, including the reasonable allocation to Tenant of all costs and expenses to do so. Tenant shall not use the areas outside of the Premises for the placement of dumpsters, refuse collection, outdoor storage or parking of cars and/or pickup trucks which are not in working order. Upon request, Landlord provide Tenant with the right to use an additional one hundred and sixteen (116) parking spaces (the "Additional Parking Spaces"). The Additional Parking Spaces will be located as shown on Exhibit G attached (which shows a capacity for 158 parking spaces). Landlord shall provide, at Landlord's sole cost and expense and not as Tax Expenses, a striped parking pad as shown in substantially the condition set forth in Exhibit G which shall include striping, lights, fencing, grading and automatic gates for security as shown. Tenant shall be solely responsible for the costs of permitting and constructing a corridor connecting the Premises with the parking area, as shown on Exhibit G. If the City of San Leandro or Tenant should determine that Tenant's use of the Premises requires the availability of more than two hundred twenty (220) parking spaces, Landlord shall grant Tenant the right to use additional parking spaces as required by the City in addition to the Additional Parking Spaces on Exhibit G. Tenant will cooperate with Landlord in petitioning the City to reduce its parking requirements, if the parking required by the City exceeds Tenant's actual needs."*

3. Exhibit G. Exhibit G to the Lease is hereby deleted in its entirety and replaced with Exhibit 1 attached to this Amendment.

4. Ratification. Except as modified by this Amendment, the Lease and all the terms, covenants, conditions and agreements thereof are hereby in all respects ratified, confirmed and approved.

5. Full Force and Effect. This Amendment contains the entire understanding between the parties with respect to the matters contained herein. Except as modified by this Amendment, the Lease shall remain unchanged and shall continue in full force and effect. No representations, warranties, covenants or agreements have been made concerning or affecting the subject matter of this Amendment, except as are expressly contained herein and in the Lease.

This Amendment may not be changed orally, but only by an agreement in writing signed by the party against whom enforcement of any waiver, change or modification or discharge is sought.

6. Counterparts; Facsimile Transmission. This Amendment may be executed in any number of identical counterparts each of which shall be deemed to be an original and all, when taken together, shall constitute one and the same instrument. A facsimile or similar transmission of a counterpart signed by a party hereto shall be regarded as signed by such party for purposes hereof.

IN WITNESS WHEREOF, Landlord and Tenant have executed and delivered this Amendment as of the date and year first above written.

**LANDLORD:**

DOOLITTLE WILLIAMS, LLC,  
a California limited liability company

By: /s/ Terrence McGrath

Name: Terrence M. McGrath

Title: Managing Member

Date: June 1, 2009

**TENANT:**

ENERGY RECOVERY, INC.,  
a Delaware corporation

By: /s/ Carolyn F. Bostick

Name: Carolyn F. Bostick

Title: VP and General Counsel

Date: June 2, 2009

By: /s/ Robyn A. Hegarty

Name: Robyn A. Hegarty

Title: Director of Accounting

Date: June 2, 2009



**EXHIBIT 1**

**EXHIBIT G**

attached

Exhibit 1

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**SECOND AMENDMENT TO MODIFIED INDUSTRIAL GROSS LEASE**

THIS SECOND AMENDMENT TO MODIFIED INDUSTRIAL GROSS LEASE (this "Second Amendment") is made as of June 26, 2009, by and between DOOLITTLE WILLIAMS, LLC, a California limited liability company ("Landlord"), and ENERGY RECOVERY, INC., a Delaware corporation ("Tenant").

**RECITALS:**

- A. Landlord and Tenant entered into that certain Modified Industrial Gross Lease dated as of November 25, 2008 (the "Original Lease"), relating to certain premises described in the Lease.
- B. Landlord and Tenant subsequently entered into that certain First Amendment to Modified Industrial Gross Lease dated as of May 28, 2009 (the "First Amendment"). The Original Lease as amended by the First Amendment is referred to herein collectively as the "Lease".
- C. Landlord and Tenant now desire to further amend the Lease to, among other things, add additional space to the leased Premises, all as more fully set forth below.
- D. All capitalized terms used in this Second Amendment shall have the respective meanings given to them in the Lease unless otherwise defined herein.

**AGREEMENT:**

NOW, THEREFORE, in consideration of the premises and the mutual covenants herein contained and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties hereby amend the Lease on the terms hereof effective as of the date hereof, notwithstanding anything to the contrary contained therein:

1. Expansion of Warehouse Premises.

(a) The increment of space in the Warehouse located at 2250 Williams Street, San Leandro, California which is adjacent to the existing Warehouse Premises and which is labeled "Expansion Space" on the attached Exhibit 2, consisting of approximately 45,000 rentable square feet, shall be defined and referred to herein as the "Expansion Space" and shall be added to the Premises covered by the Lease on the terms and conditions set forth herein. Landlord and Tenant agree that for the purpose of the Lease, as amended by this Second Amendment, the Expansion Space shall be conclusively deemed to contain 46,250 square feet.

(b) As used herein, the "Expansion Commencement Date" shall mean the date on which Landlord tenders possession of the Expansion Space to Tenant following the vacating of the Expansion Space by the existing tenant, Portfolio Productions, Inc., a California corporation, dba Sitcom ("Sitcom") and otherwise in the condition required by this Second Amendment. Landlord estimates that the Expansion Commencement Date will occur on August 1, 2009 (the "Estimated Expansion Date"); provided, however, that if Landlord is unable to

tender possession of the Expansion Space to Tenant in the condition required by Section 1(d) of this Second Amendment by the Estimated Expansion Date, then: (i) the validity of this Second Amendment shall not be affected or impaired thereby; (ii) Landlord shall not be in default hereunder or be liable for damages therefor; and (iii) Tenant shall accept possession of the Expansion Space on the date when Landlord tenders possession thereof to Tenant in the condition required by Section 1(d) of this Second Amendment. The term of the lease of the Expansion Space shall begin on the Expansion Commencement Date and shall be coterminous with the Term as defined in Sections 1 and 3.02 of the Lease (i.e. ten (10) years from the Commencement Date, as that term is defined in the Lease and amended by Section 7 below of this Second Amendment).

(c) As of the Expansion Commencement Date, the definition of "Warehouse Premises" in the Defined Terms of the Lease shall be modified to provide that the "Warehouse Premises" contains a total of 63,750 rentable square feet consisting of the 17,500 rentable square feet in the originally demised Warehouse Premises (referred to in this Second Amendment as the "Original Warehouse Premises") and the Expansion Space consisting of 46,250 rentable square feet; provided, however, that in the event the Expansion Commencement Date should occur earlier than the Commencement Date for the rest of the Premises, then the term "Warehouse Premises" as used in the Lease as amended by this Second Amendment shall apply to the Expansion Space only prior to the occurrence of the Commencement Date. The Expansion Space shall remain a portion of the "Warehouse Premises" throughout the Term of the Lease (including any exercised Renewal Terms).

(d) Tenant shall accept the Expansion Space in its "AS IS" state and condition and Landlord shall have no obligation to make or pay for any improvements or renovations in or to the Expansion Space or to otherwise prepare the Expansion Space for Tenant's occupancy except that Landlord shall, at Landlord's sole cost and expense, prior to the Expansion Commencement Date, remove Sitcom's racks from the Expansion Space and repair any damage caused by the rack removal or the vacating of the Expansion Space by Sitcom.

