

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

FORM 10-Q

(Mark One)

R **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended March 31, 2011

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)

01-0616867  
(IRS Employer Identification No.)

1717 Doolittle Drive  
San Leandro, CA 94577  
(Address of Principal Executive Offices)

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

Smaller reporting company

(Do not check if a 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 April 30, 2011, there were 52,609,423 shares of the registrant's common stock outstanding.

ENERGY RECOVERY, INC.

QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED MARCH 31, 2011

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## PART I — FINANCIAL INFORMATION

## Item 1. Financial Statements (unaudited)

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

	<u>March 31,</u> <u>2011</u>	<u>December 31,</u> <u>2010</u>
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 52,589	\$ 55,338
Restricted cash	4,634	4,636
Accounts receivable, net of allowance for doubtful accounts of \$34 and \$44 at March 31, 2011 and December 31, 2010, respectively	8,507	9,649
Unbilled receivables, current	4,979	2,278
Inventories	9,408	9,772
Deferred tax assets, net	2,097	2,097
Prepaid expenses and other current assets	4,607	4,428
<b>Total current assets</b>	<b>86,821</b>	<b>88,198</b>
Restricted cash, non-current	1,380	2,244
Property and equipment, net	21,900	22,314
Goodwill	12,790	12,790
Other intangible assets, net	8,006	8,352
Other assets, non-current	2	19
<b>Total assets</b>	<b>\$ 130,899</b>	<b>\$ 133,917</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 1,304	\$ 1,429
Accrued expenses and other current liabilities	5,385	5,248
Income taxes payable	20	13
Accrued warranty reserve	867	1,028
Deferred revenue	619	2,341
Current portion of long-term debt	128	128
Current portion of capital lease obligations	129	160
<b>Total current liabilities</b>	<b>8,452</b>	<b>10,347</b>
Long-term debt	53	85
Capital lease obligations, non-current	60	144
Deferred tax liabilities, non-current, net	317	317
Deferred revenue, non-current	286	157
Other non-current liabilities	2,073	2,067
<b>Total liabilities</b>	<b>11,241</b>	<b>13,117</b>
Commitments and Contingencies (Note 8)		
<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; 52,608,629 and 52,596,170 shares issued and outstanding at March 31, 2011 and December 31, 2010, respectively	53	53
Additional paid-in capital	112,653	112,025
Notes receivable from stockholders	(38)	(38)
Accumulated other comprehensive loss	(92)	(80)
Retained earnings	7,082	8,840
<b>Total stockholders' equity</b>	<b>119,658</b>	<b>120,800</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 130,899</b>	<b>\$ 133,917</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)

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2011</b>	<b>2010</b>
Net revenue	\$ 10,367	\$ 12,615
Cost of revenue	5,703	5,257
Gross profit	<u>4,664</u>	<u>7,358</u>
Operating expenses:		
General and administrative	4,057	3,733
Sales and marketing	2,070	1,960
Research and development	1,029	828
Amortization of intangible assets	346	683
Total operating expenses	<u>7,502</u>	<u>7,204</u>
Income (loss) from operations	(2,838)	154
Interest expense	(20)	(21)
Other non-operating income (expense), net	194	(18)
Income (loss) before provision from income taxes	(2,664)	115
Provision for (benefit from) income taxes	(906)	47
Net income (loss)	<u>\$ (1,758)</u>	<u>\$ 68</u>
Earnings (loss) per share:		
Basic	<u>\$ (0.03)</u>	<u>\$ 0.00</u>
Diluted	<u>\$ (0.03)</u>	<u>\$ 0.00</u>
Number of shares used in per share calculations:		
Basic	<u>52,586</u>	<u>51,243</u>
Diluted	<u>52,586</u>	<u>53,652</u>

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

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

	Three Months Ended March 31,	
	2011	2010
<b>Cash Flows From Operating Activities</b>		
Net income (loss)	\$ (1,758)	\$ 68
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	1,204	1,126
Loss on disposal of fixed assets	77	—
Interest accrued on notes receivables from stockholders	—	(1)
Share-based compensation	607	597
Net unrealized (gain) loss on foreign currency transactions	(188)	14
Excess tax benefit from share-based compensation arrangements	—	(25)
Recoveries of doubtful accounts	(10)	(28)
Provision for warranty claims	77	121
Valuation adjustments for excess or obsolete inventory	225	101
Amortization of inventory acquisition valuation step-up	—	422
Other non-cash adjustments	(31)	(25)
Changes in operating assets and liabilities:		
Accounts receivable	1,325	(2,844)
Unbilled receivables	(2,651)	(618)
Inventories	139	(2,858)
Deferred tax assets and liabilities, net	—	(1)
Prepaid and other assets	(164)	(534)
Accounts payable	(174)	1,292
Accrued expenses and other liabilities	(291)	(1,929)
Income taxes payable	5	(275)
Deferred revenue	(1,594)	910
<b>Net cash used in operating activities</b>	<u>(3,202)</u>	<u>(4,487)</u>
<b>Cash Flows From Investing Activities</b>		
Capital expenditures	(339)	(4,199)
Proceeds from sale of capitalized assets	55	—
Restricted cash	866	122
<b>Net cash provided by (used in) investing activities</b>	<u>582</u>	<u>(4,077)</u>
<b>Cash Flows From Financing Activities</b>		
Repayment of long-term debt	(32)	(202)
Repayment of capital lease obligation	(115)	(51)
Net proceeds from issuance of common stock	18	148
Excess tax benefit from share-based compensation arrangements	—	25
Repayment of notes receivables from stockholders	—	55
<b>Net cash used in financing activities</b>	<u>(129)</u>	<u>(25)</u>
<b>Effect of exchange rate differences on cash and cash equivalents</b>	<u>—</u>	<u>(15)</u>
<b>Net decrease in cash and cash equivalents</b>	(2,749)	(8,604)
<b>Cash and cash equivalents, beginning of period</b>	55,338	59,115
<b>Cash and cash equivalents, end of period</b>	<u>\$ 52,589</u>	<u>\$ 50,511</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”, “ERI”, “we” or “us”) develops, manufactures and sells high-efficiency energy recovery devices for use in seawater desalination. Our products are sold under the trademarks ERI™, PX™, PEI™, Pressure Exchanger™, PX Pressure Exchanger™, Pump Engineering™ and Quadribaric™. Our energy recovery devices make desalination affordable by capturing and reusing the otherwise lost pressure energy from the concentrated seawater reject stream of the desalination process. We also manufacture and sell high pressure pumps and circulation pumps for use in desalination. Our products are developed and manufactured in the United States of America (“U.S.”) at our headquarters in San Leandro, California, and at our facility in New Boston, Michigan. Additionally, we have direct sales offices and technical support centers in Madrid, Dubai, and Shanghai.

The Company was incorporated in Virginia in April 1992 and reincorporated in Delaware in March 2001. Shares of our common stock began trading publicly in July 2008. We have five wholly-owned subsidiaries: Osmotic Power, Inc., Energy Recovery, Inc. International, Energy Recovery Iberia, S.L., Pump Engineering, Inc., and ERI Energy Recovery Ireland Ltd. incorporated in September 2005, July 2006, September 2006, November 2009, and April 2010, respectively.

***Use of Estimates***

The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles (“U.S. GAAP”) requires our management to make judgments, estimates and assumptions that affect the amounts reported in the Condensed Consolidated Financial Statements and accompanying notes. Our most significant estimates and judgments involve the determination of revenue recognition, allowance for doubtful accounts, allowance for product warranty, valuation of stock options, valuation of goodwill and acquired intangible assets, useful lives for depreciation and amortization, valuation adjustments for excess and obsolete inventory, deferred taxes and valuation allowances on deferred tax assets. Actual results could differ materially from those estimates.

***Basis of Presentation***

The Condensed Consolidated Financial Statements include the accounts of Energy Recovery, Inc. and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

The accompanying Condensed Consolidated Financial Statements have been prepared by us, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to such rules and regulations. The December 31, 2010 Condensed Consolidated Balance Sheet was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP; however, we believe that the disclosures are adequate to make the information presented not misleading. These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the audited Consolidated Financial Statements and the notes thereto for the fiscal year ended December 31, 2010 included in our Annual Report on Form 10-K filed with the SEC on March 15, 2011.

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.

