POWERSECURE INTERNATIONAL, INC.
Form 10-Q
May 07, 2009

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

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended March 31, 2009**

**or**

o **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 1-12014**

**POWERSECURE INTERNATIONAL, INC.**

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware<br>(State or other jurisdiction of incorporation or organization) | 84-1169358<br>(I.R.S. Employer Identification No.) |
| 1609 Heritage Commerce Court<br>Wake Forest, North Carolina<br>(Address of principal executive offices) | 27587<br>(Zip code) |

(919) 556-3056

(Registrant s telephone number, including area code)

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

Yes þ No o

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes o No o

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 o | Accelerated filer þ | Non-accelerated filer o<br>(Do not check if a smaller reporting company) | Smaller reporting company o |

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

Yes o No þ

As of May 1, 2009, 17,175,109 shares of the issuer s Common Stock were outstanding.

**POWERSECURE INTERNATIONAL, INC.**
**FORM 10-Q**
**For the Quarterly Period Ended March 31, 2009**
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**PART I.**
**FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES**
**CONSOLIDATED BALANCE SHEETS (unaudited)**
**(in thousands, except share data)**

| | March 31, 2009 | December 31, 2008 |
|---|---|---|
| **Assets** | | |
| Current Assets: | | |
| Cash and cash equivalents | $ 22,953 | $ 24,316 |
| Trade receivables, net of allowance for doubtful accounts of $234 and $276, respectively | 20,360 | 25,215 |
| Inventories | 20,451 | 19,713 |
| Deferred income taxes | 2,919 | 2,919 |
| Prepaid expenses and other current assets | 938 | 1,680 |
| Total current assets | 67,621 | 73,843 |
| Property, plant and equipment: | | |
| Equipment | 20,904 | 20,297 |
| Furniture and fixtures | 657 | 650 |
| Land, building and improvements | 4,695 | 4,674 |
| Total property, plant and equipment, at cost | 26,256 | 25,621 |
| Less accumulated depreciation and amortization | 4,100 | 3,739 |
| Property, plant and equipment, net | 22,156 | 21,882 |
| Other assets: | | |
| Goodwill | 7,256 | 7,256 |
| Restricted annuity contract | 2,154 | 2,133 |
| Intangible rights and capitalized software costs, net of accumulated amortization of $1,579 and $1,453, respectively | 1,182 | 1,276 |
| Investment in unconsolidated affiliate | 3,957 | 4,106 |
| Other assets | 350 | 338 |
| Total other assets | 14,899 | 15,109 |
| **Total Assets** | $ 104,676 | $ 110,834 |

*See accompanying notes to consolidated financial statements.*

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**POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES**
**CONSOLIDATED BALANCE SHEETS (unaudited)**
**(in thousands, except share data)**

| | March 31, 2009 | December 31, 2008 |
|---|---|---|
| **Liabilities and Stockholders Equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 3,758 | $ 5,817 |
| Accrued and other liabilities | 20,564 | 23,147 |
| Restructuring charges payable | 1,119 | 1,349 |
| Current income taxes payable | 45 | 181 |
| Current unrecognized tax benefit | 79 | 79 |
| Capital lease obligations | 726 | 716 |
| Total current liabilities | 26,291 | 31,289 |
| Long term liabilites: | | |
| Capital lease obligations | 5,016 | 5,201 |
| Unrecognized tax benefit | 790 | 790 |
| Deferred compensation | 471 | 388 |
| Restructuring charges | 86 | 355 |
| Total long term liabilities | 6,363 | 6,734 |
| Commitments and contingencies | | |
| Stockholders Equity : | | |
| PowerSecure International stockholders equity: | | |
| Preferred stock undesignated, $.01 par value; 2,000,000 shares authorized; none issued and outstanding | | |
| Preferred stock Series C, $.01 par value; 500,000 shares authorized; none issued and outstanding | | |
| Common stock, $.01 par value; 25,000,000 shares authorized; 17,081,608 and 17,071,889 shares issued and outstanding, respectively | 171 | 171 |
| Additional paid-in-capital | 108,697 | 108,384 |
| Accumulated deficit | (36,880) | (35,744) |
| Total PowerSecure International stockholders equity | 71,988 | 72,811 |
| Noncontrolling interest | 34 | |
| Total stockholders equity | 72,022 | 72,811 |

| | | |
|---|---|---|
| **Total Liabilities and Stockholders Equity** | $ 104,676 | $ 110,834 |

*See accompanying notes to consolidated financial statements.*

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**POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)**
**(in thousands, except per share data)**

| | Three Months Ended March 31, 2009 | Three Months Ended March 31, 2008 |
|---|---|---|
| Revenues | $ 19,720 | $ 33,575 |
| Cost of sales | 13,846 | 23,555 |
| Gross profit | 5,874 | 10,020 |
| Operating expenses: | | |
| General and administrative | 6,020 | 7,243 |
| Selling, marketing and service | 831 | 1,325 |
| Depreciation and amortization | 542 | 457 |
| Research and development | 20 | 19 |
| Total operating expenses | 7,413 | 9,044 |
| Operating income (loss) | (1,539) | 976 |
| Other income and (expenses): | | |
| Management fees | 105 | 149 |
| Interest and other income | 53 | 226 |
| Interest and finance charges | (174) | (51) |
| Equity income | 477 | 964 |
| Income (loss) before income taxes | (1,078) | 2,264 |
| Income tax provision | (24) | (312) |
| Income (loss) from continuing operations | (1,102) | 1,952 |
| Discontinued operations | | |
| Loss on disposal | | (42) |
| Loss from operations, including tax benefit of $2 in 2008 | | (35) |
| Loss on discontinued operations | | (77) |
| Net income (loss) | (1,102) | 1,875 |
| Less: Net income attributable to noncontrolling interest | (34) | |
| Net income (loss) attributable to PowerSecure International | $ (1,136) | $ 1,875 |
| Basic earnings (loss) per share attributable to PowerSecure International common stockholders: | | |
| Income (loss) from continuing operations | $ (0.07) | $ 0.12 |
| Loss from discontinued operations | .00 | (0.01) |

| | | |
|---|---|---|
| Net income (loss) attributable to PowerSecure International common stockholders: | $ (0.07) | $ 0.11 |
| | | |
| Diluted earnings (loss) per share attributable to PowerSecure International common stockholders: | | |
| Income (loss) from continuing operations | $ (0.07) | $ 0.11 |
| Loss from discontinued operations | .00 | (0.00) |
| Net income (loss) attributable to PowerSecure International common stockholders: | $ (0.07) | $ 0.11 |
| | | |
| Amounts attributable to PowerSecure International common stockholders: | | |
| Income (loss) from continuing operations, net of tax | $ (1,136) | $ 1,952 |
| Discontinued operations, net of tax | | (77) |
| Net income (loss) | $ (1,136) | $ 1,875 |

*See accompanying notes to consolidated financial statements.*

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**POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)**
**(in thousands)**

| | Three Months Ended March 31, 2009 | 2008 |
|---|---|---|
| **Cash flows from operating activities:** | | |
| Net income (loss) | $ (1,136) | $ 1,875 |
| Adjustments to reconcile net income (loss) to net cash used in operating activities: | | |
| Depreciation and amortization | 542 | 457 |
| Noncontrolling interest | 34 | |
| Deferred income taxes | | 65 |
| Loss on disposal of miscellaneous assets | 26 | 5 |
| Equity in income of unconsolidated affiliate | (477) | (964) |
| Distributions from unconsolidated affiliate | 607 | 544 |
| Stock compensation expense | 354 | 614 |
| Changes in operating assets and liabilities, net of effect of aquisitons: | | |
| Trade receivables, net | 4,855 | 1,539 |
| Inventories | (820) | 2,374 |
| Other current assets and liabilities | 606 | (1,916) |
| Assets of discontinued operations held for sale | | 2,400 |
| Other noncurrent assets | (11) | 77 |
| Accounts payable | (2,059) | 177 |
| Restructuring charges | (499) | (555) |
| Accrued and other liabilities | (2,583) | (8,363) |
| Liabilities of discontinued operations held for sale | | (755) |
| Deferred compensation obligation | 83 | 83 |
| Restricted annuity contract | (21) | (35) |
| Net cash used in operating activities | (499) | (2,378) |
| **Cash flows from investing activities:** | | |
| Purchases of property, plant and equipment | (582) | (7,413) |
| Additions to intangible rights and software development | (72) | (78) |
| Proceeds from sale of property, plant and equipment | 6 | 1 |
| Net cash used in investing activities | (648) | (7,490) |
| **Cash flows from financing activities:** | | |
| Proceeds from term loan | | 2,584 |
| Proceeds from stock option exercises, net of shares tendered | (41) | 86 |
| Borrowings (payments) on line of credit | | |
| Payments on capital lease obligations | (175) | |
| Net cash provided by (used in) financing activities | (216) | 2,670 |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (1,363) | (7,198) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR | 24,316 | 28,710 |

| | | |
|---|---|---|
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | $ 22,953 | $ 21,512 |