## 2. Demising Wall; Alterations; Restoration; Letter of Credit; Permits.

(a) All costs associated with the improvement and alteration of the Expansion Space (collectively, the "Expansion Space Alterations") shall be borne solely by Tenant. Such Expansion Space Alterations expressly include (i) the installation of a demising wall (the "Demising Wall") to separate the Expansion Space from the remainder of the Warehouse that will remain occupied by Sitcom (the "Sitcom Remainder Space") and (ii) any required seismic upgrades of the Warehouse (the "Seismic Upgrade Work"). All Expansion Space Alterations shall be performed in compliance with the terms of Sections 8.02 and 7.05 of the Lease.

(b) Tenant shall engage Engineered Construction Services Corporation ("ECS") as the construction manager for the Expansion Space Alterations, including without limitation the construction of the Demising Wall. Tenant shall obtain an estimate of ECS's fees for the construction management services to be provided in conjunction with the Expansion Space Alterations, following which Tenant shall contract directly with ECS for such work.

(c) The Demising Wall shall be erected between the Expansion Space and the Sitcom Remainder Space with minimal disruption to Sitcom's use of and access to its premises, including minimizing all dust and noise impacting the Sitcom Remainder Space. Further, Tenant shall provide appropriate security for Sitcom's warehouse inventory located in the Sitcom Remainder Space throughout the process of construction of the Demising Wall. Provided that Tenant manages the process of construction of the Demising Wall in a commercially reasonable manner, Tenant shall not be liable to Sitcom or otherwise for payment of any claims asserted by Sitcom for business interruption resulting from performance of any of the Expansion Space Alterations, including the Demising Wall construction and the Seismic Upgrade Work.

(d) Landlord acknowledges and agrees that Tenant shall be permitted to perform, subject to compliance with Sections 8.02 and 7.05 of the Lease, the following alterations to the Expansion Space as part of the Expansion Space Alterations:

- (i) increase the roof height of the Warehouse in a partial section over an area of the Expansion Space that will house a large spray dryer;
- (ii) dig an open trench pit for an iso-static press;
- (iii) dig an approximately 150-foot trench, approximately 12-20 inches deep, for a kiln transfer car system;
- (iv) build a heat-resistant room for kiln exhaust equipment;
- (v) modify the roof structure to accommodate HVAC systems;
- (vi) add additional gas capacity up to 36 million BTU per hour;
- (vii) upgrade the electrical system to accommodate multiple pieces of machinery;
- (viii) install a dust collection system;
- (ix) add a water tank/berm system (transferred to the Expansion Space from phase 1 construction in the original Warehouse Premises);
- (x) modify the plumbing system as required;
- (xi) perform concrete floor work as required;
- (xii) add bathroom and office space as needed to accommodate staff needs; and
- (xiii) perform such other work as may be required to adapt the Expansion Space to Tenant's industrial needs.

(e) Consistent with the terms of Section 8.02 of the Lease, Tenant shall be obligated to restore the Expansion Space to its original condition existing prior to performance of

the Expansion Space Alterations, including removal of the concrete block portion of the Demising Wall; provided, however, that Tenant's obligations under Section 8.02 with respect to the Expansion Space expressly exclude the obligations (i) to return the roof to its original height, (ii) to remove or undo any Seismic Upgrade Work and (iii) to remove the parking corridor (as set forth in Section 10.06) along the north wall (as shown on the attached Exhibit 2). Notwithstanding the foregoing, Landlord shall have the option, by not less than twelve (12) months' notice to Tenant, to authorize Tenant to leave some or all of the Expansion Space Alterations in place upon surrender of the Expansion Space at the end of the Term.

(f) If, upon the date that is twelve (12) months before the expiration of the Term, Tenant's cash assets on hand as reported by its most recent Form 10Q, is less than Three Million Dollars (\$3,000,000) or upon an uncured material financial default by Tenant (including without limitation Tenant's failure to pay rent when due following receipt of any applicable notice required by the Lease), Landlord shall require Tenant to deliver to Landlord an irrevocable standby letter of credit in an amount equal to \$250,000.00 (the "Letter of Credit") to secure Tenant's obligations to restore the Premises as required by Section 8.02 of the Lease and the foregoing Section 2(e) of this Second Amendment, which Letter of Credit shall (1) be addressed to Landlord, (2) be in a form reasonably satisfactory to Landlord (3) be issued by a federally insured financial institution with minimum assets of Ten Billion Dollars (\$10,000,000,000.00) (the "Minimum Assets"), upon which presentment may be made in a local office of the financial institution, (4) allow for partial and multiple draws thereunder, and (5) have an expiration date not earlier than thirty (30) days after the scheduled Term expiration date (as the same may be extended) or in the alternative, have a term of not less than one (1) year. In addition, the Letter of Credit shall provide that, in the event of Landlord's assignment of its interest in the Lease, the Letter of Credit shall be freely transferable by Landlord to the assignee without charge to Landlord or approval of the issuer. The Letter of Credit shall provide for same day or next business day payment to Landlord upon the issuer's receipt of a sight draft from Landlord together with Landlord's certificate signed by two officers or managers certifying that the requested sum is due and payable from Tenant and Tenant has failed to pay, and with no other conditions.

The Letter of Credit shall be replaced by a new Letter of Credit if the issuing financial institution: (i) has assets which fall below the Minimum Assets; (ii) enters into any form of regulatory or governmental proceeding, including without limitation any receivership instituted or commenced by the Federal Deposit Insurance Corporation (the "FDIC"); (iii) is otherwise declared insolvent, is downgraded by the FDIC, is determined to be less than well capitalized by the appropriate Federal banking agency under the prompt corrective action rules of the FDIC, or closes for any reason; or (iv) in any manner communicates (including without limitation communications sent by or on behalf of the FDIC) its unwillingness to honor the terms of the Letter of Credit. If Tenant fails to deliver to Landlord the replacement Letter of Credit within fifty (50) days following Landlord's written demand for same, Landlord shall be entitled to draw down the entire Letter of Credit and, until Tenant delivers to Landlord the replacement Letter of Credit as required by this paragraph, hold the drawn cash as a security deposit (which need not be segregated from Landlord's other funds and which shall not accrue interest for Tenant's benefit, in each case unless otherwise required by applicable law).

In the event that Tenant is in default under the terms and provisions of the Lease with respect to Tenant's restoration obligations, Landlord shall have the right, at any time after such default, without giving any further notice to Tenant: (1) to make a partial draw upon said Letter of Credit in an amount necessary to cure such default or (2) to draw down the entire amount of such Letter of Credit at such time, and any such amounts received by Landlord shall be held by Landlord (and need not be segregated or accrue interest unless otherwise required by applicable law) and shall be applied in accordance with the terms of the Lease as amended hereby in the same manner as a security deposit to cure Tenant's default.

To the extent that Landlord has not previously drawn upon the Letter of Credit, and to the extent that Tenant is not otherwise in default of its restoration obligations under the Lease as of the expiration date of the Lease, Landlord shall return the Letter of Credit to Tenant within thirty (30) days following the expiration of the Term of the Lease.

(g) Tenant shall be solely responsible to obtain all construction permits for the Expansion Space Alterations and all use permits for Tenant's operations in the Expansion Space as may be required by the City of San Leandro or any other governmental agency with jurisdiction over the Premises. Tenant's submittal of its applications for any permits relating to the Expansion Space Alterations shall be completely separate from the permit applications submitted or to be submitted in conjunction with the phase I work being completed in the remainder of the Premises. In no event shall the achievement of "Substantial Completion" of the phase I improvement work in the remainder of the Premises or the determination of the Commencement Date for the Lease (including payment of Rent) be delayed in any manner by virtue of the design or construction of the Expansion Space Alterations.