Our presentation of certain expenses and liabilities in our Condensed Consolidated Financial Statements has changed from prior periods. In our Condensed Consolidated Statements of Operations, amortization expense recorded in connection with finite-lived intangible assets was previously included in the caption “General and Administrative” and is now included in the caption “Amortization of Intangible Assets.” In our Condensed Consolidated Balance Sheets, deferred service revenue that is expected to be realized more than twelve months from the balance sheet date was previously included in the caption “Other Non-current Liabilities” and is now included in the caption “Deferred Revenue, Non-current.” We believe that these changes provide a more meaningful presentation of our operating expenses and long-term obligations. Amounts presented for the three months ended March 31, 2010 and as of December 31, 2010 have been reclassified to conform to the current presentation.

### Recently Adopted Accounting Guidance

On January 1, 2011, we adopted guidance issued by the Financial Accounting Standards Board ("FASB") on revenue arrangements with multiple deliverables. The guidance is effective for revenue arrangements entered into or materially modified on or after January 1, 2011. Under the new guidance, when vendor specific objective evidence or third party evidence for deliverables in an arrangement cannot be determined, a best estimate of the selling price is required to separate deliverables and allocate arrangement consideration using the relative selling price method. The new guidance eliminates the use of the residual value method for determining the allocation of arrangement consideration and includes new disclosure requirements on how the application of the relative selling price method affects the timing and amount of revenue recognition. Adoption of the new guidance did not have a material impact on our financial statements.

### Recent Accounting Guidance Not Yet Adopted

During the quarter ended March 31, 2011, there were no new accounting pronouncements or updates to recently issued accounting pronouncements disclosed in our Annual Report on Form 10-K for the year ended December 31, 2010 that affect our results of operations, financial condition, liquidity or disclosures.

### Note 2 — Goodwill and Other Intangible Assets

In December 2009, we acquired 100% of the equity interests of Pump Engineering, LLC, a private US company and supplier of energy recovery technology and pumps for use in the global desalination market. The purchase price was allocated to the tangible assets and intangible assets acquired and liabilities assumed based on their estimated fair values on the acquisition date, with the remaining unallocated purchase price recorded as goodwill. As of March 31, 2011, there were no changes in the recognized amounts of goodwill resulting from the acquisition of Pump Engineering, LLC.

Our intangible assets include intangible assets acquired in the acquisition of Pump Engineering, LLC and costs related to our development of patents. The following is a summary of our identifiable intangible assets as of March 31, 2011 and December 31, 2010, respectively (in thousands, except useful life data):

	March 31, 2011			
	Gross Carrying Amount	Accumulated Amortization	Accumulated Impairment Losses	Net Carrying Amount
Developed Technology	\$ 6,100	\$ (813)	\$ —	\$ 5,287
Non-compete agreements	1,310	(566)	—	744
Trademarks	1,200	(80)	—	1,120
Customer relationships	990	(396)	—	594
Patents	585	(282)	(42)	261
	<u>\$ 10,185</u>	<u>\$ (2,137)</u>	<u>\$ (42)</u>	<u>\$ 8,006</u>

	December 31, 2010			
	Gross Carrying Amount	Accumulated Amortization	Accumulated Impairment Losses	Net Carrying Amount
Developed Technology	\$ 6,100	\$ (659)	\$ —	\$ 5,441
Non-compete agreements	1,310	(461)	—	849
Trademarks	1,200	(65)	—	1,135
Customer relationships	990	(330)	—	660
Patents	585	(276)	(42)	267
	<u>\$ 10,185</u>	<u>\$ (1,791)</u>	<u>\$ (42)</u>	<u>\$ 8,352</u>

### Note 3 — Earnings (Loss) per Share

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

	Three Months Ended March 31,	
	2011	2010
Numerator:		
Net income (loss)	\$ (1,758)	\$ 68
Denominator:		
Weighted average common shares outstanding	52,586	51,243
Effect of dilutive securities:		
Restricted stock units		4
Stock options	—	500
Warrants	—	1,905
Total shares for purpose of calculating diluted earnings (loss) per share	52,586	53,652
Earnings (loss) per share:		
Basic	\$ (0.03)	\$ 0.00
Diluted	\$ (0.03)	\$ 0.00

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

	Three Months Ended March 31,	
	2011	2010
Restricted awards*	37	—
Stock options**	4,543	2,672
Warrants	970	—

\* Includes restricted stock and restricted stock units.

\*\* For 2010, this represents options where the exercise price was higher than the average stock price during the period.

### Note 4 — Other Financial Information

#### Inventories

Our inventories consisted of the following (in thousands):

	March 31,	December 31,
	2011	2010
Raw materials	\$ 5,015	\$ 5,866
Work in process	2,262	831
Finished goods	2,131	3,075
	\$ 9,408	\$ 9,772

#### Revenue by Product Category

The Company manufactures and sells high-efficiency energy recovery products, high pressure pumps and related parts and services under one operating segment (see Note 9 — “Business Segment and Geographic Information”). Although the Company operates under one segment, it categorizes revenue based on type of energy recovery device and its related products and services. The following table reflects revenue by product category for the periods indicated (in thousands):

	Three Months Ended March 31,	
	2011	2010
PX devices and related products and services	\$ 8,779	\$ 10,378
Turbochargers and pumps	1,588	2,237
	\$ 10,367	\$ 12,615



## Note 5 — Long-Term Debt and Capital Leases

### Long-Term Debt

As of March 31, 2011, long term debt consisted of one equipment promissory note payable. Future minimum principal payments due under this long-term debt arrangement consist of the following (in thousands):

	<b>March 31, 2011</b>
2011 (remaining nine months)	\$ 96
2012	85
	<u>\$ 181</u>

Effective February 2009, we entered into a loan and security agreement with a financial institution. This agreement was amended in May 2010 which increased the total available credit line from \$15.0 million to \$16.0 million. Under the amended agreement, we are allowed to draw advances up to \$10.0 million on a revolving line of credit or utilize up to \$15.9 million as collateral for irrevocable standby letters of credit, provided that the aggregate of the advances and the collateral do not exceed the total available credit line of \$16.0 million. Advances under the revolving line of credit incur interest based on either a prime rate index or LIBOR plus 1.375%. As of March 31, 2011, there were no advances drawn on this line of credit. The amended agreement expires in May 2012 and is collateralized by substantially all of our assets.

We are subject to certain financial and administrative covenants under the 2009 loan and security agreement. As of March 31, 2011, we were non-compliant with a financial covenant under this credit agreement. Section 6.6(c) of the 2009 loan and security agreement sets forth a covenant that requires our company to meet a minimum net income requirement for the fiscal year. The covenant was not satisfied due to a net loss reported for the 2010 fiscal year. As a result, we may be requested by the bank to provide cash collateral for our outstanding standby letters of credit that are currently collateralized by our line of credit. We continue to have discussions with the bank and are considering alternative arrangements including cancellation of the credit line and utilizing available cash to collateralize outstanding standby letters of credit. We have no borrowings under the line and have used the line of credit exclusively for the issuance of standby letters of credit. We believe that our cash and cash equivalents significantly exceed the amount of collateral needed to support the outstanding standby letters of credit and that using the cash to collateralize outstanding standby letters of credit will not have a material adverse effect on our financial position or results of operations.

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. These letters of credit are collateralized by our credit line or restricted cash and generally terminate within 12 to 36 months from issuance. At March 31, 2011 and December 31, 2010, amounts outstanding on letters of credit collateralized by our line of credit totaled approximately \$8.0 million and \$7.6 million, respectively.

### Capital Leases

Future minimum payments under capital leases consist of the following (in thousands):

	<b>March 31, 2011</b>
2011 (remaining nine months)	\$ 104
2012	79
2013	17
Total future minimum lease payments	200
Less: amount representing interest	(11)
Present value of net minimum capital lease payments	189
Less: current portion	(129)
Long-term portion	<u>\$ 60</u>

**Note 6 — Equity****Share-based Compensation Expense**

For the three months ended March 31, 2011 and 2010, we recognized share-based compensation expense related to employees and consultants as follows (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Cost of revenue	\$ 41	\$ 48
General and administrative	390	412
Sales and marketing	136	128
Research and development	40	9
	<u>\$ 607</u>	<u>\$ 597</u>

As of March 31, 2011, total unrecognized compensation cost related to non-vested share-based awards, net of estimated forfeitures, was \$5.5 million, which is expected to be recognized as expense over a weighted-average period of approximately 2.5 years.

In February 2011, our board of directors appointed a new Chief Executive Officer (CEO). Upon board approval, the new CEO was granted 800,000 stock options. The options vest over a period of four years and carry an exercise price of \$3.41.