*See accompanying notes to consolidated financial statements.*

**POWERSECURE INTERNATIONAL, INC. AND SUBSIDIARIES**
**Notes to Unaudited Consolidated Financial Statements**
As of March 31, 2009 and December 31, 2008 and
For the Three Month Periods Ended March 31, 2009 and 2008
(in thousands, except per share data)

**1. Description of Business and Basis of Presentation**

**Description of Business**

PowerSecure International, Inc., based in Wake Forest, North Carolina was incorporated on April 5, 1991. We are a leading provider of Energy and Smart Grid Solutions and Energy Services to utilities, commercial, institutional and industrial customers, and oil and natural gas producers. We provide our products and services across the strategic business areas of Interactive Distributed Generation®, Utility Infrastructure, Energy Efficiency, and Energy Services.

Through our PowerSecure, Inc. subsidiary we focus on three of these areas, including Interactive Distributed Generation®, Utility Infrastructure, and Energy Efficiency. Our core Interactive Distributed Generation® business involves installing sophisticated electric generation equipment directly at the location where power is utilized. This equipment provides a dependable backup power supply during power outages, while at the same time providing a more efficient and environmentally friendly means of delivering power during high cost periods of peak power demand. Our intelligent Interactive Distributed Generation® systems contain our electronic controls technology which enables our systems to be monitored 24x7 by our monitoring center, safeguarding our customers from power outages and their related costs. Through this monitoring center, we utilize our proprietary smart grid capabilities to forecast utilities peak demand periods, and electronically deploy our systems to deliver more efficient and environmentally friendly power during these periods of peak demand. Our systems also enable utilities to delay new infrastructure investments for transmitting and distributing power, and minimize energy losses associated with moving electricity over long distances.

Our Utility Infrastructure business, which is an extension of our Interactive Distributed Generation® business, provides utilities with regulatory consulting and rate design services and power system engineering and construction services. Our Energy Efficiency business is focused on providing lighting solutions for commercial, industrial, and institutional customers, including our state-of-the-art green EfficientLights LED lighting technology for refrigerated cases in grocery and retail drug stores.

Through our Southern Flow Companies, Inc. and WaterSecure Holdings, Inc. subsidiaries we focus on business opportunities in the energy services field. Our Energy Services businesses serve the oil and natural gas industry with natural gas measurement products and services, through Southern Flow, and water processing services, through WaterSecure.

Our Southern Flow subsidiary provides natural gas measurement services to customers involved in the business of oil and natural gas production, transportation and processing, with a focus on the natural gas market. WaterSecure Holdings, Inc. (formerly known as Marcum Gas Transmission, Inc.), which we also refer to as WaterSecure , owns approximately 40% of the equity interests in an unconsolidated business, Marcum Midstream 1995-2 Business Trust, which we refer to as MM 1995-2 or as our WaterSecure operations . Our WaterSecure operations business operates water processing and disposal facilities in northeastern Colorado.

See Note 10 for more information concerning our reportable segments.

**Basis of Presentation**

***Organization*** The accompanying consolidated financial statements include the accounts of PowerSecure International, Inc. and its subsidiaries, primarily, PowerSecure, Inc. ( our PowerSecure subsidiary ) (and its majority-owned and wholly-owned subsidiaries, UtilityEngineering, Inc., PowerServices, Inc., EnergyLite, Inc. EfficientLights, LLC and Reid s Trailer, Inc. dba PowerFab), Southern Flow Companies, Inc. ( Southern Flow ), Marcum Gas Metering, Inc. ( MGM ), and WaterSecure Holdings, Inc. ( WaterSecure ) (and its majority-owned subsidiary, Conquest Acquisition Company LLC ( CAC LLC )), collectively referred to as the Company or we or us our .

These consolidated financial statements have been prepared pursuant to rules and regulations of the Securities and Exchange Commission. The accompanying consolidated financial statements and notes thereto should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2008.

In management s opinion, all adjustments (all of which are normal and recurring) have been made which are necessary for a fair presentation of the consolidated financial position of us and our subsidiaries as of March 31, 2009 and the consolidated results of our operations and cash flows for the three month periods ended March 31, 2009 and March 31, 2008.

***Principles of Consolidation*** The consolidated financial statements include the accounts of PowerSecure International, Inc. and its subsidiaries after elimination of intercompany accounts and transactions. We use the equity method to account for our investment in unconsolidated affiliate.

***Reclassification*** Certain 2008 amounts have been reclassified to conform to current year presentation. Such reclassifications had no impact on our previously reported results of operations or stockholders equity.

***Use of Estimates*** The preparation of our consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires that our management make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates include percentage-of-completion estimates for revenue and cost of sales recognition, allowance for doubtful accounts receivable, inventory valuation reserves, and our deferred tax valuation allowance.

**2. Summary of Significant Accounting Policies and Recent Accounting Pronouncements**

***Revenue Recognition*** For our distributed generation turn-key project-based sales and our utility infrastructure projects, we recognize revenue and profit as work progresses using the percentage-of-completion method, which relies on various estimates. We believe the use of the percentage-of-completion method of accounting for our distributed generation projects is preferable to the completed contract method because a typical distributed generation construction project occurs over several accounting periods and the percentage-of-completion method is a better method to match the revenues and costs to the reporting period in which the construction services are performed. Nearly all of our distributed generation projects are fixed-price contracts, with the exception of certain contracts which provide for additional billings based on wire usage to connect the distributed generation equipment to customer facilities.

In applying the percentage-of-completion method to our distributed generation turn-key projects, we have identified the key output project phases that are standard components of our construction projects. We have further identified, based on past experience, an estimate of the value of each of these output phases based on a combination of costs incurred and the value added to the overall construction project. While the order of these phases varies depending on the project, each of these output phases is necessary to complete each project and each phase is an integral part of the turnkey product solution we deliver to our customers. We use these output phases and percentages to measure our progress toward completion of our construction projects. For each reporting period, the status of each project, by phase, is determined by employees who are managers of or are otherwise directly involved with the constructions project and is reviewed by our accounting personnel. Utilizing this information, we recognize project revenues (and associated project costs) and gross profit based on the percentage associated with output phases that are complete or in process on each of our projects.

In applying the percentage-of-completion method to our utility infrastructure projects, sales and gross profit are recognized as work is performed based on the relationship between actual costs incurred and total estimated costs at completion.

In all cases where we utilize the percentage-of-completion, revenues and gross profit are adjusted prospectively for revisions in estimated total contract costs and contract values. Estimated losses, if any, are recorded when identified. While a project is in process, amounts billed to customers in excess of revenues recognized to date are classified as current liabilities. Likewise, amounts recognized as revenue in excess of actual billings to date are recorded as unbilled accounts receivable. In the event a contract provides for adjustments to the contract price for actual wire or other raw material usage, we recognize the associated revenue when the actual costs are incurred and the customer is billed.