3. Permitted Uses. Tenant shall be permitted to use the Expansion Space for its business, including the design, manufacture and assembly of ceramic and other parts for its products, subject to the terms of the Lease as amended hereby.

4. Base Rent. Section 1.01 item 12 of the Lease is hereby deleted and replaced with the following:

"12. Base Rent: \$0.75 per rentable square foot per month for the Building; \$0.50 per rentable square foot per month for the Original Warehouse Premises; and \$0.428 per rentable square foot for the Expansion Space."

5. Rent Escalations. Section 1.01 item 14 of the Lease is hereby deleted and replaced with the following:

"14. Rent Escalations: The Base Rent for the Building and the Original Warehouse Premises shall increase by 2.5% upon each anniversary of the Commencement Date (as defined in Section 3.01); and the Base Rent for the Expansion Space shall increase by 2.5% upon each anniversary of the Expansion Commencement Date (as defined in the Second Amendment to the Lease)."

6. Modification of Tenant's Proportionate Share. Effective as of the Commencement Date, Tenant's Share of Warehouse Tax Expenses, Tenant's Share of

Warehouse Insurance Expenses and Tenant's Share of Warehouse Operating Expenses as earlier set forth in Section 1.01 of the Lease, items 17a, 19a, and 22, respectively, shall be 28.57%.

7. Term. Section 3.01 of the Lease is deleted in its entirety and replaced with the following:

"3.01 *Commencement Date*. The Term shall commence on the later to occur of the following dates (the "Commencement Date"): (i) the date of Substantial Completion (as defined in *Exhibit D*) of the Building and the Original Warehouse Premises (i.e. the Premises excluding the Expansion Space), or (ii) the Scheduled Commencement Date. Notwithstanding the foregoing, if the date of Substantial Completion of the Premises, excluding the Expansion Space, should occur after December 1, 2009 through no fault or delay of Landlord, the Commencement Date will be deemed to be December 1, 2009."

8. Base Rent. The first sentence of Section 4.01 of the Lease is hereby deleted and replaced with the following:

"The Base Rent for each of the Building, the Original Warehouse Premises, and the Expansion Space shall be as set forth in Section 1.01 and as confirmed in the Commencement Date Memorandum signed by the parties. Effective as of the Expansion Commencement Date, Tenant shall pay Base Rent for the Expansion Space (\$0.428 per rentable square foot per month, i.e. \$19,795.000 per month). Effective as of the Commencement Date, as that term is amended in the Second Amendment to the Lease, Tenant shall pay Base Rent for the Building and the Original Warehouse Premises. If the City of San Leandro authorizes Tenant to occupy the First Floor of the Building prior to Substantial Completion of the remainder of the Building, Tenant shall pay Base Rent for the square footage in the First Floor of the Building upon occupancy thereof and Base Rent for the square footage in the Second Floor of the Building upon the Commencement Date. Notwithstanding any early occupancy of the First Floor, the Term for both the First Floor and Second Floor of the Building shall be coterminous, i.e., ten (10) years from the Commencement Date."

9. Section 11.03. The first three sentences of Section 11.03 of the Lease are hereby deleted and replaced with the following:

"11.03. *Option to Terminate*, (i) If the Building is damaged or destroyed to the extent that Landlord determines in good faith that the Building cannot, with reasonable diligence, be fully repaired or restored by Landlord within two hundred seventy (270) days after the date of the damage or destruction, notwithstanding the fact that the Expansion Space and/or the Original Warehouse Premises has not been totally damaged or destroyed, the sole right of both Landlord and Tenant shall be the option to terminate this Lease, (ii) If the Expansion Space or the Original Warehouse Premises is damaged or destroyed to the extent that Landlord determines in good faith that such space cannot, with reasonable diligence, be fully repaired or restored by Landlord within two



hundred ten (210) days after the date of the damage or destruction, notwithstanding the fact that the Building has not been totally damaged or destroyed, the sole right of Landlord shall be the option to terminate this Lease with respect to the Expansion Space and/or the Original Warehouse Premises (as applicable) only.”

10. Section 11.04. The first three sentences of Section 11.04 of the Lease are hereby deleted and replaced with the following new sentences:

“11.04. *Option to Terminate for Uninsured Casualty.* In the event the Building is damaged or destroyed and is not fully covered by the insurance proceeds received by Landlord under the insurance policies required under Section 6.02, Landlord may terminate this Lease by written notice to Tenant given within thirty (30) days after the date of Landlord’s receipt of written notice from Landlord’s insurance company that said damage or destruction is not so covered. In the event the Expansion Space and/or the Original Warehouse Premises is damaged or destroyed and is not fully covered by the insurance proceeds received by Landlord under the insurance policies required under Section 6.02, Landlord may terminate this Lease with respect to the Expansion Space and/or the Original Warehouse Premises only by written notice to Tenant given within thirty (30) days after the date of Landlord’s receipt of written notice from Landlord’s insurance company that said damage or destruction is not so covered. If Landlord does not elect to terminate this Lease, this Lease shall remain in full force and effect, and the Building and/or the Expansion Space and/or the Original Warehouse Premises (as applicable) shall be repaired and rebuilt in accordance with the provisions for repair set forth in Section 11.01. If this Lease is terminated pursuant to this Section 11.04 with respect to the Original Warehouse Premises only, or the Expansion Space only, then after the date of such termination the Base Rent shall be reduced accordingly.”

11. Section 12.02. Section 12.02 of the Lease is hereby deleted in its entirety and replaced with the following:

“12.02. *Partial Condemnation.* If any portion of the Premises is Condemned, and such partial condemnation renders the Premises unusable for Tenant’s business, or if a substantial portion of the Building or the Expansion Space is Condemned, as reasonably determined by Landlord, this Lease shall terminate as of the date of title vesting in such proceeding and rent shall be adjusted to the date of termination. If such partial condemnation does not render the Premises unusable for the business of Tenant or less than a substantial portion of the Building or the Expansion Space is Condemned, Landlord shall promptly restore the Premises to the extent of any condemnation proceeds recovered by Landlord, less the portion thereof lost in such condemnation, and this Lease shall continue in full force and effect except that after the date of such title vesting, the Base Rent, Tenant’s Share of Warehouse Tax Expenses, Tenant’s Share of Warehouse Expenses, and Tenant’s Share of Warehouse Operating Expenses shall be adjusted as reasonably determined by Landlord. Tenant hereby waives the

provisions of California Code of Civil Procedure Section 1265.130 permitting a court of law to terminate this Lease.”