In April 2011, our board of directors appointed a new Chief Financial Officer (CFO). Pending approval by the board, the new CFO will receive a grant of 400,000 stock options.

**Note 7 — Income Taxes**

Our effective tax rate for the three months ended March 31, 2011 and 2010 was 34% and 41%, respectively. These effective tax rates differ from the U.S. statutory rate principally due to the effect of state income taxes and non-deductible share-based compensation relative to pretax income, offset in part with respect to 2010 by deductions related to manufacturing and credits related to research and development. The change in the effective tax rate from the comparable period in the prior year was principally due to our forecasted pre-tax loss position for full year 2011 as of the end of the first quarter of 2011 versus a forecasted pretax income position for full year 2010 as of the end of the first quarter of 2010. There have been no other material changes to our income tax position during the three months ended March 31, 2011.

**Note 8 — Commitments and Contingencies****Operating Lease Obligations**

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

	<b>March 31, 2011</b>
2011 (remaining nine months)	\$ 1,179
2012	1,529
2013	1,563
2014	1,559
2015	1,477
Thereafter	5,990
	<u>\$ 13,297</u>

**Product Warranty**

We sell products with a limited warranty for a period ranging from one to six years. We accrue for warranty costs based on estimated product failure rates, historical activity and expectations of future costs. Periodically, we evaluate and adjust 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 three months ended March 31, 2011 and 2010 (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
Balance, beginning of period	\$ 1,028	\$ 605
Warranty costs charged to cost of revenue	77	121
Utilization of warranty	(238)	(18)
Balance, end of period	<u>\$ 867</u>	<u>\$ 708</u>

### *Purchase Obligations*

We enter into purchase order arrangements with our vendors. As of March 31, 2011, there are open purchase orders for which we have not yet received the related goods or services. The majority of these purchase order arrangements are related to various key raw materials and components parts and are subject to change based on our sales demand forecasts. We have the right to cancel most of these arrangements prior to the date of delivery. As of March 31, 2011, we had approximately \$3.2 million of cancelable open purchase order arrangements related primarily to materials and parts and \$0.1 million of noncancelable open purchase order arrangements related to manufacturing equipment.

Additionally, we have entered into a noncancelable supply agreement with a vendor in order to manage the cost and availability of key raw materials and components. Under this agreement, we have committed to future minimum annual purchases of raw materials and components as follows (in thousands):

	<b>March 31, 2011</b>
2011 (remaining nine months)	\$ 1,400
2012	1,600
2013	1,600
	<u>\$ 4,600</u>

### *Guarantees*

We enter into indemnification provisions under our agreements with other companies in the ordinary course of business, typically with customers. Under these provisions, we generally indemnify and hold harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of our activities, generally limited to personal injury and property damage caused by our employees at a customer's desalination plant in proportion to the employee's percentage of fault for the accident. Damages incurred for these indemnifications would be covered by our general liability insurance to the extent provided by the policy limitations. We have not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the estimated fair value of these agreements is not material. Accordingly, there are no liabilities recorded for these agreements as of March 31, 2011 and December 31, 2010.

In certain cases, we issue warranty and product performance guarantees to our 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 generally standby letters of credit and remain in place for periods ranging from 12 to 36 months which relate to the underlying product warranty period. The standby letters of credit are issued under our credit facility or are collateralized by restricted cash, as follows (amounts in thousands):

	<b>March 31, 2011</b>	<b>December 31, 2010</b>
Standby letters of credit issued under credit facility	\$ 7,971	\$ 7,565
Standby letters of credit collateralized by restricted cash	1,163	1,954
	<u>\$ 9,134</u>	<u>\$ 9,519</u>

### *Litigation*

We are not currently a party to any material litigation and 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.

### **Note 9 — Business Segment and Geographic Information**

We manufacture and sell high efficiency energy recovery products and related services and operate under one segment. Our chief operating decision maker is the chief executive officer ("CEO"). The CEO reviews financial information presented on a consolidated basis for purposes of making operating decisions and assessing financial performance. Accordingly, we have concluded that we have one reportable segment.

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

	Three Months Ended March 31,	
	2011	2010
Domestic revenue	\$ 873	\$ 1,192
International revenue	9,494	11,423
<b>Total revenue</b>	<b>\$ 10,367</b>	<b>\$ 12,615</b>
<b>Revenue by country:</b>		
India	27%	3%
China	17	3
Cyprus	11	—
Spain	10	8
Australia	*	54
Others	35	32
<b>Total</b>	<b>100%</b>	<b>100%</b>

\* Less than 1%.

Approximately 99% of our long-lived assets were located in the United States at March 31, 2011 and December 31, 2010.

#### Note 10 — Concentrations

Three customers, UTE Desaladora Qingdao (a Befesa Agua entity), IDE Technologies Ltd., and Hydrochem (S) Pte Ltd (a Hyflux company) accounted for approximately 19%, 15% and 15%, respectively, of our accounts receivable at March 31, 2011. As of December 31, 2010, three customers, Hydrochem (S) Pte Ltd (a Hyflux company), UTE Desaladora Qingdao (a Befesa Agua entity), and Nirosoft Industries Ltd. accounted for approximately 22%, 16%, and 10% of our trade accounts receivable, respectively.

Revenue from customers representing 10% or more of net revenue varies from period to period. For the three months ended March 31, 2011, IDE Technologies Ltd. and UTE Desaladora Qingdao (a Befesa Agua entity) accounted for approximately 38% and 16% of our net revenue, respectively. For the three months ended March 31, 2010, Thiess Degremont J.V. (a joint venture of Thiess Pty Ltd and Degremont S.A.) and Acciona Agua accounted for approximately 28% and 24% of our net revenue, respectively.

No other customer accounted for more than 10% of our net revenue during any of these periods.

#### Note 11 — Fair Value Measurements

We follow the authoritative guidance for fair value measurements and disclosures, which among other things, defines fair value, establishes a consistent framework for measuring fair value and expands disclosure for each major asset and liability category measured at fair value on either a recurring or nonrecurring basis. Fair value is defined as an exit price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability.

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

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

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

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

Cash and restricted cash are measured at fair value on a recurring basis using market prices on active markets for identical securities (Level 1). The carrying amounts of accounts receivable, accounts payable and other accrued expenses approximate fair value because of the short maturity of those instruments. The carrying amount of the contingent consideration arising from our acquisition of Pump Engineering, LLC is measured at fair value on a recurring basis using unobservable inputs in which little or no market activity exists (Level 3). The estimated fair value of the contingent consideration is determined based on an assessment of the weighted probability of payment under various scenarios.

The fair value of financial assets and liabilities measured on a recurring basis is as follows (in thousands):

	<b>Fair Value Measurement at Reporting Date Using</b>			
	<b>March 31, 2011</b>	<b>Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
Assets:				
Cash and cash equivalents	\$ 52,589	\$ 52,589	\$ —	\$ —
Restricted Cash	6,014	6,014	—	—
<b>Total</b>	<b>\$ 58,603</b>	<b>\$ 58,603</b>	<b>\$ —</b>	<b>\$ —</b>
Liabilities:				
Contingent consideration*	\$ 1,353	\$ —	\$ —	\$ 1,353
<b>Total</b>	<b>\$ 1,353</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$ 1,353</b>

	<b>Fair Value Measurement at Reporting Date Using</b>			
	<b>December 31, 2010</b>	<b>Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)</b>	<b>Significant Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>
Assets:				
Cash and cash equivalents	\$ 55,338	\$ 55,338	\$ —	\$ —
Restricted Cash	6,880	6,880	—	—
<b>Total</b>	<b>\$ 62,218</b>	<b>\$ 62,218</b>	<b>\$ —</b>	<b>\$ —</b>
Liabilities:				
Contingent consideration*	\$ 1,353	\$ —	\$ —	\$ 1,353
<b>Total</b>	<b>\$ 1,353</b>	<b>\$ —</b>	<b>\$ —</b>	<b>\$ 1,353</b>

\* Included in Accrued Expenses and Other Current Liabilities

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

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

*Forward-looking statements 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 belief that our energy recovery devices make seawater reverse osmosis and other fluid processes in which our devices are used offer a more affordable means of production;*
- our objective of finding new applications for our technology outside of desalination, expanding and enhancing our offerings for the desalination industry, and developing new products for new markets;*
- our plan to manufacture a portion of our ceramics components internally;*
- our expectation that our expenditures for research and development will increase;*
- our expectation that we will continue to rely on sales of our energy recovery devices for a substantial portion of our revenue;*
- our expectation that sales outside of the United States will remain a significant portion of our revenue;*
- 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; and*
- our expectation that a portion of our revenue could continue to be denominated in foreign currencies.*

*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 May 6, 2011. 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 15, 2011.*

### Overview

We are in the business of designing, developing and manufacturing energy recovery devices for seawater reverse osmosis desalination. Our company was founded in 1992 and we introduced the initial version of our Pressure Exchanger(TM) energy recovery device in early 1997. In December 2009, we acquired Pump Engineering, LLC, which manufactures centrifugal energy recovery devices, known as turbochargers, and high pressure pumps.