Because the percentage-of-completion method of accounting relies upon estimates described above, recognized revenues and profits are subject to revision as a project progresses to completion. Revisions in profit estimates are charged to income in the period in which the facts that give rise to the revision become known. In the event we were required to adjust any particular project s estimated revenues or costs, the effect on the current period earnings may or may not be insignificant. If, however, conditions arise that requires us to adjust our estimated revenues or costs for a series of similar construction projects, the effect on current period earnings would most likely be significant. In addition, certain contracts provide for cancellation provisions prior to completion of a project. The cancellation provisions generally provide for payment of costs incurred, but may result in an adjustment to profit already recognized in a prior period.

We recognize equipment and product revenue, in accordance with the SEC s Staff Accounting Bulletin No. 101, when persuasive evidence of a non-cancelable arrangement exists, delivery has occurred and/or services have been rendered, the price is fixed or determinable, and collectability is reasonably assured. Equipment and product sales are generally made directly to end users of the product, who are responsible for payment for the product.

Service revenue includes regulatory consulting and rate design services, power system engineering services, energy conservation services, chart services, field services, laboratory analysis, data management services, and monitoring and maintenance services. Revenues from these services are recognized when the service is performed and the customer has accepted the work.

Revenues on our recurring revenue distributed generation projects are recognized over the term of the contract as we provide utilities and their customers with access to distributed generation systems for standby power and peak shaving or, in certain cases, when energy savings are realized by the customer at their site. These contracts can involve multiple parties, with one party paying us for the value of backup power (usually, but not always, a commercial, industrial, or institutional customer), and one party paying us for the value of the electrical capacity provided by the system (usually a utility).

Sales of certain goods or services sometimes involve the provision of multiple elements. Revenues from contracts with multiple element arrangements are recognized as each element is earned based on the relative fair value of each element and when the delivered elements have value to customers on a standalone basis. Amounts allocated to each element are based on its objectively determined fair value, such as the sales price for the product or service when it is sold separately or competitor prices for similar products or services.

***Cash and Cash Equivalents*** Cash and all highly liquid investments with a maturity of three months or less from the date of purchase, including money market mutual funds, short-term time deposits, and government agency and corporate obligations, are classified as cash and cash equivalents.

***Concentration of Credit Risk*** We are subject to concentrations of credit risk from our cash and cash equivalents and accounts receivable. We limit our exposure to credit risk associated with cash and cash equivalents by placing our cash and cash equivalents with multiple domestic financial institutions. Nevertheless, our cash in bank deposit accounts at these financial institutions frequently exceeds federally insured limits. We further limit our exposure to credit risk associated with these cash accounts by adherence to our investment policy. We have not experienced any losses in such accounts.

From time to time, we have derived a material portion of our revenues from one or more significant customers. To date, nearly all our revenues have been derived from sales to customers within the United States.

***Warranty Reserve*** We provide a standard one-year warranty for our distributed generation and switchgear equipment, and a five-year warranty for our EfficientLights lighting product. In addition, we offer extended warranty terms on our distributed generation turn-key and switchgear projects. We reserve for the estimated cost of product warranties when revenue is recognized, and we evaluate our reserve periodically by comparing our warranty repair experience by product. The purchase price for extended warranties or extended warranties included in the contract terms are deferred as a component of our warranty reserve.

***Noncontrolling Interest*** In late 2007, the Financial Accounting Standards Board ( FASB ) issued Financial Accounting Standards ( FAS ) No. 160, Noncontrolling Interests in Consolidated Financial Statements-an amendment of ARB No. 51 ( FAS 160 ), which establishes accounting and reporting standards for the noncontrolling interest in a subsidiary (minority interest) and for the deconsolidation of a subsidiary. We adopted the provisions of FAS 160 on a prospective basis beginning January 1, 2009. Accordingly, the noncontrolling shareholder s interest in the equity of EfficientLights at March 31, 2009 is included as a component of stockholders equity in our consolidated balance sheet at March 31, 2009. The noncontrolling shareholder s interest in the income (losses) of EfficientLights is included in our consolidated statements of operations in determining net income (loss) and earnings per share attributable to PowerSecure International common stockholders. At December 31, 2008, the accumulated losses of the noncontrolling shareholder s interest in EfficientLights exceeded his basis. Under ARB No. 51, the noncontrolling shareholder s interest in the current period income of EfficientLights would have been offset against the accumulated unrecognized noncontrolling shareholder losses. Accordingly, the effect of adopting the provisions of FAS 160 on our statement of operations for the three months ended March 31, 2009 was to increase the net loss attributable to PowerSecure International shareholders by $34 for the effects of the unrecovered losses attributable to the noncontrolling shareholder that were accumulated prior to December 31, 2008.

***Share-Based Compensation*** We account for share-based compensation in accordance with the provisions of FAS No. 123 (Revised 2004), Share-Based Payment ( FAS 123(R) ), which requires measurement of compensation cost for all stock-based awards at the fair value on date of grant and recognition of compensation over the service period for awards expected to vest. We measure the fair value of restricted stock awards based on the number of shares granted and the quoted price of our common stock on the date of the grant, and we measure the fair value of stock options using the Black-Scholes valuation model. These fair values are recognized as compensation expense over the service period, net of estimated forfeitures.

Pre-tax share-based compensation expense for our stock options and restricted stock awards recognized under FAS 123(R) during the three months ended March 31, 2009 and 2008 was $354 and $614, respectively, and is included in general and administrative expense in the accompanying consolidated statements of operations.

***Income Taxes*** We account for income taxes in accordance with the provisions of FAS No. 109, Accounting for Income Taxes ( FAS 109 ) and in accordance with the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 ( FIN 48 ). Accordingly, we recognize deferred income tax assets and liabilities for the estimated future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. We have net operating loss carryforwards available in certain jurisdictions to reduce future taxable income. Future tax benefits for net operating loss carryforwards are recognized to the extent that realization of these benefits is considered more likely than not. To the extent that available evidence raises doubt about the realization of a deferred income tax asset, a valuation allowance is established. FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing a minimum recognition threshold for a tax position taken or expected to be taken in a tax return that is required to be met before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition.

**Recent Accounting Pronouncements**

***Accounting for Business Combinations*** In late 2007, the FASB issued FAS No. 141(R), Business Combinations-a replacement of FASB Statement No. 141 ( FAS 141(R) ), which significantly changes the principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. FAS 141(R) also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. We adopted the provisions of FAS 141(R) effective January 1, 2009. The adoption of FAS

141(R) had no effect on our financial position, results of operations or financial statement disclosures.

***Derivative Instruments and Hedging Activities*** In March 2008, the FASB issued FAS No. 161, Disclosures About Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 ( FAS 161 ). FAS 161 amends FAS No. 133 by requiring expanded disclosures about, but does not change the accounting for, derivative instruments and hedging activities, including increased qualitative, quantitative, and credit-risk disclosures. We adopted the provisions of FAS 161 effective January 1, 2009. The adoption of FAS 161 had no effect on our financial position, results of operations or financial statement disclosures.

***Useful Life of Intangible Assets*** In April 2008, the FASB issued FASB Staff Position ( FSP ) FAS 142-3, Determination of Useful Life of Intangible Assets ( FSP FAS 142-3 ). FSP FAS 142-3 amends the factors that should be considered in developing the renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FAS 142, Goodwill and Other Intangible Assets. FSP FAS 142-3 also requires expanded disclosure related to the determination of intangible asset useful lives. We adopted the provisions of FSP FAS 142-3 effective January 1, 2009. The adoption of FSP FAS 142-3 had no effect on our financial position or results of operations or financial statement disclosures.

***Participating Securities*** In June 2008, the FASB issued FSP Emerging Issues Task Force ( EITF ) 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities ( FSP EITF 03-6-1 ). FSP EITF 03-6-1 clarifies that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and are to be included in the computation of earnings per share under the two-class method described in SFAS No. 128, Earnings Per Share. We adopted the provisions of FSP EITF 03-6-1 effective January 1, 2009. All of our unvested restricted stock awards contain nonforfeitable rights to dividends on a basis equal to our other common stockholders. Accordingly, the adoption of FSP EITF 03-6-1 increased our weighted average shares outstanding at March 31, 2008 (for comparative purposes), although there was no effect on our earnings per share for that period.