12. Section 16.12. Section 16.12 of the Lease is hereby deleted in its entirety and replaced with the following:

“16.12 *Surrender*. Upon the expiration or earlier termination of this Lease, Tenant shall surrender the Premises to Landlord in the same condition as existed on the date Tenant originally took possession thereof, reasonable wear and tear excepted. Tenant shall not commit or allow any waste or damage to be committed on any portion of the Premises or the Property. All property that Tenant is required to surrender shall become Landlord’s property upon the termination of this Lease. If Tenant fails to timely remove its personal property from the Premises, Landlord may keep and use them or remove any of them and cause them to be stored or sold in accordance with applicable law, all at Tenant’s sole cost and expense. All keys to the Premises or any part thereof shall be surrendered to Landlord upon expiration or sooner termination of the Term. Tenant shall give written notice to Landlord at least thirty (30) days prior to vacating the Premises and shall meet with Landlord for a joint inspection of the Premises at the time of vacating, but nothing contained herein shall be construed as an extension of the Term or as a consent by Landlord to any holding over by Tenant. In the event of Tenant’s failure to give such notice or participate in such joint inspection, Landlord’s inspection at or after Tenant’s vacating the Premises shall conclusively be deemed correct for purposes of determining Tenant’s responsibility for repairs and restoration. Notwithstanding anything to the contrary herein, as part of Tenant’s surrender obligations, Tenant shall return the service corridor in the same condition as of the date hereof (including if applicable, restoration of the wall separating the Building from the Warehouse and installation of a carbon monoxide ventilation system equivalent to the one located in the Building as of the date hereof), except that Tenant shall not be required to relocate and or reinstall any rollup doors.)

13. Commencement Date Memorandum. Exhibit C to the Lease is hereby deleted and replaced with the amended Commencement Date Memorandum attached hereto as Exhibit 3.

14. Exhibit D. Paragraph 2 of Exhibit D Work Letter of the Lease is hereby deleted and replaced with the following:

“2. *Landlord’s Work*. Landlord at its expense shall perform the following work in the Premises (collectively, the “Landlord’s Work”): (a) remove any tiles in the Building’s stairwell that contain asbestos and that are identified by Tenant prior to the Commencement Date; (b) level the floor slabs in the area identified on *Schedule 1* attached hereto between column lines N2-N5 and P2-P5; (c) replace the staircase railings and restore adjacent walls; (d) replace the non-conforming staircase in the front lobby to conform to Tenant design specifications, with the understanding that Tenant will reimburse Landlord on demand for 50% of these replacement costs; (e) remove all asbestos tiles from the north exit corridor of the

Building; (f) transfer telephone switching equipment for tenants other than Tenant to a location outside of the Premises; and (g) provide community access to main electrical switch.”

15. Parking. The first sentence of Section 10.06, as amended by the First Amendment, is hereby deleted and replaced with the following:

“Any monetary obligations imposed by the City of Leandro or other governmental entity relative to parking rights with respect to the Premises shall be considered as Tax Expenses and shall be paid by Tenant under Section 5 of the Lease.”

16. Brokers. Landlord and Tenant each warrants that it has had no dealings with any broker or agent in connection with the negotiation or execution of this Second Amendment other than Don Jones Companies (representing Tenant), whose commission shall be paid by Landlord pursuant to a separate agreement. Landlord and Tenant each agree to indemnify, defend and hold the other harmless from and against any claims by any other broker, agent or other person claiming a commission or other form of compensation by virtue of having dealt with such party with regard to this leasing transaction.

17. Ratification. Except as modified by this Second Amendment, the Lease and all the terms, covenants, conditions and agreements thereof are hereby in all respects ratified, confirmed and approved.

18. Full Force and Effect. This Second Amendment contains the entire understanding between the parties with respect to the matters contained herein. Except as modified by this Second Amendment, the Lease shall remain unchanged and shall continue in full force and effect. No representations, warranties, covenants or agreements have been made concerning or affecting the subject matter of this Second Amendment, except as are expressly contained herein and in the Lease. This Second Amendment may not be changed orally, but only by an agreement in writing signed by the party against whom enforcement of any waiver, change or modification or discharge is sought.

19. Counterparts; Facsimile Transmission. This Second Amendment may be executed in any number of identical counterparts each of which shall be deemed to be an original and all, when taken together, shall constitute one and the same instrument. A facsimile or similar transmission of a counterpart signed by a party hereto shall be regarded as signed by such party for purposes hereof.

20. Condition Precedent. This Second Amendment is expressly conditioned upon (i) receipt of approval from Landlord’s lender, which Landlord shall promptly seek and (ii) termination of Sitcom’s lease with respect to the Expansion Space (and relocation of a portion of their premises to another portion of the Warehouse) on such terms and conditions as shall be determined by Landlord in its sole discretion. Landlord shall advise Tenant if and when the foregoing conditions precedent have been met, provided that if Landlord has not notified Tenant by close of business on July 15, 2009 that these condition have been met, then this Second

Amendment shall be null and void and of no force or effect, and the Lease shall continue as written unaffected by the terms of this Second Amendment.

IN WITNESS WHEREOF, Landlord and Tenant have executed and delivered this Second Amendment as of the date and year first above written.

**LANDLORD:**

DOOLITTLE WILLIAMS, LLC,  
a California limited liability company

By: /s/ Terrence McGrath

Name: Terrence M. McGrath

Title: Managing Member

Date: June 26, 2009

**TENANT:**

ENERGY RECOVERY, INC.,  
a Delaware corporation

By: /s/ Terril Sandlin

Name: Terrill L. Sandlin

Title: VP of Manufacturing

Date: June 26, 2009

By: /s/ Tom Willardson

Name: Thomas Willardson

Title: Chief Financial Officer

Date: June 29, 2009



**EXHIBIT 3**  
**COMMENCEMENT DATE MEMORANDUM**

\_\_\_\_\_, 20\_\_

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Re: 1717 Doolittle Drive / 2250 Williams Street Modified Industrial Gross Lease dated as of November 21, 2008, as amended by First Amendment to Modified Industrial Gross Lease dated as of May 28, 2009 and by Second Amendment to Modified Industrial Gross Lease dated as of June 25, 2009 (collectively, the "Lease") between DOOLITTLE WILLIAMS, LLC, a California limited liability company ("Landlord"), and ENERGY RECOVERY, INC., a Delaware corporation ("Tenant"). Capitalized terms used herein but not defined shall be given the meanings assigned to them in the Lease.

Ladies and Gentlemen:

1. *Condition of Premises.* Tenant has accepted possession of the Premises pursuant to the Lease. Any improvements required by the terms of the Lease to be made by Landlord have been completed to the full and complete satisfaction of Tenant in all respects except for the punchlist items (if any) described on *Schedule I* hereto (the "Punchlist Items"), and except for such Punchlist Items (if any), Landlord has fulfilled all of its duties under the Lease with respect to such initial improvements. Furthermore, Tenant acknowledges that the Premises are suitable for the Permitted Uses.

2. *Commencement Date.* The Commencement Date of the Lease is \_\_\_\_\_, 2009.

3. *Expansion Commencement Date.* The Expansion Commencement Date for the Expansion Space is \_\_\_\_\_, 2009.

4. *Expiration Date.* The Term is scheduled to expire on \_\_\_\_\_, 20\_\_.

5. *Premises.* The Building contains 106,250 rentable square feet. The Warehouse Premises contain 63,750 rentable square feet consisting of (i) the 17,500 rentable square foot Original Warehouse Premises and (ii) the 46,250 rentable square foot Expansion Space. Landlord and Tenant stipulate that the square footage measurements set forth in the preceding sentence are conclusive as to the square footage of the Building and the Warehouse Premises for purposes of determining Base Rent and shall be binding upon them.