A significant portion of our net revenue typically has been generated by sales to a limited number of large engineering, procurement 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 6 to 16 months. A single large desalination project can generate an order for numerous energy recovery devices and generally represents an opportunity for significant revenue. We also sell our devices to many small to medium size original equipment manufacturers, or OEMs, which commission smaller desalination plants, order fewer energy recovery devices per plant and have shorter sales cycles.

Due to the fact that a single order for our energy recovery devices by a large engineering, procurement and construction firm for a particular plant may represent significant revenue, we often experience significant fluctuations in net revenue from quarter to quarter and from year to year. Historically, our engineering, procurement and construction firm customers tended to order a significant amount of equipment for delivery in the fourth quarter and, as a consequence, a significant portion of our annual sales occurred during that quarter. In fiscal year 2010, the fourth quarter revenues did not reflect as high of a percentage of the annual revenues as in past years due to shipment delays caused by customer project delays.

A limited number of our customers accounts for a substantial portion of our net revenue and accounts receivable. Revenue from customers representing 10% or more of net revenue varies from period to period. For the three months ended March 31, 2011, IDE Technologies Ltd. and UTE Desaladora Qingdao (a Befesa Agua entity) accounted for approximately 38% and 16% of our net revenue, respectively. For the three months ended March 31, 2010, Thiess Degremont J.V. (a joint venture of Thiess Pty Ltd and Degremont S.A.) and Acciona Agua accounted for approximately 28% and 24% of our net revenue, respectively. No other customers accounted for more than 10% of our net revenue during any of these periods.

During the three months ended March 31, 2011 and 2010, 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 energy recovery devices. We also derive revenue from the sale of high pressure and circulation pumps, which we manufacture and sell in connection with our energy recovery devices for use in desalination plants. We also receive incidental revenue from the sale of spare parts and from services, such as product support, that we provide to our customers.

Our condensed consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States, or GAAP. These accounting principles require us to make estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the condensed consolidated financial statements as well as the reported amounts of revenue and expense during the periods presented. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that we make these estimates and judgments. To the extent 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, share-based compensation, inventory valuation, allowances for doubtful accounts, income taxes and the valuation of deferred tax assets, and valuation of goodwill and other intangible assets.

### *First Quarter of 2011 Compared to First Quarter of 2010*

#### **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 March 31,					
	2011		2010		Change Increase / (Decrease)	
<b>Results of Operations:**</b>						
Net revenue	\$ 10,367	100%	\$ 12,615	100%	\$ (2,248)	(18)%
Cost of revenue	5,703	55%	5,257	42%	446	8%
Gross profit	4,664	45%	7,358	58%	(2,694)	(37)%
Operating expenses:						
General and administrative	4,057	39%	3,733	30%	324	9%
Sales and marketing	2,070	20%	1,960	16%	110	6%
Research and development	1,029	10%	828	7%	201	24%
Amortization of intangible assets	346	3%	683	5%	(337)	(49)%
Total operating expenses	7,502	72%	7,204	57%	298	4%
Income (loss) from operations	(2,838)	(27)%	154	1%	(2,992)	*
Interest expense	(20)	(0)%	(21)	(0)%	1	5%
Other non-operating income (expense), net	194	2%	(18)	(0)%	212	*
Income (loss) before provision for income taxes	(2,664)	(26)%	115	1%	(2,779)	*
Provision for (benefit from) income taxes	(906)	(9)%	47	0%	(953)	*
Net income (loss)	\$ (1,758)	(17)%	\$ 68	1%	\$ (1,826)	*

\* Not meaningful

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

## Net Revenue

Our net revenue decreased \$2.2 million for the three months ended March 31, 2011 compared to the three months ended March 31, 2010. The decrease was primarily due to a decrease in shipments of turbochargers and pumps, a decrease in the average sales price of the PX devices, and a decrease in aftermarket parts and services during the current quarter compared to the same period last year.

For the three months ended March 31, 2011, the sales of PX devices and related products and services accounted for approximately 85% of our revenue and sales of turbochargers and pumps accounted for approximately 15%. For the three months ended March 31, 2010, the sales of PX devices and related products and services accounted for approximately 82% of our revenue and sales of turbochargers and pumps accounted for approximately 18%.

The following geographic information includes net revenue from 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 March 31,	
	2011	2010
Domestic revenue	\$ 873	\$ 1,192
International revenue	9,494	11,423
<b>Total revenue</b>	<b>\$ 10,367</b>	<b>\$ 12,615</b>
Revenue by country:		
India	27%	3%
China	17	3
Cyprus	11	—
Spain	10	8
Australia	*	54
Others	35	32
<b>Total</b>	<b>100%</b>	<b>100%</b>

\* Less than 1%.

## Gross Profit

The following table reflects the impact of product sales activities to our overall gross margin for the periods indicated (in thousands, except percentages):

	Three Months Ended March 31,					
	2011			2010		
	PX and Related Products and Services	Turbochargers and Pumps	Total	PX and Related Products and Services	Turbochargers and Pumps	Total
Net revenue	\$ 8,779	\$ 1,588	\$ 10,367	\$ 10,378	\$ 2,237	\$ 12,615
Cost of revenue	4,367	1,336	5,703	3,701	1,556	5,257
Gross margin	\$ 4,412	\$ 252	\$ 4,664	\$ 6,677	\$ 681	\$ 7,358
Gross margin %	50%	16%	45%	64%	30%	58%



Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including share-based compensation), manufacturing overhead, warranty costs, depreciation expense, and manufactured components. The largest component of our cost of revenue is raw materials, primarily ceramic materials. For the three months ended March 31, 2011, gross profit as a percentage of net revenue was 45%. For the three months ended March 31, 2010, gross profit as a percentage of net revenue was 58%.

The decrease in gross profit as a percentage of net revenue for the three months ended March 31, 2011 as compared to the same period last year was primarily due to a decrease in the average sales prices of our PX devices and an increase in overhead costs related to our PX devices, turbochargers, and pumps, largely attributed to the underutilization of our manufacturing facilities in the first quarter of 2011 as compared to the first quarter of 2010.

Future gross profit is highly dependent on the product and customer mix of our net revenues, overall market demand and competition, and the volume of production in our own ceramics factory and our assembly operations that determines our operating leverage. Accordingly, we are not able to predict our future gross profit levels with certainty. In addition, our recent production facility expansion will continue to have a negative impact to our margins if our production volume does not increase in the foreseeable future.

#### *General and Administrative Expense*

General and administrative expense increased by \$324,000, or 9%, to \$4.0 million for the three months ended March 31, 2011 from \$3.7 million for the three months ended March 31, 2010. General and administrative expense as a percentage of our net revenue increased to 39% for the three months ended March 31, 2011 from 30% for the three months ended March 31, 2010 as general and administrative costs increased period over period as described above while net revenue decreased.

General and administrative average headcount decreased to 36 for the first quarter of 2011 from 41 for the first quarter of 2010 largely as a result of reductions in force at our corporate headquarters during late 2010 and early 2011. In February 2011, our Chief Executive Officer (CEO) announced his retirement and our board of directors appointed a new Chief Executive Officer (CEO). General and administrative costs increased as a result of non-recurring expenses related to the retirement of the former CEO and the appointment of a new CEO. This increase was partially offset by a decrease in compensation and employee benefit costs related to the overall decrease in headcount.

Of the \$324,000 net increase in general and administrative expense, increases of \$639,000 related to compensation and employee-related benefits and \$10,000 related to local taxes and other administrative costs. These increases in costs were offset in part by decreases of \$186,000 related to professional and other services and \$139,000 related to occupancy costs. Share-based compensation expense included in general and administrative expense was \$390,000 for the three months ended March 31, 2011 and \$412,000 for the three months ended March 31, 2010.