***Defensive Intangible Assets*** In November 2008 the FASB ratified EITF Issue No. 08-7, Accounting for Defensive Intangible Assets , or EITF 08-7. EITF 08-7 applies to defensive intangible assets, which are acquired intangible assets that the acquirer does not intend to actively use but intends to hold to prevent its competitors from obtaining access to them. As these assets are separately identifiable, EITF 08-7 requires an acquiring entity to account for defensive intangible assets as a separate unit of accounting, which should be amortized to expense over the period the asset diminished in value. Defensive intangible assets must be recognized at fair value in accordance with SFAS 141R and SFAS 157. We adopted the provisions of EITF 08-07 effective January 1, 2009. The adoption of EITF 08-07 had no effect on our financial position, results of operations or financial statement disclosures.

***Fair Value Accounting Standards*** On April 9, 2009, the FASB adopted three new guidelines under the so-called mark-to-market accounting rule, addressing concerns over the application of fair value accounting standards given the current market conditions. All three pieces of guidance are effective for periods ending after June 15, 2009.

The first, FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly , allows companies to value assets at what they would sell for in an orderly sale, as opposed to a forced or distressed sale. This includes certain hard-to-value troubled mortgages, corporate loans, and consumer loans. The new rule establishes a process, by which companies look at several factors and use their judgment to decide whether a formerly active market has become inactive. If found to be inactive, a company must then determine if broker quotes, observed prices, or a discounted cash flow analysis indicate distressed transactions. We do not expect the adoption of FSB FAS 157-4 will have any impact on our financial position, results of operations or financial statement disclosures.

The second, FSP FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments (OTTI) , changes the way companies are calculating OTTI for debt securities. Under FSP FAS 115-2 and FAS 124-2, recognition of OTTI is based on management s assertion it does not have the intent to sell the debt instrument and it is more likely than not it will not have to sell the debt instrument before recovery of its cost basis. As such, when adjusting the debt instrument to fair value on the company s balance sheet, the credit component of an other-than-temporary impairment of a debt security will be recorded through earnings and the remaining portion in other comprehensive income. The credit portion of the change in fair value of the debt security is measured on the basis of an entity s estimate of the decrease in expected cash flows. We do not expect the adoption of FSB FAS 115-2 and FAS 124-2 will have any impact on our financial position, results of operations or financial statement disclosures.

The third, FSP FAS 107-1 and APB 28-1, Interim Disclosures About Fair Value of Financial Instruments , increases the frequency of disclosures that provide qualitative and quantitative information about fair value estimates for financial instruments not currently measured on the balance sheet at fair value. The FSP now requires disclosures typically only reported in annual report to be included in the quarterly reports. The FSP does not require any new disclosures related to fair value estimates. We do not expect the adoption of FSP FAS 107-1 and APB 28-1 will have any impact on our financial position, results of operations or financial statement disclosures.

***Employers Disclosures about Postretirement Benefit Plan Assets*** In December 2008, the FASB issued FSP FAS 132(R)-1, Employers Disclosures about Postretirement Benefit Plan Assets , which requires additional disclosures for employers pension and other postretirement benefit plan assets. As pension and other postretirement benefit plan assets were not included within the scope of SFAS No. 157, FSP FAS 132(R)-1 requires employers to disclose information about fair value measurements of plan assets similar to the disclosures required under SFAS No. 157, the investment policies and strategies for the major categories of plan assets, and significant concentrations of risk within plan assets. FSP FAS 132(R)-1 will be effective for us as of December 31, 2009. We do not expect the adoption of this standard will have any impact on our financial position, results of operations or financial statement disclosures.

**3. Earnings (Loss) per Share**

Basic earnings (loss) per share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share is computed using the weighted average number of common shares outstanding and, when dilutive, potential common shares from stock options and warrants using the treasury stock method. Diluted earnings per share excludes the impact of potential common shares related to stock options and warrants in periods in which we reported a loss from continuing operations or in which the option or warrant exercise price is greater than the average market price of our common stock during the period because the effect would be antidilutive. A total of 376,000 common shares issuable upon the exercise of in-the-money stock options and warrants were excluded from the diluted weighted average number of shares outstanding for the three months ended March 31, 2009 because their effect was antidilutive.

The following table sets forth the calculation of basic and diluted earnings (loss) per share attributable to PowerSecure International, Inc. common stockholders:

| | Three Months Ended March 31, | |
|---|---|---|
| | **2009** | **2008** |
| Amounts attributable to PowerSecure International, Inc. common stockholders: | | |
| Income (loss) from continuing operations | $ (1,136) | $ 1,952 |
| Loss from discontinued operations | | (77) |
| Net income (loss) | $ (1,136) | $ 1,875 |
| Basic weighted-average common shares outstanding in period | 17,095 | 16,897 |
| Add dilutive effects of stock options and warrants | | 622 |
| Diluted weighted-average common shares outstanding in period | 17,095 | 17,519 |
| Basic earnings (loss) per common share: | | |
| Income (loss) from continuing operations | $ (0.07) | $ 0.12 |
| Loss from discontinued operations | | (0.01) |
| Basic earnings (loss) per common share | $ (0.07) | $ 0.11 |
| Diluted earnings (loss) per common share: | | |
| Income (loss) from continuing operations | $ (0.07) | $ 0.11 |
| Loss from discontinued operations | | (0.00) |
| Diluted earnings (loss) per common share | $ (0.07) | $ 0.11 |

**4. Investment in Unconsolidated Affiliate**

Through WaterSecure, we currently own 40.45% of MM 1995-2, which we account for under the equity method. MM 1995-2 owns and operates five water processing and disposal facilities located in northeastern Colorado. The balance of our equity investment in MM 1995-2 includes approximately $804 and $822 of unamortized purchase premiums we paid on our acquired interests at March 31, 2009 and December 31, 2008, respectively. The premiums are being amortized over a period of 14 years, which represents the weighted average useful life of the underlying assets acquired.

The following table sets forth certain summarized financial information for MM 1995-2 at March

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31, 2009 and December 31, 2008 and for the three months ended March 31, 2009 and 2008:

| | March 31, 2009 | December 31, 2008 |
|---|---|---|
| Total current assets | $ 2,759 | $ 4,645 |
| Property, plant and equipment, net | 9,318 | 8,067 |
| Total other assets | 14 | 17 |
| Total assets | $ 12,091 | $ 12,729 |
| Total current liabilities | $ 1,272 | $ 1,393 |
| Long-term note payable | 3,355 | 3,550 |
| Total shareholders equity | 7,464 | 7,786 |
| Total liabilities and shareholders equity | $ 12,091 | $ 12,729 |

| | Three Months Ended March 31, | |
|---|---|---|
| | 2009 | 2008 |
| Total revenues | $ 2,986 | $ 4,889 |
| Total costs and expenses | 1,808 | 2,231 |
| Net income | $ 1,178 | $ 2,658 |

**5. Debt**

***Line of Credit*** We have an existing credit agreement with Citibank, N.A., as the administrative agent, along with SunTrust Bank and BB&T, providing for a $50 million senior, first-priority secured revolving and term credit facility. The credit facility, as amended, is a $50,000 senior, first-priority secured revolving credit facility that is guaranteed by all of our active subsidiaries and secured by all of our assets and the assets of our active subsidiaries.

We may, from time to time, request an increase in the aggregate revolving commitment amount by up to $15,000 without the prior consent of the lenders provided that each lender has the unilateral right to determine whether it agrees to increase its revolving commitment and that no lender is required to increase its individual pro rata commitment amount without such lender s consent.

The credit facility, as a revolving credit facility, matures and terminates on November 13, 2011. However, we have the option prior to that maturity date to convert a portion of outstanding principal balance, in an amount not to exceed the present value of estimated annual contract revenues receivable under the initial term of contracts for recurring revenue projects executed after December 31, 2007, into a non-revolving term loan for a two year period expiring November 12, 2013, making quarterly payments based upon a four year fully amortized basis.