6. *Base Rent.* (i) Base Rent for the Building and the Original Warehouse Premises shall be the following amounts for the following periods of time:

Lease Year	Monthly Base Rent
1	\$ 88,438.00
2	\$ 90,648.00
3	\$ 92,915.00
4	\$ 95,238.00
5	\$ 97,618.00
6	\$100,059.00
7	\$102,560.00

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Lease Year	Monthly Base Rent
8	\$105,124.00
9	\$107,753.00
10	\$110,446.00

(ii) Base Rent for the Expansion Space shall be the following amounts for the following periods of time:

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Lease Year	Monthly Base Rent
1	\$19,795.00,
2	\$20,290.00
3	\$20,797.00
4	\$21,317.00
5	\$21,850.00
6	\$22,396.00
7	\$22,956.00
8	\$23,530.00
9	\$24,118.00
10	\$24,721.00

7. *Contact Person.* Tenant's contact person in the Premises is:

Attention:  
Telephone:  
Facsimile:  
Email:

8. *Ratification.* Tenant hereby ratifies and confirms its obligations under the Lease, and represents and warrants to Landlord that it has no defenses thereto. Additionally, Tenant further confirms and ratifies that, as of the date hereof, (a) the Lease is and remains in good standing and in full force and effect, and (b) Tenant has no claims, counterclaims, set-offs or defenses against Landlord arising out of the Lease or in any way relating thereto or arising out of any other transaction between Landlord and Tenant.

9. *Binding Effect; Governing Law.* Except as modified hereby, the Lease shall remain in full effect and this Commencement Date Memorandum shall be binding upon Landlord and Tenant and their respective successors and assigns. If any inconsistency exists or arises between the terms of this Commencement Date Memorandum and the terms of the Lease, the terms of this Commencement Date Memorandum shall prevail. This Commencement Date Memorandum shall be governed by the laws of the State of California.

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Please indicate your agreement to the above matters by signing this letter in the space indicated below and returning an executed original to us.

Sincerely,

DOOLITTLE WILLIAMS, LLC,  
a California limited liability company,

By:  
Name:  
Title:

Agreed and accepted:

ENERGY RECOVERY, INC.,  
a Delaware corporation

By:  
Name:  
Title:

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**SCHEDULE 1**  
**PUNCLIST ITEMS**

**ENERGY RECOVERY, INC.  
CHANGE IN CONTROL SEVERANCE PLAN**

**Article 1. Establishment, Term and Purpose**

**1.1. Establishment and Term of the Plan.** The Energy Recovery, Inc. Change in Control Severance Plan ("Plan") is designed to provide severance benefits to certain executives and other key employees of the Company in the event that their employment is terminated without cause or for good reason as a result of a change in control of the Company. The Plan will commence on August 4, 2009 (the "Effective Date") and will end on December 31, 2010, unless extended as set forth below in Article 5.

**1.2. ERISA.** This Plan is intended to be (i) an employee benefit plan within the meaning of Section 3(3) of the Employee Retirement Income Security Act of 1974 ("ERISA"), and (ii) an unfunded plan maintained by the Company for a select group of management or highly compensated employees within the meaning of Sections 201, 301, and 401 of ERISA, and any ambiguities herein shall be interpreted consistent with such intentions.

**Article 2. Definitions**

As used in this Plan, the following capitalized terms will have the meanings set forth below:

**(a) "Affiliate"** means any company Controlled by, or under common Control with, the Company. "Control" means the Company's right to vote 50% or more of the outstanding shares of the voting stock of the subject company.

**(b) "Cause"** means, in the context of employment termination:

(i) Participant's performance of any act which, if Participant were prosecuted, would constitute a felony or misdemeanor;

(ii) Participant's failure to carry out his or her material duties;

(iii) Participant's dishonesty towards or fraud upon the Company which is injurious to the Company;

(iv) Participant's violation of confidentiality obligations to the Company or misappropriation of Company assets; or

(v) Participant's death or disability, as defined in the Company long-term disability plan in which the Participant participates or, if the Participant does not participate in such a plan, the principal long-term disability plan that covers the Company's senior-level executives.

**(c) "Change in Control"** means:

(i) an acquisition of 50% or more of the outstanding common stock or voting securities of the Company by an person or entity, other than the Company, a Company employee benefit plan or a corporation controlled by the Company's shareholders;

(ii) changes in the composition of the Company's Board of Directors (the "Board") over a rolling twelve-month period, which changes result in less than a majority of the directors consisting of Incumbent Directors. "Incumbent Directors" include directors who are or were either

(x) members of the Board as of the Effective Date or

(y) elected, or nominated for election, to the Board with the affirmative votes of at least a majority of the Incumbent Directors at the time of such election or nomination. Incumbent Directors do not include any individual not otherwise an Incumbent Director whose election or nomination resulted from an actual or threatened proxy contest (relating to the election of directors to the Board); or

(iii) consummation of a complete liquidation or dissolution of the Company, or a merger, consolidation or sale of all or substantially all of the Company's then existing assets (collectively, a "Business Combination"), other than a Business Combination:

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(x) in which the stockholders of the Company immediately prior to the Business Combination receive 50% or more of the voting stock resulting from the Business Combination,

(y) through which at least a majority of the members of the Board are Incumbent Directors; and

(z) after which no individual, entity or group (excluding any corporation resulting from the Business Combination or any employee benefit plan of such corporation or of the Company) owns 50% or more of the stock of the corporation resulting from the Business Combination who did not own such stock immediately before the Business Combination.

(d) **“Company”** means Energy Recovery, Inc., a Delaware corporation.

(e) **“Good Reason”** means, the occurrence of any one or more of the following without the Participant’s express written consent:

(i) the termination or material breach of this Plan by the Company;

(ii) the failure by the Company to have any successor, or any assignee of all or substantially all of the Company’s assets, assume this Plan;

(iii) any material diminishment in Participant’s title, position, duties, responsibility or status after the Change in Control, provided that reporting to a business unit head instead of to the Chief Executive Officer will not constitute a material diminishment if the Participant’s duties and responsibilities otherwise remain substantially the same;

(iv) any material reduction in, limitation of, or failure to pay or provide any, compensation provided to the Participant under any agreement or understanding between the Participant and the Company, or pursuant to the Company’s policies and past practices, as of the date immediately prior to the Change in Control;

(v) any material reduction in the Participant’s base salary or target bonus opportunity from the amounts in effect immediately prior to the Change in Control; or

(vi) any change in the Participant’s place of employment that increases Participant’s commuting distance by more than 30 miles over his or her commuting distance immediately prior to the Change in Control.

Good Reason will only be deemed to exist if the Participant provides notice of the condition(s) constituting Good Reason within 45 days of the existence of the condition and gives the Company 45 days from its receipt of such notice to remedy the condition. If the condition is remedied, Good Reason will not be deemed to exist.

(d) **“Participant”** means any full-time employee of the Company or an Affiliate whom the Compensation Committee, in its sole discretion, makes a participant of the Plan. The Committee or its delegate also may, from time to time and by written notice to the affected Participant(s), remove any previously selected Participant(s) from continued participation in this Plan. Any removal of a Participant will not be effective until 12 months after such notice is delivered to the Participant.

### Article 3. Change in Control Benefits

**3.1. Protected Termination.** In the event that, within twelve months after a Change in Control, Participant is terminated without Cause or terminates his or her employment voluntarily with Good Reason, Participant will be entitled to the Severance Benefits defined below.