#### *Sales and Marketing Expense*

Sales and marketing expense increased by \$110,000, or 6%, to \$2.1 million for the three months ended March 31, 2011 from \$2.0 million for the three months ended March 31, 2010. Sales and marketing average headcount remained static at 27 for the first quarters of 2011 and 2010. As a percentage of our net revenue, sales and marketing expense increased to 20% for the three months ended March 31, 2011 compared to 16% for the three months ended March 31, 2010, primarily due to lower net revenue for the current period.

Of the \$110,000 increase in sales and marketing expense for the three months ended March 31, 2011, an increase of \$122,000 related primarily to commissions to outside sales representatives was slightly offset by a decrease of \$12,000 in promotional, occupancy and other costs. Share-based compensation expense included in sales and marketing expense was \$136,000 for the three months ended March 31, 2011 and \$128,000 for the three months ended March 31, 2010.

#### *Research and Development Expense*

Research and development expense increased by \$201,000, or 24%, to \$1.0 million for the three months ended March 31, 2011 from \$0.8 million for the three months ended March 31, 2010. Research and development expense as a percentage of our net revenue increased to 10% for the three months ended March 31, 2011 from 7% for the three months ended March 31, 2010 as research and development expense increased for those periods while net revenue decreased.

Average headcount in our research and development department remained relatively static at 14 for the first quarter of 2011 compared to 15 for the first quarter of 2010. Share-based compensation expense included in research and development expense was \$40,000 for three months ended March 31, 2011 and \$9,000 for the three months ended March 31, 2010.

Of the \$201,000 increase in research and development expense for the three months ended March 31, 2011, increases of \$205,000, primarily related to labor costs associated with test runs of our internally developed ceramics formulations, and \$51,000, related to research and development direct project costs, were slightly offset by a decrease in occupancy costs of \$55,000.

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

#### *Amortization of Intangible Assets*

Amortization of intangible assets is primarily related to finite-lived intangible assets acquired as a result of our purchase of Pump Engineering, LLC in December 2009. These intangible assets include developed technology, non-compete agreements, backlog, trademarks, and customer relationships. Amortization expense decreased by \$337,000 during the first quarter of 2011 compared to the first quarter of 2010 due to backlog being fully amortized during fiscal year 2010.

#### *Non-operating Income, Net*

Non-operating income (expense), net, changed favorably by \$213,000 to \$174,000 of other net income for the three months ended March 31, 2011 from \$(39,000) of other net expense for the three months ended March 31, 2010. The favorable variance was primarily due to \$268,000 in net foreign currency gains recorded during the first quarter of 2011 compared to \$(23,000) in net foreign currency losses recorded during the first quarter of 2010, primarily a result of a favorable change in exchange rates and an increase in Euro-denominated sales contracts. The favorable impact of net foreign currency gains during the three months ended March 31, 2011 was slightly offset by a loss of \$77,000 on the sale of equipment during the first quarter of 2011 and decrease of \$1,000 in interest income.

### **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 March 31, 2011, we issued common stock for aggregate net proceeds of \$83.9 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 March 31, 2011, our principal sources of liquidity consisted of unrestricted cash and cash equivalents of \$52.6 million, which are invested primarily in money market funds, and accounts receivable of \$8.5 million.

Under a loan and security agreement with a financial institution, amended in May 2010, we are allowed to draw advances up to \$10.0 million on a revolving line of credit or utilize up to \$15.9 million as collateral for irrevocable standby letters of credit, provided that the aggregate of the outstanding advances and collateral do not exceed the total available credit line of \$16.0 million. Advances under the revolving line of credit incur interest based on either a prime rate index or LIBOR plus 1.375%. As of March 31, 2011, there were no advances drawn under this line of credit. The amended agreement expires in May 2012 and is collateralized by substantially all of the company's assets.

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 our revolving line of credit. The letters of credit generally terminate within 12 to 36 months from issuance. As of March 31, 2011, the amounts outstanding on irrevocable letters of credit collateralized under our credit agreement totaled approximately \$8.0 million.

We are subject to certain financial and administrative covenants under the 2009 loan and security agreement. As of March 31, 2011, we were non-compliant with a financial covenant under this credit agreement. Section 6.6(c) of the 2009 loan and security agreement sets forth a covenant that requires our company to meet a minimum net income requirement for the fiscal year. The covenant was not satisfied due to a net loss reported for the 2010 fiscal year. As a result, we may be requested by the bank to provide cash collateral for our outstanding standby letters of credit that are currently collateralized by our line of credit. We continue to have discussions with the bank and are considering alternative arrangements including cancellation of the credit line and utilizing available cash to collateralize outstanding standby letters of credit. We have no borrowings under the line and have used the line of credit exclusively for the issuance of standby letters of credit. We believe that our cash and cash equivalents significantly exceed the amount of collateral needed to support the outstanding standby letters of credit and that using the cash to collateralize outstanding standby letters of credit will not have a material adverse effect on our financial position or results of operations.

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

Net cash used in operating activities was \$3.2 million and \$4.5 million for the three months ended March 31, 2011 and 2010, respectively. For the three months ended March 31, 2011 and 2010, net loss of \$(1.8) million and net income of \$0.1 million, respectively, were adjusted to \$0.2 million and \$2.4 million, respectively, by non-cash items totaling \$2.0 million and \$2.3 million, respectively. Non-cash adjustments primarily include depreciation, amortization, unrealized gains and losses on foreign exchange, share-based compensation, provisions for doubtful accounts, warranty reserves and excess and obsolete inventory reserves.

The net cash outflow effect from changes in assets and liabilities was approximately \$(3.4) million and \$(6.9) million for the three months ended March 31, 2011 and 2010, respectively. Net changes in assets and liabilities are primarily attributable to changes in inventory as a result of the timing of order processing and product shipments, changes in accounts receivable and unbilled receivables as a result of timing of invoices and collections for large projects, and changes in prepaid expenses and accrued liabilities as a result of the timing of payments to employees, vendors and other third parties.

#### ***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 provided by (used in) investing activities was \$0.6 million and \$(4.1) million for the three months ended March 31, 2011 and 2010, respectively. The favorable variance of \$4.7 million in cash flows from investing activities for the three months ended March 31, 2011 compared to the three months ended March 31, 2010 was primarily due to a decrease in capital expenditures of \$3.9 million for seismic upgrades and the build-out of ceramics capabilities at our new facility, an increase of \$0.7 million in the release of restricted cash that had been used to collateralize standby letters of credit, and proceeds of \$0.1 million from the sale of capital assets.

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

Net cash used in financing activities was \$129,000 and \$25,000 for the three months ended March 31, 2011 and 2010, respectively. The \$104,000 decrease in net cash flows from financing activities was primarily due to decreases in proceeds from stock option and warrant exercises, excess tax benefits related to share-based compensation arrangements, and repayments of promissory notes by stockholders during the first quarter of 2011 compared to the first quarter of 2010. In addition, capital lease payments increased during the current quarter due to an accelerated pay off of an equipment lease. These unfavorable variances were partially offset by a decrease in debt payments during the three months ended March 31, 2011 compared to the three months ended March 31, 2010 as a result of paying off two notes payable during the first quarter of 2010.

#### ***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. We may enter into potential material investments in, or acquisitions of, complementary businesses, services or technologies, in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

### Contractual Obligations

We lease facilities under fixed non-cancelable operating leases that expire on various dates through 2019. The total of the future minimum lease payments under these leases as of March 31, 2011 is \$13.3 million. For additional information, see Note 8 — “Commitments and Contingencies” to the unaudited condensed consolidated financial statements.

In the course of our normal operations, we also entered into purchase commitments with our suppliers for various key raw materials and components parts. The purchase commitments covered by these arrangements are subject to change based on our sales forecasts for future deliveries. As of March 31, 2011, we had approximately \$3.2 million of cancelable open purchase order arrangements related primarily to materials and parts and \$0.1 million of noncancelable open purchase order arrangements related to manufacturing equipment.

We have entered into a supply agreement with a vendor in order to manage the cost and availability of key raw materials and components. The agreement is subject to minimum annual purchase requirements and is noncancelable. Under this agreement, we have committed to raw material and component minimum purchases as follows (in thousands):

	<b>March 31, 2011</b>
2011 (remaining nine months)	\$ 1,400
2012	1,600
2013	1,600
	<u>\$ 4,600</u>

We have agreements with guarantees or indemnity provisions that we have entered into with customers and others in the ordinary course of business. Based on our historical experience and information known to us as of March 31, 2011, we believe that our exposure related to these guarantees and indemnities as of March 31, 2011 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 Disclosure About Market Risk,” in our Annual Report on Form 10-K for the year ended December 31, 2010.