We intend to use the proceeds available under the credit facility to finance our PowerSecure subsidiary s recurring revenue projects as well as to finance capital expenditures, working capital, acquisitions, and general corporate purposes. Our outstanding borrowings under the credit facility at any time, the proceeds of which were used for working capital purposes and not in connection with recurring revenue projects, cannot exceed $15,000.

Outstanding balances under the credit facility bear interest, at our discretion, at either the London Interbank Offered Rate for the corresponding deposits of U. S. Dollars plus an applicable margin, which is on a sliding scale ranging from 175 basis points to 300 basis points based upon the our leverage ratio, or at Citibank s alternate base rate plus an applicable margin, on a sliding scale ranging from 0 basis points to 125 basis points based upon our leverage ratio. Our leverage ratio is the ratio of our funded indebtedness as of a given date to our consolidated EBITDA as defined in the credit agreement for the four consecutive quarters ending on such date. Citibank s alternate base rate is equal to the higher of the Federal Funds Rate as published by the Federal Reserve of New York plus 0.50%, and Citibank s prime commercial lending rate.

The credit facility is not subject to any borrowing base computations or limitations, but does contain certain financial covenants. Our maximum leverage ratio cannot exceed 3.25. Our minimum fixed charge coverage ratio must be in excess of 1.50, where the fixed charge coverage ratio is defined as the ratio of the aggregate of our trailing 12 month consolidated EBITDA plus our lease or rent expense minus our taxes based on income and payable in cash, divided by the sum of our consolidated interest charges plus our lease or rent expenses plus our scheduled principal payments and dividends, computed over the previous period. Also, our minimum asset coverage must be in excess of 1.25, where our asset coverage is defined as the summation of 80% of the book value of accounts receivable plus 60% of the book value of inventory plus 50% of the book value of net fixed assets, divided by total funded debt outstanding. In addition, we are required to maintain a minimum consolidated tangible net worth, computed on a quarterly basis, equal to approximately $42.8 million, plus 50% of our net income each year ending after December 31, 2007, with no reduction for any net loss in any year, plus 100% of any equity we raise through the sale of equity interests, less the amount of any non-cash charges or losses. Finally, our debt to worth ratio, which is the ratio of our total consolidated indebtedness to our consolidated tangible net worth, cannot exceed 1.5 to 1.0 at the end of any quarter. At March 31, 2009, we were in compliance with these financial covenants.

Under the credit facility, our cumulative capital expenditures beginning in 2008 cannot exceed the sum of $5,000 plus $1,250 per quarter, on a cumulative basis, plus an allowance for our PowerSecure subsidiary recurring revenue projects generated after December 31, 2007. The credit facility contains other representations and warranties and affirmative and negative covenants, including restrictions with respect to liens, indebtedness, loans and investments, material changes in our business, asset sales or leases or transfers of assets, restricted payments such as distributions and dividends, mergers or consolidations and transactions with affiliates.

Upon the sale of any of our assets or the assets of our subsidiaries other than in the ordinary course of business or the public or private sale of any of our equity or debt or the equity or debt of our subsidiaries other than equity issuances where the aggregate net equity proceeds do not exceed $10,000, we are required to use the net proceeds thereof to repay any indebtedness then outstanding under the credit facility, except for certain reinvestment provisions.

Our obligations under the credit facility are secured by guarantees and security agreements by each of our active subsidiaries, including but not limited to our PowerSecure subsidiary, Southern Flow and WaterSecure. The guarantees guaranty all of our obligations under the credit facility, and the security agreements grant to the lenders a first priority security interest in virtually all of the assets of each of the parties to the credit agreement.

The credit agreement also contains customary events of default, including payment defaults, breach of representations and warranties, covenant defaults, cross-defaults, certain bankruptcy or insolvency events, judgment defaults and certain ERISA-related events.

At March 31, 2009 and December 31, 2008, there were no balances outstanding under the credit facility and we had $50,000 available to borrow. However, the availability of this capital under our credit facility includes restrictions on the use of proceeds, and is dependent upon our ability to satisfy certain financial and operating covenants, as described above.

***Equipment Line*** On July 22, 2008, Caterpillar Financial Services Corporation ( Caterpillar ) renewed a line of credit to finance the purchase, from time to time, of Caterpillar generators to be used in our PowerSecure subsidiary s projects, primarily those projects sold under the recurring revenue model, pursuant to a letter by Caterpillar containing the terms of this credit line. The line of credit was increased from its previous $7,500 level to $10,000. Under this line of credit, our PowerSecure subsidiary may submit equipment purchases to Caterpillar for financing, and Caterpillar may provide such financing in its discretion at an interest rate, for a period of time between 12 and 60 months and upon such financing instruments, such as a promissory note or an installment sales contract, as are set by Caterpillar on a project by project basis. The line of credit expires on September 30, 2009 (subject to renewal, if requested by our PowerSecure subsidiary and accepted by Caterpillar in its sole discretion), or at an earlier date upon notice given by Caterpillar in its sole discretion. The letter setting forth the terms of the line of credit confirms the intent of Caterpillar to finance equipment purchases by our PowerSecure subsidiary, but is not an unconditional binding commitment to provide such financing. The line of credit contains various customary provisions and is contingent upon the continued credit-worthiness of our PowerSecure subsidiary in the sole discretion of Caterpillar. This line of credit from Caterpillar is a permitted indebtedness under our credit facility with Citibank. At March 31, 2009 and December 31, 2008, there were no balances borrowed or outstanding under the equipment line of credit with Caterpillar.

**6. Capital Lease Obligations**

In December 2008, we entered into a sale and leaseback transaction with SunTrust Equipment Finance and Leasing, an affiliate of SunTrust bank, resulting in the sale of distributed generation equipment placed in service at customer locations and a lease of the equipment from SunTrust. We received $5,912 from the sale of the equipment which we are repaying under the terms of the lease with monthly payments of $85 of principal and interest over a period of 84 months. At the expiration of the term of the lease, we have the option to purchase the equipment for $1, assuming no default under the lease by us has occurred and is then continuing. The lease is guaranteed by us under an equipment lease guaranty. The lease and the lease guaranty constitute permitted indebtedness under our current credit agreement, under which an affiliate of the lessor is one of the lenders.

We intend to use the proceeds of the lease financing to finance our PowerSecure subsidiary s recurring revenue projects as well as to finance capital expenditures and working capital. We account for the lease financing as a capital lease in our consolidated financial statements in accordance with generally accepted accounting principles.

The lease provides our PowerSecure subsidiary with limited rights, subject to the lessor s approval which will not be unreasonably withheld, to relocate and substitute equipment during its term. The lease contains customary representations and warranties, covenants relating to the use and maintenance of the equipment, indemnification, events of default, including payment defaults, breach of representations and warranties, covenant defaults, cross-defaults, certain bankruptcy or insolvency events, customary for leases of this nature. The lease also grants to the lessor certain remedies upon a default, including the right to cancel the lease, to accelerate all rent payments for the remainder of the term of the lease, to recover liquidated damages, or to repossess and re-lease, sell or otherwise dispose of the equipment.

Under the lease guaranty, we have unconditionally guaranteed the obligations of our PowerSecure subsidiary under the lease for the benefit of the lessor.

Capital lease obligations at March 31, 2009 and December 31, 2008 consist of our obligations under the equipment lease described above as well as $5 of other lease obligations.

**7. Share-Based Compensation**

We account for share-based compensation related to stock options and restricted stock awards in accordance with the provisions of FAS 123(R), which requires the measurement and recognition of compensation expense for all share-based awards made to employees and directors based on estimated fair values.