**3.2 Severance Benefits.** Upon termination without Cause or with Good Reason within twelve months after a Change in Control, Participant will receive all payments required by applicable local law, including all earned and unpaid salary, any accrued and unused vacation pay and all earned but unpaid and un-deferred bonus attributable to the year that ends immediately before the year in which the Participant’s termination occurs, less deductions required or permitted by law. Participants will also be entitled to receive the following additional benefits (“Severance Benefits”) in exchange for an agreement to release all claims known or unknown against the Company and for the restrictive covenants set forth in Article 8:

(a) an additional payment equal to the sum of: (i) 12 months’ severance pay determined by Participant’s regular base rate of pay for work for the Company and/or Affiliates in effect as of the date of the employment

termination and (ii) 100% of Participant's target annual bonus under the Company's bonus program (or any successor bonus program) for the fiscal year in which the Change in Control occurs, less deductions required or permitted by applicable law (the "Additional Payment");

(b) immediate vesting of all unvested equity compensation held by the Participant as of the date of termination; in the case of unvested equity compensation where the amount payable is based on the satisfaction of performance criteria, the amount of unvested equity will be determined by deeming all performance criteria satisfied at 100% of target, less deductions required or permitted by applicable law; to the extent the equity compensation is subject to Section 409A of the Internal Revenue Code of 1986, as amended (the "Code"), the vesting acceleration of the equity compensation shall not cause any distribution or payment under the equity compensation to be made before the earliest date it may be made without violating Code section 409A.

(c) if the Participant timely elects to continue Participant's medical, dental, and vision benefits under COBRA (including, if applicable, continuation of coverage for the Participant's spouse and dependents), then, contingent upon the Participant paying his or her share of the monthly COBRA premium, the Company will pay its share of the monthly premium under COBRA to the same extent it pays for coverage under the Company's group plans for active employees and their dependents, if applicable, for 12 months after the Participant's termination, unless the Participant becomes eligible for group medical, dental, and vision coverage through another employer. Participant will have an obligation to notify the Company upon becoming eligible for group medical, dental and vision benefits from another employer during the 12 month period. At the end of any Company-paid period of COBRA coverage, the Participant may, at his own expense, continue COBRA coverage for the remainder of the period for which the Participant is eligible. The preceding provisions will be modified to the extent medical, dental, and vision benefits are not provided through the purchase of insurance, but are provided by the Company on a self-insured basis. In that case, the Participant will be required to initially pay the entire monthly premium, but will be reimbursed each month an amount equal to the monthly amount (if any) that the Company would pay (or would incur as its share of the cost) each month for an active employee with the same coverage; and

(d) payment by the Company for the reasonable costs of outplacement services for the Participant during the six months following termination in an amount up to \$10,000. No payment, however, will be made in lieu of outplacement services.

**3.3 Form and Timing of Severance Benefits.** Participant will receive the Additional Payment in a single lump sum ten (10) days after the "Separation from Service" or ten (10) days after the Company's receipt of the signed unrevoked release agreement, whichever is later — unless Participant is a "Specified Employee" and delayed payment is required to avoid a prohibited distribution under Code section 409A(a)(2), or any successor thereto. The terms "Specified Employee" and "Separation from Service" have the same meanings as those terms have in Code section 409A and related guidance. In the event payment must be delayed, it shall be made in accordance with Section 9.2 hereof.

**3.4 Payment Obligation.** Except as otherwise provided, Severance Benefits under the Plan will not be reduced or affected by any offset, counterclaim, recoupment, defense or other right which the Company may have against the Participant or anyone else. Company, however, reserves all rights to pursue any and all causes of action that it otherwise might have against the Participant. In addition, any violation by Participant of Article 8 will result in a cessation of the Company's obligation to provide Severance Benefits and will entitle the Company to seek repayment of any payments previously made.

**3.5 Other Benefits.** Participant will not be required to mitigate the amount of the Severance Benefits by seeking alternative employment or other work. With the exception of COBRA payments, the amount of the Severance Benefits will not be reduced by amounts earned by Participant as a result of employment by another employer or other work after the date of termination. All payments, benefits and amounts provided under this Plan will be in addition to and not in substitution for any disability, workers' compensation or other Company benefit plan distribution that a Participant is entitled to at his or her date of termination. Notwithstanding the preceding sentence or anything else contained herein to the contrary, a Participant's Severance Benefits under this Plan shall be reduced by the severance benefits that the Participant may be entitled to under any applicable laws or any other plan, program, agreement or other arrangement with the Company or an Affiliate, including, without limitation, any such benefits provided for by an employment agreement.

**3.6 General Release.** Any other provision of this Plan notwithstanding, Section 3.1 above will not apply unless Participant has executed a general release in a form reasonably satisfactory to the Company of all known and unknown claims that Participant may then have against the Company or persons affiliated with the Company and has expressly agreed in writing not to prosecute any legal action or other proceeding based on any of such claims. Such release must be signed and returned within 45 days of the date of the Participant's Qualifying Termination (as this term is hereinafter defined) and remain unrevoked for any revocation required by applicable law.

**3.7 Employment Status.** Unless otherwise provided in another written agreement between a Participant and the Company or an Affiliate or by applicable law, the employment of the Participant by the Company is "at will," and, prior to the effective date of a Change in Control, may be terminated by the Company or an Affiliate at any time, subject to applicable law. Participant's eligibility for Severance Benefits under this Plan does not affect the Company's continuing right to terminate Participant at any time or absent a Change in Control, subject to any limitations imposed by contract or applicable law.

#### **Article 4. Acceleration of Equity Vesting upon Change in Control.**

Notwithstanding any provisions to the contrary in this Plan and to the extent permitted under the equity compensation plan of the Company under which the equity compensation was granted, if a Change in Control occurs and a Participant's equity compensation is not converted, assumed, or replaced by a successor entity, then immediately prior to the Change in Control such equity compensation shall become fully exercisable and vested and all forfeiture restrictions on such equity compensation shall immediately lapse. In the case of equity compensation, the amount of which is based on the satisfaction of performance criteria, all performance criteria will be deemed satisfied at target.

#### **Article 5. Term**

At the end of its current term, the Plan will be extended automatically for one additional year, unless the Compensation Committee delivers written notice, at least six months prior to the end of each such term, to each Participant that this Plan will not be extended (a "Non-Renewal Notice"). If such notice is timely given, this Plan will terminate at the end of the term then in progress. Notwithstanding the preceding sentences, however, this provision for automatic extension will have no application following a Change in Control of the Company. In the event a Change in Control occurs during the initial or any extended term, this Plan will remain in effect for the longer of: 12 months beyond the month in which such Change in Control occurred; or (ii) until all obligations of the Company hereunder have been fulfilled and until all benefits required hereunder have been paid to Participants. For all purposes of this Plan, only one Change in Control will be taken into account, i.e., if a Change in Control is followed by a second Change in Control during the term of this Plan, the second Change in Control will be ignored for all purposes.

#### **Article 8. Restrictive Covenants**

By accepting participation in this Plan and receiving the benefits provided for by Section 3.1 of this Plan, each Participant will be deemed to, and does, agree to each of the following subsections:

**(a) Non-Compete and Non-Solicit.** For one (1) year after any termination under the Plan that gives rise to benefits under the Plan (a "Qualifying Termination"), Participant will not, directly or indirectly, engage in or render any service of a business, commercial or professional nature to any other person, entity or organization, whether for compensation or otherwise, that is in competition with Company (or the employing Affiliate) anywhere in the world. In accordance with this restriction, but without limiting its terms, Participant will not: (i) enter into or engage in any business which competes with the business of Company (or Affiliate); (ii) solicit customers, business, patronage or orders for, or sell, any products or services in competition with, or for any business that competes with, the business of Company (or Affiliate); (iii) divert, entice, or take away any customers, business, patronage or orders of Company (or Affiliate) or attempt to do so; or (iv) promote or assist, financially or otherwise, any person, firm, association, partnership, corporation or other entity engaged in any business which competes with the business of Company (or Affiliate).