#### *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.

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 due 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 March 31, 2011, we had cash and cash equivalents totaling \$52.6 million and restricted cash totaling \$6.0 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, capital expenditures and possible future acquisitions. 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.**

(a) *Evaluation of disclosure controls and procedures.* Under the supervision and with the participation of our management, including the President and Chief Executive Officer and the 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.

(b) *Changes in internal controls.* There were no changes in our internal control over financial reporting during the quarter ended March 31, 2011 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**

***Almost all of our revenue is derived from sales of energy recovery devices and pumps used in reverse osmosis desalination; a decline in demand for desalination or the reverse osmosis method of desalination will reduce demand for our products and will cause our sales and revenue to decline.***

Products for the desalination market have historically accounted for a high percentage of our revenue. We expect that the revenue from these products will continue to account for most of our revenue in the foreseeable future. Any factors adversely affecting the demand for desalination, including changes in weather patterns, increased precipitation in areas of high human population density, new technology for producing fresh water, increased water conservation or reuse, political changes and unrest, changes in the global economy, or changes in industry or governmental regulations, would reduce the demand for our energy recovery products and services and would cause a significant decline in our revenue. Similarly, any factors adversely affecting the demand for energy recovery products in reverse osmosis desalination, including, new energy technology or reduced energy costs, new methods of desalination that reduce pressure and energy requirements, improvements in membrane technology would reduce the demand for our energy recovery devices and would cause a significant decline in our revenue. Some of the factors that may affect sales of our energy recovery devices and pumps 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 for political, economic or other factors, especially in these regions. Other factors that could affect the number and capacity of desalination plants built or the timing of their completion include: the availability of required engineering and design resources, a weak global economy, shortage in the supply of credit and other forms of financing, changes in government regulations, permitting requirements or priorities, or reduced capital spending for desalination. Each of these factors could result in reduced or uneven demand for our products. Pronounced variability or delays in the construction of desalination plants or reductions in spending for desalination could negatively impact our sales and revenue and make it difficult for us to accurately forecast our future sales and revenue, which could lead to increased inventory and use of working capital.

***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 membrane 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. Water shortages and demand for desalination can also be adversely affected by water conservation and water reuse initiatives.

***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 postponed due to delays in, or failure to obtain, approval, financing or permitting for plant construction because of political factors, including political unrest in key desalination markets, such as the Middle East, or adverse and increasingly uncertain financial conditions or other factors. Even though we may have a signed contract to provide a certain number of energy recovery devices by a certain date, shipments may be suspended or delayed at the request of customers. Such shipping delays negatively impact our results of operations and revenue. 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.

***We rely on a limited number of engineering, procurement and construction firms for a large portion of our revenue. If these customers delay or cancel their commitments, do not purchase our products in connection with future projects, or are unable to attract and retain sufficient qualified engineers to support their growth, our revenue could significantly decrease, which would adversely affect our financial condition and future growth.***

There are a limited number of large engineering, procurement and construction firms in the desalination industry and these customers account for a substantial portion of our net revenue. One or more of these customers represents 10% or more of our total revenue each year and the customers in this category vary from year to year. See Note 10 — "Concentrations" to the Condensed Consolidated Financial Statements regarding the impact of customer concentrations on our Condensed Consolidated Financial Statements. Since we do not have long-term contracts with these large customers but sell to them on a purchase order or project basis, these orders may be postponed or delayed on short or no notice. If any of these customers reduces or delays its purchases, cancels a project, decides not to specify our products for future projects, fails to attract and retain qualified engineers and other staff, fails to pay amounts due us, experiences financial difficulties or reduced demand for its services, we may not be able to replace that lost business and our projected revenue may significantly decrease, which will adversely affect our financial condition and future growth.

***We face competition from a number of companies that offer competing energy recovery and pump 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 and pumps for desalination plants is competitive and evolving. We expect competition, especially competition on price and warranty terms, to persist and intensify as the desalination market grows, and new competitors may enter the market. Some of our current and potential competitors may have significantly greater financial, technical, marketing and other resources than we do, longer operating histories or greater name recognition. They may also be able to devote greater resources to the development, promotion, sale and support of their products and respond more quickly to new technology. These companies may also have more extensive customer bases, broader customer relationships across product lines, or long-standing or exclusive relationships with our current or potential customers. They may also have more extensive products and product lines that would enable them to offer multi-product or packaged solutions or competing products at lower prices or with other more favorable terms and conditions. As a result, our ability to penetrate the market or sustain our market share may be adversely impacted, which would affect our business, operating results and financial condition. In addition, if another one of our competitors were to merge or partner with another company, the change in the competitive landscape could adversely affect our continuing ability to compete effectively.

***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. A weak global economy may cause our customers to delay product orders or shipments, or delay or cancel planned or new desalination projects, including 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 or shipment 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. 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. Since a single order for our energy recovery devices may represent significant revenue, we have experienced significant fluctuations in revenue from quarter to quarter and year to year and we expect such fluctuations to continue. As a result, comparing our operating results on a period-to-period basis may not be meaningful. You should not rely on our past results as an indication of our future performance. If our revenue or operating results fall below the expectations of investors or securities analysts or below any guidance we may provide to the market, the price of our common stock would likely decline substantially.

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

- fluctuations in demand, sales cycles and pricing levels for our products and services;
- the cyclical nature of equipment purchasing for planned reverse osmosis desalination plants, which historically resulted in increased product shipments in the fourth quarter in most years;
- 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 timely ship new products and product enhancements that meet customer demand and contractual and technical requirements, including scheduled delivery dates, performance tests and product certifications;

- the ability of our customers to obtain other key plant components 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;
- our ability to maintain efficient factory throughput in our new facility and minimize overhead given significant variability in orders from quarter to quarter and year to year;
- 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 components, including 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, including conditions that affect the valuation of the U.S. dollar against other currencies.

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

Our contracts with large engineering, procurement and construction firms generally contain holdback provisions that delay final installment payments up to 24 months after the product has been shipped 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 is subject to such holdback provisions and are accounted for as unbilled receivables until we deliver invoices for payment. Such holdbacks can result in relatively high current and non-current unbilled receivables. If we are unable to invoice and collect these performance holdbacks or if our customers fail to make these payments when due under the 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 for certain positions with industry-specific experience. Given the nature of the reverse osmosis desalination industry, the number of qualified candidates for certain positions is limited. Our ability to grow depends on recruiting and retaining skilled employees with relevant experience, competing with larger, often better known companies and offering competitive total compensation packages. Our failure to retain existing or attract future talented and experienced key personnel could harm our business.

***The success of our business depends in part on our ability to enhance and scale our existing products, develop new products for desalination, diversify into new markets by developing or acquiring new technology and to generate and fulfill sales orders for new products.***

Our future success depends in part on our ability to enhance and scale existing products and to develop new products for desalination and applications outside desalination. While new or enhanced products and services have the potential to meet specified needs of new or existing markets, their pricing may not meet customer expectations and they may not compete favorably with products and services of current or potential competitors. New products may be delayed or cancelled if they do not meet specifications, performance requirements or quality standards, or perform as expected in a production environment. Product designs also may not scale as expected. We may have difficulty finding new markets for our existing technology or developing or acquiring new products for new markets. Customers may not accept or be slow to adopt new products and services and potential new markets may be too costly to penetrate. In addition, we may not be able to offer our products and services at prices that meet customer expectations without increasing our costs and eroding our margins. We may also have difficulty executing plans to break into new markets, expanding our operations to successfully manufacture new products or scaling our operations to accommodate increased business. If we are unable to develop competitive new products, open new cost-effective markets, and scale our business to support increased sales and new markets, 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 outsource the production of our ceramic components to a limited number of ceramic vendors. In 2010, to diversify our supply of ceramics and retain more control over our intellectual property, we developed our own ceramics plant at our headquarters in San Leandro, California to manufacture some of our ceramic components. 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 manufacturing may be adversely affected. If we are unable to ramp-up the internal production of our ceramic parts or manufacture these parts in-house cost-effectively and/or one of our ceramic suppliers goes out of business, we may be exposed to increased risk of supply chain disruption and capacity shortages and our business and financial results, including our cost of goods sold and margins may be adversely affected. During the ramp-up phase of bringing our ceramics facility on line, we expect our cost of goods sold to be negatively affected until we optimize production throughput.