***Stock Plans*** We have granted stock options and restricted stock awards to employees, directors, advisors and consultants under various stock plans. We currently maintain two stock plans. Under our 1998 Stock Incentive Plan, as amended (the 1998 Stock Plan ), we granted incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock, performance awards and other stock-based awards to our officers, directors, employees, consultants and advisors for shares of our common stock. Stock options granted under the 1998 Stock Plan contained exercise prices not less than the fair market value of our common stock on the date of grant, and had a term of 10 years from the date of grant. Nonqualified stock option grants to our directors under the 1998 Stock Plan generally vested over periods up to two years. Qualified stock option grants to our employees under the 1998 Stock Plan generally vested over periods up to five years. The 1998 Stock Plan expired on June 12, 2008, and no additional awards may be made under the 1998 Stock Plan, although awards granted prior to such date will remain outstanding and subject to the terms and conditions of those awards.

In March 2008, our board of directors adopted the PowerSecure International, Inc. 2008 Stock Incentive Plan (the 2008 Stock Plan ), which was approved by our stockholders at the Annual Meeting of Stockholders held on June 9, 2008. The 2008 Stock Plan authorizes our board of directors to grant incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock, performance awards and other stock-based awards to our officers, directors, employees, consultants and advisors for up to an aggregate of 600,000 shares of our common stock. Stock options granted under the 2008 Stock Plan must contain exercise prices not less than the fair market value of our common stock on the date of grant, and must contain a term not in excess of 10 years from the date of grant. The 2008 Stock Plan replaced our 1998 Stock Plan.

***Stock Options*** Net income (loss) for the three months ended March 31, 2009 and 2008 includes $89 and $212, respectively, of pre-tax compensation costs related to outstanding stock options. The after-tax compensation cost of outstanding stock options for the three months ended March 31, 2009 and 2008 was $54 and $129, respectively. All of the stock option compensation expense is included in general and administrative expenses in the accompanying consolidated statements of operations.

A summary of option activity for the three months ended March 31, 2009 is as follows:

| | Shares | Weighted Average Exercise Price | | Weighted Average Remaining Contractual Term (years) | Aggregate Intrinsic Value | |
|---|---|---|---|---|---|---|
| Balance, December 31, 2008 | 1,708 | $ | 5.21 | | | |
| Granted-Directors | | | | | | |
| Granted-Employees | | | | | | |
| Exercised | (30) | | 1.50 | | | |
| Canceled | | | | | | |
| Forfeited | | | | | | |
| Balance, March 31, 2009 | 1,678 | $ | 5.28 | 5.52 | $ | (1.86) |
| Exercisable, March 31, 2009 | 1,306 | $ | 4.68 | 4.66 | $ | (1.26) |

A summary of option activity for the three months ended March 31, 2008 is as follows:

| | Shares | Weighted Average Exercise Price | | Weighted Average Remaining Contractual Term (years) | Aggregate Intrinsic Value | |
|---|---|---|---|---|---|---|
| Balance, December 31, 2007 | 1,728 | $ | 5.34 | | | |
| Granted-Directors | | | | | | |
| Granted-Employees | 20 | | 12.36 | | | |
| Exercised | (48) | | 1.79 | | | |
| Canceled | | | | | | |
| Forfeited | | | | | | |
| Balance, March 31, 2008 | 1,700 | $ | 5.52 | 5.82 | $ | 6.32 |
| Exercisable, March 31, 2008 | 1,348 | $ | 4.12 | 5.25 | $ | 7.74 |

There were no stock options granted to either employees or to directors during the three months ended March 31, 2009, and there were no stock options granted to directors during the three months ended March 31, 2008. The weighted average grant date fair value of the 20,000 options granted to employees during the three months ended March 31, 2008 was $6.66. The fair value was measured using the Black-Scholes valuation model with the following assumptions: expected stock price volatility of 60.3%; risk free interest rate of 3.16%; no dividends; and an expected future life of five years.

We amortize the fair value of stock option grants over their respective service periods using the straight-line method and assuming a forfeiture rate of 5%. As of March 31, 2009 and December 31 2008, there was $1,164 and $1,453, respectively, of total unrecognized compensation costs related to all of our outstanding stock options. These costs at March 31, 2009 are expected to be recognized over a weighted average period of 1.49 years.

During the three months ended March 31, 2009 and 2008, the total intrinsic value of stock options exercised was $66 and $492, respectively. Cash received from stock option exercises for the three months ended March 31, 2009 and 2008 was $45 and $86, respectively. The total grant date fair value of stock

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options vested during the three months ended March 31, 2009 and 2008 was $183 and $232, respectively.

***Restricted Stock Awards*** Net income (loss) for the three months ended March 31, 2009 and 2008 includes $265 and $403, respectively, of pre-tax compensation costs related to outstanding restricted stock awards granted to directors, certain officers and our employees. All of the restricted stock award compensation expense during the three months ended March 31, 2009 and 2008 is included in general and administrative expenses in the accompanying consolidated statements of operations.

There were no restricted stock awards issued during the three months ended March 31, 2009 and 2008. A summary of restricted stock award activity for the three months ended March 31, 2009 is as follows:

| | Unvested Restricted Shares | | Weighted Average Grant Date Fair Value |
|---|---|---|---|
| Balance, December 31, 2008 | 628 | $ | 12.06 |
| Granted | | | |
| Vested | (69) | | 12.11 |
| Forfeited | | | |
| Balance, March 31, 2009 | 559 | $ | 12.05 |

A summary of restricted stock award activity for the three months ended March 31, 2008 is as follows:

| | Unvested Restricted Shares | | Weighted Average Grant Date Fair Value |
|---|---|---|---|
| Balance, December 31, 2007 | 641 | $ | 12.48 |
| Granted | | | |
| Vested | (60) | | 12.34 |
| Forfeited | | | |
| Balance, March 31, 2008 | 581 | $ | 12.49 |

Restricted shares are subject to forfeiture and cannot be sold or otherwise transferred until they vest. If the holder of the restricted shares leaves us before the restricted shares vest, other than due to termination by us without cause, then any unvested restricted shares will be forfeited and returned to us. The restricted shares granted to directors vest in equal amounts over a period of one or three years, depending on the nature of the grant. The restricted shares granted to employees other than officers vest in equal annual amounts over five years. The unvested restricted shares previously granted to officers are scheduled to vest as follows:

A total of 300,000 restricted shares will cliff vest in their entirety on August 15, 2012, provided the officer remains employed with us through that date.

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A total of 22,500 restricted shares will cliff vest in their entirety on December 10, 2012, provided the officers remain employed with us through that date.

The remaining 193,500 restricted shares vest in three equal annual installments, commencing when our annual report on Form 10-K for the year ended December 31, 2009 is filed, but only upon the achievement of performance targets each year relating to our net income for fiscal years 2009 through 2012.

All restricted and unvested shares will automatically vest upon a change in control.

The fair value of the cliff vesting restricted shares is being amortized on a straight-line basis over the vesting period. The fair value of the performance vesting shares is expensed as the achievement of the performance criteria becomes probable and the related service period conditions are met. At March 31, 2009, the balance of unrecognized compensation cost related to unvested restricted shares was $5,388, which, assuming all future performance criteria will be met, we expect will be recognized over a weighted average period of approximately 4 years.

**8. Commitments and Contingencies**

From time to time, we hire employees that are subject to restrictive covenants, such as non-competition agreements with their former employers. We comply, and require our employees to comply, with the terms of all known restrictive covenants. However, we have in the past and may in the future receive claims and demands by some former employers alleging actual or potential violations of these restrictive covenants. While we do not believe any pending claims have merit, we cannot provide any assurance of the outcome of these claims.

From time to time, in the ordinary course of business we encounter performance issues with key component parts we utilize in our distributed generation systems, switchgear systems, utility infrastructure products, and lighting products, such as engines, generators, breakers, fuel systems, LED and other lighting technologies, and other complex electrical components. While we strive to utilize high quality component parts from reputable suppliers, and to back-up their quality and performance with manufacturers warranties, even the best parts and components have performance issues from time to time, and these performance issues create significant financial and operating risks to our business, operations and financial results. These risks include the expense, time, focus and resources involved in repairing, replacing or modifying distributed generation systems, switchgear systems and lighting systems for component part malfunctions, whether or not covered under manufacturers warranties and the burden and costs we would incur due to manufacturers disputing or failing to timely and fully honor their warranty obligations for quality and performance issues. These risks also include the potential material and adverse effects on our business, operations, reputation and financial results, including reduced revenues, additional expenses and capital cost, and asset write-offs, due to the cancellation or deferral of projects by our customers, or claims made by our customers for damages, as a result of performance issues.