**(b) Scope of Restricted Activities.** For the purposes of Section 8(a), but without limitation thereof, Participant will be in violation thereof if Participant engages in any or all of the activities set forth therein directly as an individual on Participant's own account, or indirectly as a stockholder, partner, joint venturer, participant, agent, salesperson, consultant, officer and/or director of, or by virtue of the ownership by Participant's spouse, child or parent of any equity interest in, any firm, association, partnership, corporation or other entity engaging in any or all of such activities; provided, however, Participant's or Participant's spouse's, child's or parent's ownership of less than 1% of the issued equity interest in any publicly traded corporation will not alone constitute a violation of Article 8.

**(c) Scope of Covenants.** Company and Participant acknowledge that the time, scope, geographic area and other provisions of this section have been specifically negotiated by sophisticated commercial parties and agree that they consider the restrictions and covenants contained in this section to be reasonable and necessary for the protection of the interests of the Company, but if any such restriction or covenant will be held by any court of competent jurisdiction to be void but would be valid if deleted in part or reduced in application, such restriction or covenant will apply with such deletion or modification as may be necessary to make it valid and enforceable. The restrictions and covenants contained in each provision of this Article 8 will be construed as separate and individual restrictions and covenants and will each be capable of being severed without prejudice to the other restrictions and covenants or to the remaining provisions of this Article 8. Without in any way limiting the remedies otherwise available to the Company for breach of any provision of this Plan, the Company will be entitled to the repayment of Severance Benefits paid to a Participant under this Plan for any violation of Article 8 by Participant.

**(d) No Solicitation/Interference.** While employed by Company and until the one year anniversary of any Qualifying Termination, Participant will not directly or indirectly, at any time attempt to disrupt, damage, impair or interfere with the business of the Company or any Affiliate by raiding any of Company's or Affiliate's employees or soliciting any of them to resign from their employment by Company or Affiliate, or by disrupting the relationship between Company or any Affiliate and any of their respective consultants, agents, representatives or vendors. Participant acknowledges that this covenant is necessary to enable Company and Affiliates to maintain a stable workforce and remain in business.

**(e) Non-Disparagement** While employed by the Company and until the one year anniversary of such a Qualifying Termination, (i) the Participant shall not make or encourage or induce others to make statements or representations that disparage or otherwise impair the reputation, goodwill or commercial interests of the Company or its Affiliates or their officers, directors, employees, shareholders, agents or products. The foregoing shall not be violated by truthful statements in connection with required governmental testimony or filings, or judicial, administrative or arbitral proceedings (including, without limitation, depositions or testimony in connection with such proceedings).

#### **Article 9. Excise Tax Limitation and Compliance with Section 409A**

**9.1 Parachute Rules.** This section applies to the extent that any or all of the Severance Benefits provided for in this Plan, either alone or in conjunction with other compensatory payments, would give rise to a "parachute payment" under Sections 280G and 4999 of the Code (collectively, the "Parachute Rules") and, if after taking into account any applicable federal, state and local income taxes and the excise tax imposed by Section 4999 of the Code, the payment of reduced Severance Benefits pursuant to the waiver described in the following sentence would result in the receipt by the Participant, on an after-tax basis, of a greater payment than had the payment of Severance Benefits not been reduced. The waiver described in this section is the Participant's waiving the parachute payment to the minimum extent necessary so that the remaining value of the parachute payment equals one dollar less than the amount which would result in any compensatory payments being subject to the excise tax imposed by Section 4999 of the Code, with the result that the Participant receives only the amount of such payment which would not constitute an "excess parachute payment" under the Parachute Rules. Reduction will occur in the following order:

- (i) cancellation of acceleration of vesting on any equity awards that are in the nature of a right to exercise, such as options or stock appreciation rights;

(ii) reduction in the benefits described in Section 3.2(c) and (d) (with such reduction being applied to the benefits in the manner having the least economic impact to the Participant and, to the extent the economic impact is equivalent, such benefits will be reduced in the reverse order of when the benefits would have been provided to the Participant, that is, benefits payable later will be reduced before benefits payable earlier);

(iii) reduction of the Additional Payment;

(iv) cancellation of acceleration of vesting of equity awards not covered under (i) above; provided, however, that in the event that acceleration of vesting of equity award compensation is to be canceled, such acceleration of vesting will be canceled in the reverse order of the date of grant of such equity awards; that is, later equity awards will be canceled before earlier equity awards.

Anything to the contrary in the foregoing notwithstanding, payments or benefits that constitute nonqualified deferred compensation subject to Section 409A of the Code shall be reduced or eliminated last in time. In no event will the Company or any Affiliate be required to gross up any payment or benefit to the Participant to avoid the effects of the Parachute Rules or to pay any regular or excise taxes arising from the application of the Parachute Rules. Unless the Company or an Affiliate and the Participant otherwise agree in writing, any parachute payment calculation will be made in writing by independent public accountants agreed to by the Company or an Affiliate and the Participant, whose calculations will be conclusive and binding upon the Company or an Affiliate and the Participant for all purposes. The Company or Affiliate and the Participant will furnish to the accountants such information and documents as the accountants may reasonably request in order to make a parachute payment determination.

**9.2 Compliance with 409A.** No amount payable under this Plan that is non-qualified deferred compensation subject to Section 409A of the Code, as determined in the Committee's sole discretion, will be paid unless the Participant experiences a "Separation from Service," and, if the Participant is a Specified Employee as of the date of the Separation from Service, such amount will instead be paid or provided to the Executive on the earlier of the first business day after the date that (i) is six months following the Participant's Separation from Service or (ii) of the Participant's death, to the extent such delayed payment is required to avoid a prohibited distribution under Section 409A(a) (2) of the Code, or any successor provision thereof. It is the parties' intention that the reimbursements, payments and benefits to which the Participant could become entitled to under this Plan be exempt from or comply with Code Section 409A and the guidance promulgated thereunder; provided, however, that the Company makes no representations that the compensation or benefits provided under this Plan will be exempt from or comply with Code Section 409A. The provisions of this Section 9.2 will qualify and supersede all other provisions of this Plan as necessary to fulfill the foregoing intention. If the Company believes, at any time, that any of such reimbursement, payment or benefit is not exempt or does not so comply, the Company will in good faith amend the terms of such arrangement such that it is exempt or complies (with the most limited possible economic effect on the Participant and the Company) or to mitigate any additional tax, interest and/or penalties that may apply under Section 409A if exemption or compliance is not practicable.

#### **Article 10. Claims Procedures**

**10.1. Committee Review.** Any Participant or beneficiary of a deceased Participant (such Participant or beneficiary being referred to below as a "Claimant") may deliver to the Committee a written claim for a determination with respect to the amounts distributable to such Claimant from this Plan. Such claim will be delivered to the Committee in care of the Company in accordance with the notice provisions of Section 12.3. If such a claim relates to the contents of a notice received by the Claimant, the claim must be made within 60 days after such notice was received by the Claimant. All other claims must be made within 270 days of the date on which the event that caused the claim to arise occurred. The claim must state with particularity the determination desired by the Claimant.