***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 been installed for a limited number of 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 energy recovery 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, procurement 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 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 historically occurred in most years during the fourth quarter, which we believe generally reflects engineering, procurement and construction firm customer buying patterns. A downturn in the market and delays in, 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 and 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 PX products. If any of our ceramic 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 ceramic components for our PX products. 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 and we are unable to make up that shortfall through in-house production, 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 a limited number of suppliers for some of our components. If our suppliers are not able to meet our demand and/or requirements, our business could be harmed.***

We rely on a limited number of suppliers to produce vessel housings and stainless steel castings for our PX devices and castings for our PEI turbochargers and pumps. Our reliance on a limited number of manufacturers for these parts involves a number of 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 long term supply agreements 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 their commitments with us or fail to meet 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 significant or a large number of warranty or other claims in any given year.***

We provide a warranty for our PX and PEI brand products for a period of one to two years and provide up to a 6 year warranty for the ceramic components of our PX brand products. As our ceramics technology evolves, we may increase the ceramics warranty beyond 6 years. We test our products in our manufacturing facilities through a variety of means. However, there can be no assurance that our testing will reveal latent defects in our products, which may not become apparent until after the products have been sold into the market, or will replicate the harsh, corrosive and varied conditions of the desalination plants and other plants in which they are installed. In addition, certain components of our turbochargers and pumps are custom-made and may not scale or perform as required in production environments. Accordingly, there is a risk that we may have significant warranty claims or breach supply agreements 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 only offered up to a six year warranty on the ceramic components of our PX products in new sales agreements executed after August 7, 2007, and we have only offered PEI products since December 2009 when we acquired Pump Engineering, LLC. Accordingly, we cannot quantify the error rate of our products and the ceramic components of our PX 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 significant or large number of warranty or other 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 a limited number of United States patents and patents outside the U.S. that are counterparts to several of the U.S. patents and when their terms expire, we could become more vulnerable to increased competition. We do not hold issued patents in many of the countries where competing products are used though we do have pending applications in 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 our 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 or our customers 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 in one or more jurisdictions, 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.

***Our business entails significant costs that are fixed or difficult to reduce in the short-term while demand for our products is variable and subject to downturns, which may adversely affect our operating results.***

Our business requires investments in facilities, equipment, R&D and training that are either fixed or difficult to reduce or scale in the short term. At the same time, the market for our products is variable and has experienced downturns due to factors such as economic recessions, increased precipitation, uncertain global financial markets, and political changes, many of which are outside our control. During periods of reduced product demand, we may experience periods of excess manufacturing capacity, resulting in high overhead, which may cause gross margin, cash flow and profitability to vary in the short and long term. Similarly, while we believe that our existing manufacturing facilities are capable of meeting current demand and demand for the foreseeable future, the continued success of our business depends on our ability to expand our manufacturing, research and development and testing facilities to meet market needs. If we are unable to respond timely to an increase in demand, our revenue, gross margin, cash flow and profitability may be adversely affected.

***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 stock 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 constructed and maintained with local, regional or national government guarantees and subsidies, including tax-free bonds. The rate of construction of desalination plants depends on each governing entity's willingness and ability to obtain and allocate funds for such projects, which capabilities may be affected by the current weak global financial system and credit market 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 vary, governments in those countries may not have the necessary funding for such projects and may cancel the projects or divert funds allocated for them to other projects. Political unrest, coups or changes in government administrations may also result in policy or priority changes that may also cause governments to cancel, delay or re-contract planned or ongoing projects. Government embargoes may also prohibit sales into certain countries. As a result, the demand for our products could decline and negatively affect our revenue base, our overall profitability and pace of our expected growth. For example, in late 2009, the Algerian government increased the percentage of required government ownership in desalination plants, which led to the cancellation of the government's contract with a large U.K. engineering, procurement and construction firm and the cancellation or delay in sales of our products.

***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 some designs and components of our turbochargers and pumps are custom-made. 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 or for reasons of good long-term customer relations, we may not be willing to enforce. 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 that use our energy recovery products are outside the United States. Many of these projects are located in emerging growth countries with relatively young or unstable market economies or changing political environments. These countries may be affected significantly by the current weak global economy and unstable credit markets. We also rely on sales and technical support personnel stationed in Spain, Asia and the Middle East and we expect to continue to add personnel in other countries. Governmental changes, political unrest or reforms, or other disruptions or changes in the business, regulatory or political environments of the countries in which we sell our products or have staff could have a material adverse effect on our business, financial condition and results of operations.

Sales of our products have to date been denominated principally in U.S. dollars. 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 margins and 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;
- uncertainties related to the application of local contract and other laws, including 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, or GAAP, in the United States. Accordingly, we are 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 is 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. Our acquisition of Pump Engineering, LLC and possible future acquisitions may increase this risk by expanding the scope and nature of operations over which we must develop and maintain internal control over financial reporting. 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 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 GAAP. 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.

***Our past acquisition and future acquisitions could disrupt our business, impact our margins, cause dilution to our stockholders or harm our financial condition and operating results.***

In December 2009, we acquired privately-held competitor Pump Engineering, LLC and, in the future, we may invest in other companies, technologies or assets. We may not realize the expected benefits from our past or future acquisitions. We may not be able to find other 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 that they will ultimately strengthen our competitive or financial position or that they will not be viewed negatively by customers, financial markets, investors or the media. Acquisitions could also result in shareholder dilution or significant acquisition-related charges for restructuring, share-based compensation and the amortization of purchased technology and intangible assets. Expenses resulting from impairment of acquired goodwill, intangible assets and purchased technology could also increase over time if the fair value of those assets decreases. A future change in our market conditions, a downturn in our business, or a long-term decline in the quoted market price of our stock may result in a reduction of the fair value of acquisition-related assets. Any such impairment of goodwill or intangible assets could harm our operating results and financial condition. In addition, when we make an acquisition, we may have to assume some or all of that entity's liabilities which may include liabilities that are not fully known at the time of the acquisition. Future acquisitions may reduce our cash available for operations and other uses. If we continue to make acquisitions, we may require additional cash or use shares of our common stock as payment, which would cause dilution for our existing stockholders.

Any acquisitions that we make, including our 2009 acquisition of Pump Engineering, LLC, entail a number of risks that could harm our ability to achieve their anticipated benefits. We could have difficulties integrating and retaining key management and other personnel, aligning product plans and sales strategies, coordinating research and development efforts, supporting customer relationships, aligning operations and integrating accounting, order processing, purchasing and other support services. Since acquired companies have different accounting and other operational practices, we may have difficulty harmonizing order processing, accounting, billing, resource management, information technology and other systems company-wide. We may also have to invest more than anticipated in product or process improvements. Especially with acquisitions of privately held or non-US companies, we may face challenges developing and maintaining internal controls consistent with the requirements of the Sarbanes-Oxley Act and US public accounting standards. Acquisitions may also disrupt our ongoing operations, divert management from day-to-day responsibilities and disrupt other strategic, research and development, marketing or sales efforts. Geographic and time zone differences and disparate corporate cultures may increase the difficulties and risks of an acquisition. If integration of our acquired businesses or assets is not successful or disrupts our ongoing operations, acquisitions may increase our expenses, harm our competitive position, adversely impact our operating results and financial condition and fail to achieve anticipated revenue, cost, competitive or other objectives.

***Insiders and principal stockholders will likely have significant influence over matters requiring stockholder approval.***

Our directors, executive officers and other principal stockholders beneficially own, in the aggregate, a substantial amount of our outstanding common stock. Although they do not have majority control of the outstanding stock, these stockholders will likely have 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;
- 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.

In December 2009, we used approximately \$20.0 million, including amounts held in escrow, for the acquisition of Pump Engineering, LLC.

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. Pending such uses, we have deposited a substantial amount of the remaining net proceeds in a U.S. Treasury based money market fund. 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 6. Exhibits**

<b>Exhibit No.</b>	<b>Description</b>
10.41*	Offer Letter dated April 13, 2011, to Alexander Buehler.
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.

\* Indicates management compensatory plan, contract or arrangement.







**ENERGY RECOVERY INC.**

CORPORATE HEADQUARTERS

1717 Doolittle Drive San Leandro California 94577  
+1 (510) 485-7370 Office +1 (510) 485-7371 Fax  
April 13, 2011

Mr. Alexander Buehler

Re: Final Offer of Employment with Energy Recovery, Inc.