Although we believe our suppliers warranties generally cover these performance issues, from time to time we face disputes with our suppliers with respect to those performance issues and their warranty obligations, or the performance issues are not covered by manufacturer s warranties, and our customers may claim to incur damages as a result of those performance issues. In those cases, we vigorously defend our position and rights, including our warranty rights, and we take all commercially practical actions to ensure our customers are fully satisfied with the quality of our products and services and do not incur any damages. As of the date of this report, we have identified performance issues with approximately $5-10 million of manufacturer s component parts installed in distributed generation systems deployed at customer s sites, and additional performance issues could arise from time to time in the future. We are working collaboratively with the manufacturers to resolve these issues. However, in the event the manufacturers solutions do not fully satisfy the required performance standards, we could incur additional costs to replace, rebuild, or repair these systems, as well as incur adverse material future financial consequences related to the cancellation of customer contracts, including reduced revenues, additional expenses and capital cost, and asset write-offs. In certain instances, these performance issues could also result in customer s claims for damages. We currently expect the manufacturers to rectify these performance issues to meet our customers required performance standards with minimal additional cost to us, however, we cannot provide any assurance that an acceptable solution will be achieved in each case, or if a solution is achieved the timing or costs to us associated with such solutions. Additionally, the outcome of any warranty claims is inherently difficult to predict due to the uncertainty of technical solutions, cost, customer requirements, and the uncertainty inherent in litigation and disputes generally, and thus there is no assurance we will not be adversely affected by these, or other performance issues with key parts and components. In addition, the mere existence of performance issues, even if finally resolved with our suppliers, can have an adverse effect on our reputation for quality, which could adversely affect our business. Accordingly, potential negative financial impacts from these items cannot be estimated at this time.

From time to time, we are involved in other disputes and legal actions arising in the ordinary course of business. We intend to vigorously defend all claims against us. Although the ultimate outcome of these claims cannot be accurately predicted due to the inherent uncertainty of litigation, in the opinion of management, based upon current information, no other currently pending or overtly threatened dispute is expected to have a material adverse effect on our business, financial condition or results of operations.

**9. Income Taxes**

No current benefit for federal income taxes has been recorded for the three months ended March 31, 2009 due to our history of taxable losses, current valuation allowance and lack of seasonal patterns to support utilization of losses incurred during the period. The tax provision recorded at March 31, 2009 is our best estimate of our tax expense taking into consideration our expectation of future earnings, federal alternative minimum tax, state income tax for state jurisdictions in which we expect taxable income, and our valuation allowance.

**10. Segment Information**

Our operating segments represent components of our business for which discrete financial information is available and is reviewed regularly by the chief operating decision-maker, or decision-making group, to evaluate performance and make operating decisions. We conduct our operations through two operating segments: Energy and Smart Grid Solutions, and Energy Services. Our reportable segments are strategic business units that offer different products and services and serve different customer bases. They are managed separately because each business requires different technology and marketing strategies. Previously, we were also engaged in a third business segment, Automated Energy Data Collection and Telemetry conducted through our MGM subsidiary. That segment of our business has been discontinued and the results of its operations are excluded from our segment information below.

***Energy and Smart Grid Solutions*** Through our PowerSecure subsidiary we serve utilities and commercial, institutional, and industrial customers in the areas of Interactive Distributed Generation®, Utility Infrastructure and Energy Efficiency. Each of these PowerSecure subsidiary business units operates in a distinct market with distinct technical disciplines, but shares a common customer base with our PowerSecure subsidiary products and services and which we intend to grow through shared resources and customer leads. Accordingly, these units are included within our Energy and Smart Grid Solutions segment results; and

***Energy Services*** Through our Southern Flow and WaterSecure subsidiaries we serve customers in the oil and natural gas production business with our measurement services and products, and water processing and disposal services. Southern Flow s services include on-site field services, chart processing and analysis, laboratory analysis, and data management and reporting. These services are provided principally to customers involved in natural gas production, gathering, transportation and processing. WaterSecure, through its equity investment MM 1995-2, provides water processing and disposal for oil and natural gas producers.

The accounting policies of the reportable segments are the same as those described in Note 1 of the Notes to Consolidated Financial Statements. We evaluate the performance of our operating segments based on Income (loss) before income taxes. Intersegment sales are not significant. During the year ended December 31, 2008, we changed the composition of our reportable segments to include the management fees and equity income of our WaterSecure operations within our Energy Services segment. Previously, our WaterSecure operations were not included in our segment activity. The segment activity for the three months ended March 31, 2008 has been reclassified to conform to current year presentation.

Summarized financial information concerning our reportable segments is shown in the following table. Unallocated corporate cost amounts include corporate overhead and related items including restructuring charges, other income and assets of discontinued operations which, for purposes of evaluating the operations of our segments, are not allocated to our segment activities. Total asset amounts exclude intercompany receivable balances eliminated in consolidation.

| | Three Months Ended March 31, 2009 | | | |
|---|---|---|---|---|
| | Energy and Smart Grid Solutions | Energy Services | Unallocated Corporate Costs | Total |
| Revenues | $ 15,215 | $ 4,505 | $ | $ 19,720 |
| Cost of sales | 10,441 | 3,405 | | 13,846 |
| Gross profit | 4,774 | 1,100 | | 5,874 |
| Operating expenses: | | | | |
| General and administrative | 4,393 | 514 | 1,113 | 6,020 |
| Selling, marketing and service | 826 | 5 | | 831 |
| Depreciation and amortization | 461 | 80 | 1 | 542 |
| Reasearch and development | 20 | | | 20 |
| Total operating expenses | 5,700 | 599 | 1,114 | 7,413 |
| Operating income (loss) | (926) | 501 | (1,114) | (1,539) |
| Other income and (expenses) | | | | |
| Management fees | | 105 | | 105 |
| Equity income | | 477 | | 477 |
| Interest and other income | 3 | | 50 | 53 |
| Interest and finance charges | (107) | | (67) | (174) |
| Income (loss) before income taxes | $ (1,030) | $ 1,083 | $ (1,131) | $ (1,078) |
| Total capital expenditures | $ 541 | $ 113 | $ | $ 654 |
| Total investment in unconsolidated affiliate | $ | $ 3,957 | $ | $ 3,957 |
| Total assets | $ 69,340 | $ 15,709 | $ 19,627 | $ 104,676 |

| | Three Months Ended March 31, 2008 | | | |
|---|---|---|---|---|
| | Energy and Smart Grid Solutions | Energy Services | Unallocated Corporate Costs | Total |
| Revenues | $ 29,106 | $ 4,469 | $ | $ 33,575 |
| Cost of sales | 20,303 | 3,252 | | 23,555 |
| Gross profit | 8,803 | 1,217 | | 10,020 |
| Operating expenses: | | | | |
| General and administrative | 5,465 | 422 | 1,356 | 7,243 |

| | | | | |
|---|---|---|---|---|
| Selling, marketing and service | 1,322 | 3 | | 1,325 |
| Depreciation and amortization | 398 | 58 | 1 | 457 |
| Reasearch and development | 19 | | | 19 |
| Total operating expenses | 7,204 | 483 | 1,357 | 9,044 |
| Operating income (loss) | 1,599 | 734 | (1,357) | 976 |
| Other income and (expenses) | | | | |
| Management fees | | 149 | | 149 |
| Equity income | | 964 | | 964 |
| Interest and other income | 31 | 17 | 178 | 226 |
| Interest and finance charges | (27) | | (24) | (51) |
| Income (loss) before income taxes | $ 1,603 | $ 1,864 | $ (1,203) | $ 2,264 |
| Total capital expenditures | $ 7,449 | $ 42 | $ | $ 7,491 |
| Total investment in unconsolidated affiliate | $ | $ 4,057 | $ | $ 4,057 |
| Total assets | $ 67,317 | $ 16,806 | $ 24,647 | $ 108,770 |

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## Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

### Introduction

The following discussion and analysis of our consolidated results of operations for the three month period ended March 31, 2009, which we refer to as the first quarter 2009, and the three month period ended March 31, 2008, which we refer to as the first quarter 2008, and of our consolidated financial condition as of March 31, 2009 should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this report.