**10.2. Notification of Decision.** The Committee will consider a Claimant's claim pursuant to Section 10.1 within a reasonable time, but no later than 90 days after receiving the claim. If the Committee determines that special circumstances require an extension of time for processing the claim, written notice of the extension will be furnished to the Claimant prior to the termination of the initial 90 day period. In no event will such extension exceed a period of 90 days from the end of the initial period. The extension notice will indicate the special circumstances requiring an extension of time and the date by which the Committee expects to render the benefit determination. The Committee will notify the Claimant in writing: (a) that the Claimant's requested determination has been made, and

that the claim has been allowed in full; or (b) that the Committee has reached a conclusion contrary, in whole or in part, to the Claimant's requested determination, and such notice must set forth in a manner calculated to be understood by the Claimant: (i) the specific reason(s) for the denial of the claim, or any part of it; (ii) specific reference(s) to pertinent provisions of this Plan upon which such denial was based; (iii) a description of any additional material or information necessary for the Claimant to perfect the claim, and an explanation of why such material or information is necessary; (iv) a statement that the Claimant is entitled to receive, upon request and free of charge, reasonable access to and copies of, all documents, records and other information relevant (as defined in applicable ERISA regulations) to the Claimant's claim for benefits; and (v) a statement of the Claimant's right to seek arbitration pursuant to Section 10.3.

**10.3. Arbitration of Claims.** A Claimant's compliance with the foregoing provisions of this Article 10 is a mandatory prerequisite to a Claimant's right to commence arbitration pursuant to this section with respect to any claim for benefits under this Plan. Any dispute, controversy or claim arising hereunder or in any way related to this Plan, its interpretation, enforceability or applicability that cannot be resolved by mutual agreement of the parties (the "arbitrable claims") will be submitted to binding arbitration. The parties agree that arbitration is the parties' only recourse for such claims and hereby waive the right to pursue such claims in any other forum, unless otherwise provided by law. Any court action involving a dispute which is not subject to arbitration will be stayed pending arbitration of arbitrable disputes. The arbitrator will have the authority to issue provisional relief. The Participant and the Company further agree that each has the right, pursuant to California Code of Civil Procedure section 1281.8, to apply to a court for a provisional remedy in connection with an arbitrable dispute so as to prevent the arbitration from being rendered ineffective. Any demand for arbitration will be in writing and must be communicated to the other party prior to the expiration of the applicable statute of limitations.

The arbitration will be administered by JAMS pursuant to its Employment Arbitration Rules and Procedures. The arbitration will be conducted in the San Francisco Bay area (unless the parties mutually agree on another location) by a former or retired judge or attorney with at least 10 years experience in employment-related disputes, or a non-attorney with like experience in the area of dispute, who will have the power to hear motions, control discovery, conduct hearings and otherwise do all that is necessary to resolve the matter. The parties must mutually agree on the arbitrator. If the parties cannot agree on the arbitrator after their best efforts, an arbitrator will be selected from JAMS pursuant to its Employment Arbitration Rules and Procedures. The Company will pay the costs of the arbitrator's fees. The arbitration will be decided upon a written decision of the arbitrator stating the essential findings and conclusions upon which the award is based. The arbitrator will have the authority to award damages, if any, to the extent that they are available under applicable law(s). The arbitration award will be final and binding, and may be entered as a judgment in any court having competent jurisdiction. Either party may seek review pursuant to California Code of Civil Procedure section 1286, et seq. It is expressly understood that the parties have chosen arbitration to avoid the burdens, costs and publicity of a court proceeding, and the arbitrator is expected to handle all aspects of the matter, including discovery and any hearings, in such a way as to minimize the expense, time, burden and publicity of the process, while assuring a fair and just result. In particular, the parties expect that the arbitrator will limit discovery by controlling the amount of discovery that may be taken (e.g., the number of depositions or interrogatories) and by restricting the scope of discovery only to those matters clearly relevant to the dispute. However, at a minimum, each party will be entitled to at least one deposition and will have access to essential documents and witnesses as determined by the arbitrator. The provisions of this Section will survive the expiration or termination of the Plan, and will be binding upon the parties.

#### **Article 11. Successors and Assignment**

The Company will require any successor (whether direct or indirect, by purchase, merger, consolidation, or otherwise) of all or substantially all of the business and/or assets of the Company or of any division or subsidiary thereof (the business and/or assets of which constitute at least 50% of the total business and/or assets of the Company) to expressly assume and agree to perform the Company's obligations under this Plan in the same manner and to the same extent that the Company would be required to perform them if such succession had not taken place. This Plan will inure to the benefit of and be enforceable by each Participant's personal or legal representatives, executors, administrators, successors, heirs, distributees, devisees, and legatees. If a Participant dies while any amount would still be payable to him or her hereunder had he or she continued to live, all such amounts, unless otherwise provided herein, will be paid to the Participant's beneficiary in accordance with the terms of this Plan.



## Article 12. General

**12.1. Modification.** Except as set forth below, no provision of this Plan may be modified, waived, or discharged unless as to a Participant such modification, waiver, or discharge is agreed to in writing and signed by each affected Participant and by an authorized member of the Committee or its designee, or by the respective parties' legal representatives and successors. The consent requirement of the preceding sentence will not apply to the extent that (i) amendments provide additional benefits to Participants or are required so that the plan complies with applicable law (including Section 409A) or (ii) the amendment is not effective until one year after it is communicated to all affected Participants.

**12.2. Notice of Termination.** Any termination by the Company for Cause or by a Participant for Good Reason will be communicated by a written notice which states the specific termination provision in this Plan relied upon, and sets forth in reasonable detail the facts and circumstances claimed to provide a basis for termination of the Participant's employment under that provision.

**12.3 Notice.** For purposes of this Plan, notices, including a Notice of Termination, and all other communications provided for in this Plan will be in writing and will be deemed to have been duly given when delivered or on the date stamped as received by the U.S. Postal Service for delivery by certified or registered mail, postage prepaid and addressed: (i) if to the Participant, to his or her latest address as reflected on the records of the Company, and (ii) if to the Company: Energy Recovery Inc., 1908 Doolittle Drive, San Leandro, CA 94577, Attention: General Counsel or to such other address as the Company may furnish to the Participant in writing with specific reference to this Plan and the importance of the notice, except that notice of change of address will be effective only upon receipt.

**12.4. Applicable Law.** To the extent not preempted by the laws of the United States, the laws of the State of California will be the controlling law in all matters relating to this Plan. Any statutory reference in this Plan will also be deemed to refer to all applicable final rules and final regulations promulgated under or with respect to the referenced statutory provision.

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

I, G.G. Pique, certify that:

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

Date: August 7, 2009

/s/ G.G. Pique

Name: G.G. Pique

Title: President and Chief Executive Officer (Principal Executive Officer)

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

I, Thomas D. Willardson, certify that:

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

Date: August 7, 2009

/s/ Thomas D. Willardson

Name: Thomas D. Willardson

Title: Chief Financial Officer  
(Principal Financial Officer)

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

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

1. The Company's Quarterly Report on Form 10-Q for the period ended June 30, 2009, to which this Certification is attached as Exhibit 32.1 (the "Quarterly Report") fully complies with the requirements of Section 13(a) or Section 15(d) of the Exchange Act, and
2. The information contained in the Quarterly Report fairly presents, in all material respects, the financial condition of the Company at the end of the period covered by the Quarterly Report and results of operations of the Company for the period covered by the Quarterly Report.

IN WITNESS WHEREOF, the undersigned have set their hands hereto as of the 7th day of August 2009.

/s/ G.G. Pique  
\_\_\_\_\_  
President and Chief Executive Officer

/s/ Thomas D. Willardson  
\_\_\_\_\_  
Chief Financial Officer

Dated: August 7, 2009

Dated: August 7, 2009

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