Dear Alex,

We are pleased to offer you a full-time position with Energy Recovery, Inc. ("ERI") as Vice President and Chief Financial Officer reporting to Thomas S. Rooney, Jr., President and Chief Executive Officer, based in our headquarters in San Leandro, California. Your technical skills and work experience will provide a valuable addition to our staff.

**Salary and Start Date.** We would like your employment with ERI to begin on May 23, 2011. You will receive an annual base salary of \$300,000.00, less deductions authorized or required by law, which will be paid bi-weekly in accordance with our standard payroll practices.

**Sign-on Bonus.** This offer includes a one-time sign-on bonus of \$100,000.00, less deductions authorized or required by law, which you will receive with your first paycheck as an ERI employee if you are able to begin employment with ERI on or before May 23, 2011. If you choose to resign from ERI for any reason within the first twenty-four (24) months of your employment, you agree to return to ERI a pro-rata share of this sign-on bonus. The pro-rata share to be returned shall be based on the number of months remaining in the 24-month period at the time of resignation, divided by 24.

**Executive Bonus Plan.** You will also be eligible to participate in the Company's annual Executive Bonus Plan, under which you will be eligible to receive up to 50% of your base salary for achieving certain performance goals, subject to the Company's meeting its annual financial targets and other goals. The terms of the Executive Bonus Plan for 2011 will be finalized on or before May 15, 2011 at a meeting of the Compensation Committee of the Board of Directors. Within forty-five (45) days of your start date, you will meet with your manager and agree on goals for 2011 that align with the Company's growth strategy.

**Relocation Expenses.** As we have discussed, you will pay for up to \$50,000 in relocation expenses for you and your family for your move from France to California. ERI will cover any allowable relocation expenses in excess of \$50,000 in an amount not to exceed \$30,000. A Relocation Agreement is attached for your review and execution. As set forth in the Relocation Agreement, Allowable Expenses include: House Hunting Expenses (a trip for you and your spouse of six days duration); Temporary Living accommodations for up to three (3) months; Personal Travel to New Location (for family of five); Shipment of Household Goods (one air shipment of 1,000 lbs. and one sea shipment for a 40-ft high-cube container); Storage Items of Shipped Items to Final Destination for up to three (3) months; and Closing Costs on Home Purchase at New Location in an amount not to exceed \$10,000.00.

**Benefits.** As a full-time employee, you will be eligible to receive employee benefits which include three (3) weeks of paid time off that accrues each pay period, medical, dental and vision insurance for you and your dependents, as well as long-term disability and life insurance. You

may elect to participate in these programs as of the first day of the month following your start date. Please note that the benefits program may change from time to time at the Company's discretion.

**Stock Options.** Subject to the approval of the Company's Board of Directors or its Compensation Committee, you may be granted an option to purchase four hundred thousand (400,000) shares of the Company's Common Stock under the Company's 2008 Equity Incentive Plan. The exercise price per share will be equal to the fair market value of a share of ERI common stock based on the closing price on NASDAQ on the first Wednesday of the month following your start date, subject to the prior approval of the Compensation Committee of the ERI Board of Directors. The grant will be subject to the terms and conditions under the 2008 Equity Incentive Plan.

**Annual Refresher Option Grants.** Subject to the approval and discretion of the Company's Board of Directors or its Compensation Committee, each year you may be granted an option to purchase shares of the Company's Common Stock under the Company's 2008 Equity Incentive Plan with a fair market value targeted at \$20,000, based on stock option valuation. The exercise price per share will be equal to the closing price on NASDAQ of a share of ERI common stock on the day the Committee approves your grant, subject to the terms and conditions of the 2008 Equity Incentive Plan or such other Plan the Board and shareholders may approve.

**Change of Control Plan.** Under this offer, you will also be named a Participant in the Company's Change in Control Plan, as amended (please see attached).

**Termination.** In the event that ERI terminates your employment without Cause (as defined in Article 2 of ERI's Change in Control Plan as amended), other than after or in connection with a Change in Control, as that term is defined in the Company's Change in Control Plan, you will be entitled to all payments required by applicable local law, including all earned and unpaid salary, any accrued and unused vacation pay, less deductions required or permitted by law.

In addition, without altering the "at will" nature of your employment, you will be entitled to receive additional benefits in the form of severance ("Additional Benefits") as set forth below in exchange for an agreement to release all claims known or unknown against the Company and to satisfy certain other conditions set forth in any Company Severance Plan then in effect, including an agreement to refrain from engaging in any business or rendering service to any entity, organization or company in competition with ERI for twenty-four (24) months after your termination date and provided that ERI receives the signed, unrevoked release agreement within the stated number of days of your termination date. **Additional Benefits:** If you are terminated prior to the second anniversary of your start date, you will receive severance in the form of a lump sum payment, equal to twelve (12) months' salary. If the termination occurs after the second anniversary of your start date, you will receive severance amount in the form of a lump sum payment equal to six (6) months' salary. These Additional Benefits will be computed using your annual base salary as of the date of the termination, less deductions required or permitted by applicable law.

To the extent the Additional Benefits compensation is subject to Section 409A of the Code, the severance payment or the distribution of the equity compensation shall not be paid or made, as applicable, unless your termination of employment constitutes a "separation from service" (within the meaning of Code Section 409A and any the regulations or other guidance thereunder ("Section 409A")). In addition, no such payment or distribution will be made to you prior to the

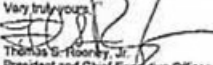
earlier of (a) the expiration of the six-month period measured from the date of your separation from service or (b) the date of your death, if you are deemed at the time of such separation from service to be a "specified employee" (within the meaning of Section 409A) and to the extent such delayed commencement is otherwise required in order to avoid a prohibited distribution under Section 409A. All payments which had been delayed pursuant to the immediately preceding sentence will be paid to you in a lump sum upon expiration of such six-month period (or, if earlier, upon your death).

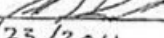
In the event that you resign or are terminated by ERI for Cause, you will only be entitled to payment required by applicable local law, including all earned and unpaid salary, any accrued and unused vacation pay and all earned but unpaid and un-deferred bonus attributable to the year that ends immediately before the year in which the termination occurs, less deductions required or permitted by law.

**Employment Status.** Although your status may change, your employment with the Company remains "at will", meaning that either you or the Company will be entitled to terminate your employment at any time and for any reason, with or without cause. Any contrary representations which may have been made to you are superseded by this offer letter. In addition, although your job duties, title, compensation, benefits, as well as the Company's personnel policies and procedures, may change in the future, the "at will" nature of your employment may not be changed.

Please note that this offer is conditioned upon your ability to present employment eligibility and properly complete the Form I-9 by the third workday after your date of hire as required by the Immigration Reform & Control Act of 1986. A copy of the form will be provided to you. It is ERI policy to conduct background checks by the second week of the employment. This offer is contingent upon positive results from the background checks. A copy of our Background Check Authorization Form had been provided to you.

Please accept this offer of employment as of the start date set forth below by signing your name and setting forth the agreed start date below. Then return this letter to me by email or fax by April 23, 2011. If your acceptance is not received by this date, we shall assume that you have declined the offer and the offer shall be null and void.

Very truly yours,  
  
Thomas D. Rooney, Jr.  
President and Chief Executive Officer

Signed Acceptance:   
Start Date: 5/23/2011

**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, Thomas S. Rooney, Jr., certify that:

1. I have reviewed this quarterly report on Form 10-Q of Energy Recovery, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 6, 2011

By: /s/ THOMAS S. ROONEY, JR.

Thomas S. Rooney, Jr.  
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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date May 6, 2011

By: /s/ THOMAS D. WILLARDSON

Thomas D. Willardson  
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, Thomas S. Rooney, Jr., 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 March 31, 2011, to which this Certification is attached as Exhibit 32.1 (the "Quarterly Report") fully complies with the requirements of Section 13(a) or Section 15(d) of the Exchange Act, and
2. The information contained in the Quarterly Report fairly presents, in all material respects, the financial condition of the Company at the end of the period covered by the Quarterly Report and results of operations of the Company for the period covered by the Quarterly Report.

/s/ THOMAS S. ROONEY, JR.  
\_\_\_\_\_  
President and Chief Executive Officer

/s/ THOMAS D. WILLARDSON  
\_\_\_\_\_  
Chief Financial Officer

Dated: May 6, 2011  
\_\_\_\_\_

Dated: May 6, 2011

\* 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.