### Overview

PowerSecure International, Inc., based in Wake Forest, North Carolina, is a leading provider of Energy and Smart Grid Solutions and Energy Services to utilities, commercial, institutional and industrial customers, and oil and natural gas producers. We provide our products and services across the strategic business areas of Interactive Distributed Generation®, Utility Infrastructure, Energy Efficiency and Energy Services.

Through our PowerSecure, Inc. subsidiary we operate our Energy and Smart Grid Solutions business segment. In this business segment, we focus on three strategic businesses: Interactive Distributed Generation®, Utility Infrastructure and Energy Efficiency. Our core Interactive Distributed Generation® business involves installing sophisticated electric generation equipment directly at the location where power is utilized. This equipment provides a dependable backup power supply during power outages, while at the same time providing a more efficient and environmentally friendly means of delivering power during high cost periods of peak power demand. Our intelligent Interactive Distributed Generation® systems contain our electronic controls technology which enables our systems to be monitored 24 x 7 by our monitoring center, safeguarding our customers from power outages and their related costs. Through this monitoring center, we utilize our proprietary smart grid capabilities to forecast utilities peak demand periods, and electronically deploy our systems to deliver more efficient and environmentally friendly power during these periods of peak demand. Our systems also enable utilities to delay new infrastructure investments for transmitting and distributing power and to minimize energy losses associated with moving electricity over long distances.

Our Utility Infrastructure business, which is an extension of our Interactive Distributed Generation® business, provides utilities with regulatory consulting and rate design services and power system engineering and construction services. Our Energy Efficiency business is focused on providing lighting solutions for commercial, industrial, and institutional customers, including our state-of-the-art green EfficientLights LED lighting technology for refrigerated cases in grocery and retail drug stores.

Through our Southern Flow and WaterSecure subsidiaries, we focus on business opportunities in the energy services field. Our Energy Services businesses serve the oil and natural gas industry with oil and natural gas measurement products and services, through Southern Flow, and water processing services, through WaterSecure.

Our Southern Flow subsidiary provides natural gas measurement services to customers involved the business of oil and natural gas production, transportation and processing, with a focus on the natural gas market. WaterSecure owns approximately 40% of the equity interests in MM 1995-2, our WaterSecure operations , an unconsolidated business. Our WaterSecure operations provide water processing and disposal services at its facilities in northeastern Colorado.

**Recent Developments**

To complement our project-based Interactive Distributed Generation® sales model, we have focused on implementing our recurring revenue business model, which is our marketing and business strategy that is designed to generate long-term revenues by generating a growing base of revenues that recur on an annual basis from ongoing and long-term distributed generation projects. Since late 2007, this strategy has generated several new long-term recurring revenue contracts with utility partners and their customers under which we provide them with efficient standby power and access to reliable distributed generation assets during peak power periods for a number of years, typically five to fifteen years, and receive revenues in each of those years. As we create an increased number of recurring revenue projects, we expect to receive an increased and more stable base of future revenue, profit and cash flow. The development of these recurring revenue projects will require a substantial increase in our capital expenditures, utilizing cash flow from operations, if needed, debt and lease financing, and will also extend revenue and profit recognition over longer periods compared to our traditional project-based sales, where revenue and profit is recognized as the projects are completed. Accordingly, as these long-term recurring revenue projects become an increasing portion of our overall projects and business, we will have a need for more capital in the short-term to finance these recurring revenue projects with the anticipated goal of greater and more stable future revenues with higher gross margins. During the first quarter 2009, we incurred approximately $0.6 million in total capital expenditures, including $0.4 million invested in capital expenditures for PowerSecure-owned distributed generation systems to generate future recurring revenue and profit under recurring revenue contracts.

Due to a decrease in revenues in our PowerSecure subsidiary, our consolidated revenues during the first quarter 2009 decreased by $13.9 million, representing a 41.3% decrease compared to our first quarter 2008 consolidated revenues. The decrease in revenues in the first quarter 2009 over the first quarter 2008 was attributable to a decline in revenues from Publix, our largest customer, along with the combination of the difficult economic environment, the uncertain regulatory environment, and the crisis in the capital markets which reduced capital spending by our customers. In anticipation of lower revenues in light of very difficult current economic conditions and the capital markets crisis, we initiated measures during the summer of 2008 as well as during the first quarter 2009 to control our costs, such as staff reductions and compensation measures such as cutbacks in certain bonus plans and other employee incentives, and other sales and general and administrative spending reductions. As a result, our total operating expenses during the first quarter 2009 decreased by $1.6 million, or 18.0%, compared to our first quarter 2008 operating expenses. We expect these cost reduction measures to continue over the near-term in order to address the negative effects of the current economic recession on our business. Over the long-term, however, we expect to continue to invest in operational infrastructure and sales and new business development to drive and support our growth. As a result of decreased prices and volumes in the oil and gas markets, our first quarter 2009 management fees and equity income from the WaterSecure operations decreased by a combined $0.5 million compared to the first quarter 2008. Overall, our loss from continuing operations was $1.1 million during the first quarter 2009, as compared to income from continuing operations of $2.0 million during the first quarter 2008. Our net loss was $1.1 million during the first quarter 2009, as compared to net income of $1.9 million during the first quarter 2008, which included a loss from discontinued operations of $0.1 million.

As discussed below under Fluctuations, our financial results will fluctuate from quarter to quarter and year to year. Thus, there is no assurance that our past results, including the results of our year

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ended December 31, 2008 or our quarter ended March 31, 2009, will be indicative of our future results, especially in light of the current significant downturn in the economy and crisis negatively affecting the credit and capital markets.

**Backlog**

As of the date of this report, our total backlog of orders expected to be recognized after March 31, 2009 is $74 million. This is equal to the $87 million backlog which was expected to be completed after December 31, 2008 as of March 12, 2009 (the date we last reported our backlog). These backlog amounts include project-based revenues projected to be recognized as projects are completed, and recurring revenue contracts which are projected to be recognized over the life of the contract, as indicated in the table below:

**Revenue backlog to be recognized after March 31, 2009**

| Description | | Anticipated Revenue | Estimated Primary Recognition Period |
|---|---|---|---|
| Project-based Revenue | Near term | $37 Million | 2Q09-4Q09 |
| Project-based Revenue | Long term | $17 Million | 2010-2011 |
| Recurring Revenue | | $33 Million | 2Q09 through 2015 |
| **Backlog to be recognized after March 31, 2009** | | **$87 Million** | |

Note: Anticipated revenue and primary recognition periods are estimates subject to change. These backlog amounts are not intended to constitute the Company s total revenue over the indicated time periods, as the Company has additional, regular on-going revenue streams. Examples of additional, regular recurring revenues include revenues from our Southern Flow business, UtilityEngineering and PowerServices engineering fees, and monitoring revenue, among others.

Orders in our backlog are subject to delay, deferral or cancellation from time to time by our customers, subject to contractual rights. Given the irregular sales cycle of customer orders, and especially of large orders, our backlog at any given time is not necessarily an accurate indication of our future revenues.

**Operating Segments**

We conduct our operations through two operating segments: Energy and Smart Grid Solutions, and Energy Services. Our reportable segments are strategic business units that offer different products and services and serve different customer bases. They are managed separately because each business requires different technology and marketing strategies. Previously, we were also engaged in a third business segment, Automated Energy Data Collection and Telemetry conducted